REPORTING REQUIREMENTS FOR STATE AND LOCAL GOVERNMENT PENSION PLANS AND TAX TREATMENT OF DEFERRED AMOUNTS UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

S. 1587

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO EXEMPT CERTAIN STATE AND LOCAL GOVERNMENT RETIREMENT SYSTEMS FROM TAXATION, AND FOR OTHER PURPOSES

S. 2627

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO DEFER FROM INCOME CERTAIN AMOUNTS DEFERRED PURSUANT TO STATE AND LOCAL PUBLIC EMPLOYEE DEFERRED COMPENSATION PLANS

MARCH 15, 1978

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REPORTING REQUIREMENTS FOR STATE AND LOCAL GOVERNMENT PENSION PLANS AND TAX TREATMENT OF DEFERRED AMOUNTS UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS

WEDNESDAY, MARCH 15, 1978

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Bentsen, Gravel and Packwood.

[The committee press release announcing this hearing and the text of the bills S. 1587 and S. 2627, follow:]

FINANCE SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS SETS HEARINGS ON S. 1587 AND ON THE DEFERRAL FROM INCOME OF CERTAIN AMOUNTS DEFERRED UNDER NON-QUALIFIED DEFERRED COMPENSATION PLANS

Senator Lloyd Bentsen (D.-Tex.), Chairman of the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Senate Committee on Finance, announced today that the Subcommittee will hold hearings on March 15 on S. 1587, a bill to exempt State and local government pension plans from Federal income tax liability and from reporting requirements required by the Employee Retirement Income Security Act of 1974 (ERISA), and on the deferral from income of certain amounts deferred under non-qualified deferred compensation plans.

The hearings will be held in Room 2221 Dirksen Senate Office Building and will begin at 10:00 A.M.

Witnesses who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on March 8, 1978.

Legislative Reorganization Act.—Senator Bentsen stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress to "file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a *summary of the principal points included in* the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least *75 copies* must be submitted by the close of business the day before the witness is scheduled to testify.

(4) *Witnesses are not to read their written statements to the Committee*, but are to confine their *fifteen minute* oral presentations to a summary of the points included in the statement.

(5) Not more than 15 minutes will be allowed for oral presentation.

Written Testimony.—Senator Bentsen stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by April 10, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

S. 1587

A BILL To amend the Internal Revenue Code of 1954 to exempt certain State and local government retirement systems from taxation, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 501(c)(11) of the Internal Revenue Code of 1954 (relating to teachers' retirement fund associations) is amended to read as follows:

"(11)(A) Retirement systems, trusts, or funds of a State, a political subdivision of a State, or an agency or instrumentality of a State or a political subdivision or a State.

"(B) Teachers retirement fund associations of a purely local character, if—

"(i) no part of their earnings insures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

"(ii) the income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect to investments.".

(b) The amendment made by subsection (a) shall apply to taxable years beginning after September 2, 1974.

SEC. 2. (a) Section 6058 of the Internal Revenue Code of 1954 (relating to information required in connection with certain plans of deferred compensation) is amended by redesignating subsection (d) as (e), and by inserting after subsection (c) the following new subsection:

"(d) EXCEPTION.—This section shall not apply with respect to plans maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or a political subdivision of a State.".

(b) The amendment made by subsection (a) shall apply with respect to plan years beginning after September 2, 1974.

S. 2627

A BILL To amend the Internal Revenue Code of 1954 to defer from income certain amounts deferred pursuant to State or local amounts deferred pursuant to State or local public employee deferred compensation plans

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 451 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULE FOR AMOUNTS DEFERRED UNDER PUBLIC EMPLOYEE DEFERRED COMPENSATION PLANS.— Notwithstanding any other provision of law, regulations shall be prescribed by the Secretary under this section corresponding to the principles relating to the exclusion from gross income of amounts deferred by participants in public employee deferred compensation plans set forth in the private letter ruling issued by the Internal Revenue Service on January 17, 1977, to the State of Louisiana Deferred Compensation Commission with respect to the State of Louisiana Deferred Compensation Plan for State Employees.".

(b) EFFECTIVE DATE.—This section, and the regulations issued thereunder, shall be effective on and after January 1, 1977. Such regulations shall not revoke any private letter rulings issued by the Internal Revenue Service with respect to any public employee deferred compensation plan or agreement authorized by State law or other applicable local, county, municipal, or political subdivision law or ordinance. The Secretary of the Treasury or his delegate shall prescribe temporary regulations pursuant to this section not later than 30 days from the date of enactment of this section.

Senator BENTSEN. It is 9:30; the hearings will come to order.

This subject is of such interest and such importance that we have a very high number of witnesses this morning who will be appearing. We have also been advised by the Senate leadership that they expect us to adjourn promptly by 12.

With that in mind, I will ask the witnesses to please summarize their statements and we will use the clock on all of the panels and they will be limited to not in excess of 15 minutes. If they want to give back any time, that would be appreciated.

I would ask that those panels would decide on having a spokesman, or, at the most, two spokesmen to speak for them.

Our first witness is Senator Stone of Florida who has long been interested in this subject, has spent a great deal of time on it, is well versed on it; has legislation which he has introduced and which helped bring about these hearings and we are very pleased to have him as the leadoff witness on this subject this morning.

Senator Stone.

STATEMENT OF HON. RICHARD STONE, A U.S. SENATOR FROM THE STATE OF FLORIDA

Senator STONE. Mr. Chairman, I thank you very much. I want to express my great and sincere appreciation to you as chairman of this subcommittee for scheduling today's hearing, particularly with the tremendous pressure of other Senate business.

We really appreciate this.

Senator BENTSEN. I would say that the Senator from Florida has a long list of credits and the Senator from Texas a small one.

Senator STONE. Well, I do so appreciate your cooperation and the Senator from Texas has earned his reputation and the friendship and respect of his colleagues and not just his own leadership of which I am an admirer.

Mr. Chairman, this bill, S. 1587, exempts State and local government pension plans from Federal tax liability and from the IRS annual reporting requirements. And, may I say, I am going to be suggesting an amendment to be considered by the subcommittee that would also have the effect of qualifying these plans from the point of of view of the beneficiaries, because of some recent attempts to make an end run in that direction.

Considerable controversy and mounting confusion have developed in the past few years as to the potential Federal tax liability and the Federal Government reporting requirements and other Federal Government authority with respect to these State and local government pension funds. And this hearing today, Mr. Chairman, ought to clarify the current situation and, I hope, underscore the importance of the enactment of S. 1587.

I introduced this bill with 11 other Senators, including the distinguished Senator from Missouri, Senator Danforth, who is on his way over here and Congressman Cunningham in the House has filed a companion bill. He is on his way here to testify to this committee.

We introduced this bill because of a very simple, but basic and important principle, and that is that State and local government pension systems are the basic responsibility of State and local government. They are not the basic responsibility of the Federal Government.

Direct Federal regulation or even major, indirect regulation of State and local government pension plans would, I think, be both unconstitutional and very inappropriate.

It certainly was never authorized by Congress and for more than 20 years there were no attempts, certainly no overt attempts to exert authority in this regard. All of a sudden, State and local pension plans, Government pension plans, are faced with that type of assertion.

Federal taxation of these plans, when Federal standards that are thus imposed are not met, is a form of Federal regulation.

S. 1587 would implement the principle of State and local government responsibility for their own pension funds by amending 501(c)(11) of the IRS code to exempt these funds from Federal taxation.

May I add a proposed amendment to qualify these plans from the point of view of the beneficiaries, because that is another attempt to do indirectly what Congress never specifically authorized the Service to do directly.

In addition, S. 1587 would amend section 6058 of the Internal Revenue Code to exempt these same pension plans from certain Internal Revenue Service reporting requirements that are generally required of private pension plans.

Recent Internal Revenue Service actions and the enactment of the Employee Retirement Income Security Act of 1974, ERISA——

Welcome, Senator Danforth. I have already mentioned, as a cointroducer, that you will testify as soon as I am through.

The ERISA has generated considerable controversy and confusion with respect to the Federal Government's authority over these plans, and a few examples will illustrate this point.

The first attempts by the IRS to assert tax and reporting authority over these funds involved the St. Joseph, Mo., Fire Department's fund and the pension plan of the town of Houtzdale, Pa. In 1972, the IRS determined that the St. Joseph Fire Department pension fund did not meet the qualifications requirements for tax exemption under the Internal Revenue Code, section 401, and consequently, the IRS taxed the income of the pension plan.

In 1975, after payment of this tax liability, the fund was advised that the tax may have been improperly imposed. Ultimately, the tax was returned to the city pending the outcome of an IRS study which is not yet completed.

An IRS attempt to enforce by fine the filing of annual reports, argued to be required under ERISA, was described in an August 26, 1977, Wall Street Journal article. After filing an annual report on the town's pension plan, Houtzdale, Pa., received a terse reply from the IRS saying that the town was 271 days late in filing.

The Houtzdale pension plan, covering the town's only full-time employee, was fined $2,710 for filing late; one employee.

In 1976, the Supreme Court case of the *National League of Cities* against *Usury* underscores the constitutional problem as to Federal regulation of State and local government pension funds. The Supreme Court held that Congress could not regulate State and local governments to the extent of requiring under the Interstate Commerce clause the payment by them of minimum wages to their employees.

This important 10th amendment protection would seem squarely in point in this instance. If you cannot, in other words, regulate minimum wages, then can you regulate minimum standards of retirement plans of State and local government and by the reporting requirements and the standard requirements, in effect impose the standards that the IRS has on the employee conditions of State and local government pension plans.

The long history of IRS treatment of State and local plans as exempt and as qualified for almost two decades, really argues for a continuation of these exemptions for those plans from regulation and confirms the absence of Federal power in this, even congressional power in this.

It certainly would seem to deny IRS regulatory authority in the absence of specific contrary statements of congressional intent.

State and local government pension plans have long relied on tax-exempt status. In other words, State and local governments have been setting up these funds for just about 20 years on an exempt basis.

Now, as a number of employees come to receive their benefits under these plans, or widows and the estates of deceased employees are about to receive, or are now receiving benefits, long invested in under purported and treated tax exempt status and exempt from reporting type status, now all of a sudden the IRS agents are not only requiring reporting of State and local plans, but they are going in and disallowing the nontax status of the receipts in the States.

That happened recently to the estate of a professor in one of our Florida State government retirement plans for educational employees.

This kind of a recent and sudden attempt by the IRS to assert this liability has left many plans in irreconcilable and confused positions and to illustrate this confusion, only too vividly.

Now, this bill, S. 1587, would eliminate this confusion and it would assure that the State and local governments retain responsibility for their own employee pension plans. Not only do we have some serious financial problems to individuals and the beneficiaries that will be avoided by passage of this bill, but we have at stake the financial viability of thousands of State and local pension plans themselves. And, of course, consequently, the economic security of millions of State and local government employees who participate in these plans.

According to a survey of the State government systems involved, the potential tax liability to these States would total more than half a billion dollars. I have been concerned in my entire study of this matter about the impact of potential Federal tax liability on beneficiaries and, as I have described, would commend to the committee's consideration an amendment which would treat these pension plans as qualified for the purposes of the Code and that would avoid possible estate tax liability and the problems of taxation of deferred compensation.

Mr. Chairman, while comprehensive congressional review of the general subject of retirement pension continues—and it is actively continuing; there is a task force on this—I would respectfully suggest that just this basic principle of S. 1587, that is, that State and local government responsibility for State and local pension funds ought to be recognized by Congress right away.

I would like to make it clear that, although I believe it is incumbent on State and local governments to provide more information about pension plans to participants, they ought to do it, especially in view of the adverse publicity that surrounds some few troubled pension plans and some plans that are under allegations of management abuse.

So increased disclosure should be the object of both State and local pension decisionmaking.

I think that these entities responsible for these pension plans are doing it and will do much more of it, but I believe that any serious effort on the part of the Federal Government to impose Federal tax liabilities on these pension plans is an invitation to disaster.

Enactment of this bill will end the confusion and, more importantly, it would appropriately recognize the constitutional and proper responsibility of State and local governments for their own pension employee plans.

Mr. Chairman, I would, in closing, like to express my concern about recent Treasury regulations regarding State deferred compensation plans. Many States are affected, including my own of Florida, and I am attaching and submitting a statement addressing this problem by my State and a statement forwarded by my Governor, Reuben Askew of Florida, and I would ask that both my statement and that of Governor Askew be included in this subcommittee hearing record.

Senator BENTSEN. Without objection, it is so ordered.

Senator STONE. Mr. Chairman, I would like to defer, if I might, to Senator Danforth, the cointroducer of this bill.

Senator BENTSEN. Senator Stone, I want to congratulate you. You are exactly within your 15-minute time limit.

[The prepared statement and attachments of Senator Stone follow:]

STATEMENT OF SENATOR RICHARD STONE

Mr. Chairman, I would like to express my great appreciation to you as Chairman of the Subcommittee, for scheduling today's hearing on S. 1587, a bill to exempt state and local government pension plans from federal tax liability and from Internal Revenue Service annual reporting requirements.

Considerable controversy and mounting confusion have developed over the past few years as to potential federal tax liability, federal government reporting requirements, and other federal government authority with respect to these pension funds. Today's hearing, Mr. Chairman, should clarify the present situation and, I believe, underscore the importance of enactment of S. 1587.

I introduced S. 1587, with eleven other senators, including the distinguished senator from Missouri, Senator Danforth, because of a very simple but important principle—state and local government pension systems are the basic responsibility of state and local governments, not the federal government. Direct federal regulation of state and local government pension plans would be both unconstitutional and inappropriate. It has certainly never been authorized by the Congress. Federal taxation of these plans, when federal standards are not met, is quite clearly a form of federal regulation. S. 1587 would implement this principle of state and local government responsibility for their own pension funds by amending Section 501(C)(11) of the Internal Revenue Code to exempt these funds from federal taxation.

In addition, S. 1587 would amend Section 6058 of the Internal Revenue Code so as to exempt these same pension plans from certain Internal Revenue Service reporting requirements generally required of private pension plans.

Recent Internal Revenue Service actions and the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) have generated considerable controversy and confusion with respect to the federal government's authority over these pension plans. A few examples will illustrate the point.

The first attempts by the Internal Revenue Service to assert federal tax and reporting authority over these funds involved the St. Joseph's, Missouri, Fire Department Fund and the pension plan of the town of Houtzdale, Pennsylvania.

In 1972, the IRS determined that the St. Joseph's Fire Department Pension Fund did not meet the qualification requirements for tax exemption under Internal Revenue Code Section 401. Consequently, the IRS taxed the income of the pension plan. In 1975, after payment of this tax liability, this Fund was advised that the tax may have been improperly imposed. Ultimately, the tax was returned to the city pending the outcome of an IRS study, not yet completed.

An IRS attempt to enforce by fine the filing of annual reports, argued to be required under ERISA, was described in an August 26, 1977 Wall Street Journal article. After filing an annual report on the town's pension plan, Houtzdale, PA. received a terse reply from the IRS saying that the town was 271 days late in filing. The Houtzdale pension plan, covering the town's only full-time employee, was fined $2,710 for filing late.

The 1976 Supreme Court case of *National League of Cities vs. Usury* underscores the Constitutional problem with federal regulation of state and local government pension funds. The Supreme Court held that Congress could not regulate state and local governments to the extent of requiring under the interstate commerce clause the payment by them of minimum wages to their employees. This important Tenth Amendment protection would seem squarely in point in this instance. The provision of benefits to employees is strictly a local matter and has little, if any, interstate consequences. The long history of IRS treatment of state and local plans as exempt and as qualified for almost two decades. argues for a continuation of the exemption of those plans from regulation and confirms the absence of congressional power. It certainly would seem to deny IRS regulatory authority absent a specific contrary statement of congressional intent. State and local government pension plans have long relied on tax exempt status. Recent and sudden attempts by the IRS to assert tax liability have left many plans in irreconcilable and confused positions.

The enactment of the Employee Retirement Income Security Act of 1974 (ERISA), has added to the uncertainty about federal authority over state and local government pension plans. Although ERISA clearly exempted these pension plans from such "qualification" requirements as vesting, funding, and participation, and from "annual registration" reporting requirements pursuant to Section 6057 of the Internal Revenue Code, there is widespread disagreement as to the application of other "qualification" requirements and reporting requirements to state and local government pension plans.

Mr. Chairman, these examples illustrate the widespread confusion over the present state of federal law with respect to state and local government pension plans. Enactment of S. 1587 will eliminate this confusion and assure that state and local governments retain responsibility for their own employee pension plans.

At stake, Mr. Chairman, is the financial viability of thousands of state and local pension plans and, consequently, the economic security of millions of state and local government employees who participate in these plans. According to a survey of the state government systems involved, the potential tax liability for these states totals to more than half a billion dollars.

I have been concerned throughout my study of this matter about the impact of potential federal tax liability on pension fund beneficiaries. In this regard, I intend to propose for your consideration and approval an amendment to S. 1587 which, in effect, treats the above mentioned government pension plans as "qualified" for purposes of the Internal Revenue Code. This avoids possible estate tax liability and other problems such as taxation of deferred compensation.

I am aware of the complex and troublesome issues which attach to the overall subject of retirement pension systems. The Congress must ultimately address these difficult issues in a comprehensive manner.

The work of this subcommittee and the study of the House of Representatives Pension Task Force of the Education and Labor Committee, soon to be issued, should better equip the Congress to develop wise and sensible policies in this area.

However, Mr. Chairman, while comprehensive Congressional review of the general subject of retirement pensions continues, I respectfully suggest that the basic principle of S. 1587—state and local government responsibility for state and local pension funds—should be recognized by Congress as soon as possible.

I want to make it very clear that I believe it is incumbent upon state and local governments to provide more information about pension plans to participants. Especially in view of the adverse publicity surrounding a few troubled pension plans and alleged pension management abuses, increased disclosure should become the object of state and local pension funds.

I am sure that some local and state government pension systems need to be improved. I believe such improvements should be brought about by governmental entities most responsible for such systems, namely, local and state governments.

I further believe that any serious effort on the part of the federal government to impose federal tax liability on these pension funds, is an invitation to disaster.

Enactment of S. 1587 will put an end to the confusion about existing federal law and Congressional intent. Most importantly, it would recognize the Constitutional and proper responsibility of state and local governments for their own employee pension plans.

Mr. Chairman, I would like to express my concern about the recent treasury regulations regarding state deferred compensation plans. Many states are affected, including my state of Florida. Attached is a statement I am submitting addressing the deferred compensation problem and a statement forwarded by Governor Reuben Askew, of Florida. I respectfully request that both my statement and that of Governor Askew be included in the subcommittee's hearing record.

S. 1587

AMENDMENT

Intended to be proposed by Mr. Stone to S. 1587, a bill to amend the Internal Revenue Code of 1954 to exempt certain State and local government retirement systems from taxation, and for other purposes, viz: On page 2, after line 24, add the following:

SEC. 3. (a) For purposes of the Internal Revenue Code of 1954, a retirement system, trust, fund, or fund association described in section 501(c)(11) of such Code shall be treated as if it met all requirements for qualification under section 401 of such Code.

(b) This section applies with respect to plan years beginning after September 2, 1974.

STATEMENT BY SENATOR STONE IN SUPPORT OF S. 2627

Mr. Chairman and distinguished members of the subcommittee, I would like to incorporate in the hearing record this statement in support of Senator Gravel's bill, S. 2627, to defer from federal income taxation amounts deferred pursuant to state or local public employee deferred compensation plans. Senator Gravel's bill, of which I am a cosponsor, would reverse proposed Treasury action that adversely affects the public employees of Florida and the public employees of at least 30 other states. It would require the Treasury to issue regulations consistent with long standing Internal Revenue Service actions upon which jurisdictions within my state, and the states of many of my colleagues have relied.

In 1976, the Florida legislature passed legislation so that the State of Florida could implement a deferred compensation plan for its employees. Because of the I.R.S. ruling moratorium on these type plans, Florida has been unable to receive a favorable tax ruling similar to the rulings at least 20 other states have received. This of course, is seriously discriminatory towards Florida. In addition to the State of Florida, it is my understanding that Alachua County and the City of St. Petersburg also have ruling requests pending at the I.R.S. concerning deferred compensation plans. Several other jurisdictions in Florida have expressed a strong interest in establishing referred compensation plans for their employees.

There are jurisdictions in Florida that have successfully implemented deferred compensation plans for their employees. On February 13, 1976, the I.R.S. issued a favorable tax ruling to the City of Jacksonville concerning its deferred compensation plan. On October 20, 1976 Orange County, Florida received a favorable ruling from the I.R.S. In specific reliance upon those rulings and other Treasury and Internal Revenue Service pronouncements, those jurisdictions undertook implementation of their plans in February, 1978 and June, 1977 respectively. In the one month that has elapsed since the implementation of the Jacksonville plan, it is my understanding that almost 500 employees have enrolled and are realizing the benefits of the plan. Unless S. 2627 is enacted, the 15,000 employees of the City of Jacksonville will be unable to utilize these type plans to help plan for their retirement.

Mr. Chairman, it is my understanding that the average annual deferral for those already enrolled in the Jacksonville plan is about $650–$700 and that the average salary of those enrolled is between $10,000 and $12,000 annually. Those figures are consistent with figures I have seen concerning other jurisdictions where plans are operational.

These deferred compensation plans allow a jurisdiction's employees to defer part of their salary to provide for their retirement. The amounts deferred are not taxed to them in the year deferred. When paid upon retirement, these amounts are then taxes as income to the participant. In these days of increasing concern over the availability of adequate income during retirement, these plans should be encouraged, not discouraged. After all, these plans provide a simple way for employees to provide for part of their own retirement, thereby not having to rely on other government assistance or programs to aid them in their later years.

From Florida's viewpoint, its plan would offer ease of administration and encouragement of voluntary savings for retirement at no additional cost to the state. Florida's employees are offered a practical method of providing for their own retirement. Everyone benefits by these type plans.

Let me emphasize that the plans already in operation in Florida and the Florida State plan are nondiscriminatory and are not foreseen as a tax shelter for the highly compensated. You've already heard the City of Jacksonville figures. According to projections supplied by the State Treasurer's office, 20,000 of Florida's 92,000 state employees will participate in the state plan within three years of implementation. The median salary of those 20,000 participants is projected to be about $15,000 a year. Those projections as well as actual experience under other state plans already in operation show that these plans are utilized by employees at the low and medium income levels. According to figures obtained with reference to other state plans, approximately 75–80 percent of the participants earn less than $20,000 yearly. I would think that Florida's experience will be similar.

The legislation that I support simply reiterates the continuous and consistent Treasury and I.R.S. policy toward these plans. For a number of years, state governments, municipalities, and other governmental units have had their plans approved for implementation by the I.R.S. Instead, rather than proposing specific legislation in its tax reform package in January 1978, less than three weeks later the Treasury Department issued proposed regulations which attempt to overturn their own I.R.S. rulings. This appears to me to be nothing more than the Treasury usurping the Constitutional function of Congress to write our nation's laws. If the administration felt the tax laws under which these rulings were approved were erroneous, it should have come forward with legislation to overturn them. I do not believe Congress should stand by for yet another example of legislation by administrative regulation.

In this connection, Mr. Chairman, I would request that a letter to me from Governor Reubin Askew of Florida, and an accompanying letter from Governor Askew to I.R.S. Commissioner Kurtz, be included in the Committee's Record immediately following my own statement.

STATE OF FLORIDA,
OFFICE OF GOVERNOR REUBIN O'D. ASKEW,
March 8, 1978.

Hon. RICHARD B. STONE,
United States Senator,
Dirksen Office Building, Washington, D.C.

DEAR DICK: Enclosed for your information is a copy of my letter of March 7 to Mr. Jerome Kurtz, Commissioner, Internal Revenue Service.

In my opinion, the rules and regulations proposed by the Internal Revenue Service as outlined in my letter to the Commissioner will adversely affect public employees in approximately thirty states which have established or have enacted legislation to establish a deferred compensation program.

Florida's deferred compensation program was submitted on September 17, 1977, and is awaiting Internal Revenue Service approval at the present time. Enabling legislation was enacted by the Legislature in 1976. During this interim period, the Advisory Council created by the Act and other interested parties have spent considerable time and effort in finalizing our plan. These parties recognize that a deferred compensation plan helps State and local governments to attract and retain talented career employees and provides a means whereby workers can increase their retirement incomes.

Retention of this benefit is of vital concern to us in Florida, and I oppose the action proposed by the Internal Revenue Service. I urge you to support legislation which will provide equitable treatment for both public and nonpublic employees. Legislation already introduced on this subject includes H.R. 10746 by Congressman Joe D. Waggonner, Jr., of Louisiana and H.R. 10893 by Congressman Otis G. Pike of New York.

Any suggestions or assistance which you can provide would be greatly appreciated and with kind regards,

Sincerely,

RUBE, *Governor*.

Enclosure.

STATE OF FLORIDA,
OFFICE OF GOVERNOR REUBIN O'D. ASKEW,
March 7, 1978.

Mr. JEROME KURTZ,
Commissioner, Internal Revenue Service, Washington, D.C.

DEAR COMMISSIONER KURTZ: The following comments are offered concerning the proposed amendment to the Income Tax Regulations (26 CFR Part I) under Section 61 of the Internal Revenue Code of 1954 as printed in the February 3, 1978 *Federal Register.*

In my opinion, this proposed rule disregards prior court decisions relating to the tax treatment of compensatory reduction plans or arrangements. Deferred compensation programs (Section 401(a), 403(a) or (b), or 405(a) of the Internal Revenue Code of 1954) which are not available to public employees are not affected by the change. Such programs, including stock options, pensions and profit sharing, have long been used as an incentive by private industry in attracting, retaining and rewarding employees.

During the past several years a substantial number of states, including Florida, have taken steps to develop and implement a deferred compensation fringe benefit for their employees. In 1976 the Florida Legislature passed enabling legislation for a deferred compensation program for employees of the State, counties, municipalities and other political subdivisions. Considerable time and effort was expended in the planning, development and preparation of Florida's plan which was submitted to your office for approval on September 17, 1977.

Public employees in Florida are required by law to participate in the State's retirement system. Eligibility for disability benefits and retirement benefits is vested after five years and ten years, respectively. Vested rights are not transferrable upon change of public employment to another state or to nonpublic employment.

Our public employees, on the average, retire with 22 years of service and receive annual benefits of $3,451. At age 65, a retired employee is eligible for a three percent cost-of-living increase each year. If the historical rate of inflation continues, their standard of living will decrease substantially unless some means is available to increase their retirement income. It is a fairly common occurrence for couples over 65 to be on some type of welfare program in spite of pensions and social security. In fact, many face the bleak prospect of having barely enough money for day-to-day necessities much less for the cost of an extended illness or for travel and long awaited pleasures and pastimes.

The deferred compensation program gives public employees an opportunity to increase their income during their old age, provided they are willing to sacrifice a portion of their earnings during their working years.

I feel that this option should not be denied to public employees and I urge you to reconsider your position on the matter. The proposed ruling conflicts with prior court decisions and clearly places public employees at a disadvantage. The entire area of income deferral should be reviewed and resolved through the legislative process in order to assure equitable treatment to all parties concerned. I do not feel that the proposed rules and regulations which address only public employee deferrals accomplish this equity.

With kind regards,

Sincerely,

REUBIN ASKEW, *Governor*.

Senator BENTSEN. Senator Danforth.

SATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator DANFORTH. I will be considerably under my allotted time, Mr. Chairman, thank you very much.

I do appreciate your holding this hearing. I think that Senator Stone has pretty well summed up the history.

I have a prepared statement and, instead of reading it, if it suits you, I would submit it for the record.

Senator BENTSEN. That is certainly agreeable.

Senator DANFORTH. It seems to me that the central question is the Federal question, that has to deal with the relationship between the Federal Government and State and local governments, and that we in Congress have to show a little more concern, I think, for the role of State and local governments than we have sometimes done in the past.

The threat of an imposed tax on a pension trust operated on behalf of employees of a municipality or employees of a State government automatically creates a crisis in Federal-State relations which, it seems to me, we should not be creating.

In the case of a tax imposed by reason of underfunding, or alleged underfunding, if a private pension trust were involved, of course, the tax would be imposed, not on the fund itself, but on the employer.

However, that would raise obvious constitutional problems in the case of a local government. Therefore, the threat to the local government is that the tax is imposed on the fund. This is the threat facing the St. Joseph, Mo., Fireman's Pension Fund.

But it seems to me to be an anomalous and counterproductive situation to impose a tax liability on a pension trust which is already underfunded and somewhat shaky financially.

In other words, if it is considered that the pension fund is in poor shape, then it would be a case of the poor getting poorer if the tax were imposed on the fund itself.

In the case of alleged discrimination, this threat has been made with respect to the State Employees' Retirement Fund in the State of Missouri. But, again, it is a very peculiar situation. The Federal Government apparently takes the position that there is discrimination within a State retirement plan because certain State officers receive better pension benefits than other State officials, yet a revenue ruling exists with respect to the Civil Service Retirement Fund under almost precisely the same fact situation, where apparently the problem does not exist.

So it seems to me that not only is it irrational to impose a tax on a fund which is viewed to be somewhat shaky, but it is clearly contrary to good, Federal-State relations if an effort is made to impose a tax on a State retirement fund when the same circumstances exist with respect to the Federal Civil Service Retirement Fund.

Finally, on the question of reporting, it is my understanding, that the bill in its present form would exempt State and municipal retirement funds from any reporting requirement. I do not, myself, think that that is correct, and it is my understanding that Senator Stone is also taking a second look at that.

It is my view that it would not be a bad idea to require some type of reporting, hopefully a very simplified version of reporting of the actuarial soundness of these funds. But I think that the idea of trying to impose the tax on them is very unfair.

Senator BENTSEN. Thank you very much, Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator BENTSEN. We appreciate the testimony from both of you gentlemen.

[The prepared statement of Senator Danforth follows:]

STATEMENT OF SENATOR JOHN C. DANFORTH

Mr. Chairman, thank you for the opportunity to appear before your subcommittee to speak in favor of S. 1587. My primary concern in this matter is the protection of employee rights without violating the jurisdiction and integrity of the States and local governmental units under our Federal system of government.

The firemen of St. Joseph, Missouri adopted a retirement plan, totally dictated by a Missouri statute enacted in 1895. The vesting, participation, funding, contributions, benefits and administration of the plan are provided by Missouri law. It is funded partly by employee contributions and partly from city contributions. Since its adoption by the City of St. Joseph in 1896 no fireman has ever retired from the force with a reduced pension benefit because of underfunding of the plan. Yet in 1972 the U.S. Department of Treasury came to the rescue of the St. Joseph firemen plan. The Government decided that the plan was not adequately funded and therefore the trust should be further depleted by requiring it to pay I.R.S. back taxes. In other words, the cure for an under-funded pension trust according to the I.R.S., is to have the pension trust pay Federal income taxes. But the Federal Government provided a solution to this solution. The trust could avoid taxation in the future if the city adopts another pension plan more to the liking of the Federal government. Late last year, the I.R.S. decided to give the firemen of St. Joseph, Missouri, their money back, pending a study of such plans.

A similar fate was accorded the Missouri State Retirement Plan for state employees. This time, however, the I.R.S. threatened to assess back taxes of over $15 million against the retirement trust, not because it was under-funded—in fact it is over-funded—but rather because the retirement benefits of certain Missouri state employees such as statewide elected officials and judges were marginally better than the benefits provided rank and file civil servants. This discrimination in favor of certain workers constitutes a violation of a key requirement for Federal tax exemption. Yet, the I.R.S. agreed not to tax the plan in the future if the Missouri state legislature would change its laws to conform to standards established by the Federal Government.

If this situation sounds familiar, it should. The U.S. Civil Service Retirement Plan provides higher retirement benefits to every Senator, Congressman and Federal Judge than is provided for all other Federal civil servants. Further there is considerable question whether the Civil Service Retirement Trust is adequately funded. Does the I.R.S. go after the U.S. Civil Service Retirement Trust for back taxes? No. The I.R.S. publishes a revenue ruling (Rev. Rul. 70-150) which with no further explanation states that the Civil Service Retirement Plan of the United States Government qualifies for tax exemption under the rules of the Tax Code. Note that no specific Federal law exempts the U.S. Civil Service Retirement Trust from taxation. The revenue ruling merely represents the opinion of the Internal Revenue Service that the Federal plan is nondiscriminatory and adequately funded and that the St. Joseph Firemen's Plan and the Missouri State Employees Plan are not qualified because they are underfunded and discriminatory.

I would like to emphasize that I am not in favor of poorly funded discriminatory pension plans. I do think employers who promise retirement benefits of their employees ought to take the necessary steps to actuarily fund these benefits. I do think that employers ought to provide the same level of benefits to all employees. The question in my mind, however, is whether the Federal Government, in dictating these values and standards to state and local governments, is within the principles of our Federal system of government.

The sole responsibility, it seems to me, of the Federal Government is to require that the trusts holding the assets of pension plans maintained by State and local governmental units publicly disclose the financial and actuarial condition of the trust itself so that state employees are adequately informed as to the security of their promised retirement benefits. If the funding is inadequate or there are other abuses present, the State or local governments have the sole jurisdiction to correct them.

In short, the retirement income security of state and local government workers is of concern to all of us, but under our system of government this is the responsibility of the State and local governments. The sole function the Federal government can and should play is to require full financial disclosure. S. 1587 removes the Federal government from the position of withholding Federal tax benefits as a tool for formulating State and local governmental policy. Although the bill does not presently require any financial disclosure on the part of state and local governmental trusts, it is my intent to investigate the feasibility of such a requirement.

Senator BENTSEN. Our next witness is Hon. John Cunningham, U.S. Representative from the State of Washington.

Congressman, we are pleased to have you.

STATEMENT OF HON. JOHN CUNNINGHAM, A. U.S. REPRESENTATIVE FROM THE STATE OF WASHINGTON

Representative CUNNINGHAM. Thank you, Mr. Chairman. It is a privilege to be here, and Senators Stone and Danforth have so adequately covered the subject that I will make my statement very short.

Senator BENTSEN. We will take your full statement for the record.

Representative CUNNINGHAM. Thank you.

I appreciate the chance to come before you today and my interest in protecting the pension plans began, really, shortly after I was elected to the State legislature. I worked with them to see that the public employee funds within the State were actuarially sound and remaining viable.

In our State, I might add, the State of Washington, I worked very hard to see that those pension plans are firm and solid commitments to the employees are upheld.

Shortly after coming to Congress in May 1977, I received a letter from Governor Dixy Lee Ray who advised that the State of Washington would stand to lose some $48 million to the Internal Revenue Service if, as a result of filing form 5500, the State retirement system was found not to be qualified for tax exemption.

Governor Ray strongly recommended that I look at Senator Stone's bill, S. 1587 and cosponsor it. In checking with Senator Stone and his staff, I discovered that, at that time, there was no primary House sponsor for the legislation and in September 1977, I did introduce H.R. 9118 which is identical to the Senator's legislation.

I might add that since the time I did introduce it, over 50 members of the U.S. House of Representatives have joined in cosponsoring the bill.

Also, Senators Magnuson and Jackson in the Senate have cosponsored S. 1587 and, with the backing of my colleagues from the State of Washington, Congressmen Pritchard and Dicks, we have a high level of State involvement in this legislation.

As I see the problem, the energy with which the Internal Revenue Service is seeking new forms of revenue knows no bounds. They seem to intend to tax everything. What the proposed taxation of the investment income of State and local retirement plans amounts to is a value-added tax. As in Europe, every time the money passes through new hands, it seems to be the IRS' intention that it be taxed.

There are three arguments against this taxation. First, grave constitutional questions exist as to whether the Federal Government may tax an entity of another level of government. The record of successful lawsuits preventing such taxation whether by the Federal Government or by some other unit of government, is extensive.

Strangely, the IRS appears to be little concerned about that question or precedent.

Next, there is the serious tax burden that such an action would shift to the people of the affected localities. Using Governor Ray's figures, it is clear that $48.5 million in taxes at the State level would have to be raised in order supplement investment income taxes by the Federal Government.

Clearly, this is unwarranted and would not be accepted by most people in the State of Washington. However, in order to assure a smooth flow of retirement benefits to pension plan participants, such an action would be required as a result of the proposed taxation.

The Internal Revenue Service is asserting that it is acting in a benevolent manner to protect pensioners from unsound plans. They claim authority both from the ERISA legislation as well as the vague granting of authority from before ERISA. As others will testify, primarily Jim Martin of the National Governors' Association, the legislative history of ERISA shows no such grant of authority.

If oversight is to be our goal or their goal, it can easily be accomplished without the threat of taxation.

I am told that the IRS spokesmen contend that taxation is not their goal. If so, I would challenge them to say so.

They claim that they need information from form 5500 in order to supervise the plans and discipline the plans not managed to the bureaucrat's standards.

Yet, taxation is one of the weapons which is being used or threatened in order to force public employee pension plans to conform to Federal guidelines.

The filing requirement was announced by press release in the summer of 1977. No public comment period was opened; no rule was proposed. The IRS simply told jurisdictions to file the form at the end of 1977.

I am pleased that this filing deadline has been extended to permit Congress some opportunity to act.

We all know that the American taxpayer is under continued assault from all sides. Seeking new sources of revenue to pay for Federal deficits which had been created by Congress, it appears that IRS is looking for new sheep to fleece.

S. 1587 and H.R. 9118 are clear signals to the Internal Revenue Service not to molest the income of retired persons who are stuck living on a fixed income. Their incomes are nibbled away by the scourge of inflation, causing the dollars they have to spend to erode in buying power.

Mr. Chairman, this brief statement merely shares my concern that the retired people of this Nation and the taxpayers in general be protected from another raid by Federal revenue agents. I commend the leadership of Senator Stone whose foresight in sponsoring S. 1587 is an example to all of us, and I sincerely thank you, Mr. Chairman, and members of the subcommittee for holding the hearings and allowing the affected parties to be heard for the first time in this issue.

I thank the chairman very much. I would be happy to answer a question, although there are others anxiously awaiting.

Senator BENTSEN. Thank you very much, Congressman. You have testified in a manner which is helpful to us in our considerations.

We will include your full testimony for the record; we appreciate your time.

Representative CUNNINGHAM. Thank you very much.

Senator BENTSEN. I have deferred my opening statement for my colleagues who had other commitments. What we are having this morning is testimony on S. 1587 which would exempt the local and State pension plans from existing reporting and other provisions in our tax law.

In addition, we are going to receive testimony on a proposal by the Treasury Department that they made on February 3, 1978, to tax the amount deferred under certain unqualified, unfunded, deferred compensation plans at the time that these amounts are earned.

S. 2627 would prevent the February 3, 1978, Treasury Department proposal from going into effect with respect to governmental deferred compensation agreements.

Now, today we have the retirement plans of the State and local governments with assets of over $100 billion. And those plans cover some 13 million participants.

I certainly agree with those witnesses who say that we should avoid unnecessary Federal interference with State and local pension plans, but let me say for the benefit of those in the audience, and for the record, that we have had some very disturbing testimony presented to this subcommittee as late as last week indicating that this committee should review some minimum standards to protect the pension beneficiaries to insure that promised benefits do not become a shattered dream for elder citizens.

Last week, we were informed that as many as 70 percent of the State and local pension plans do not disclose or do not even know the market value of their planned assets.

Now, under ERISA, we certainly required that, for the benefit of the beneficiaries, so every year they could know the value of those assets.

We had testifying before us last week the president of the New York Teachers Association who explained to this subcommittee the failure of his pension plan to provide full disclosure to the retirees of the conditions of that plan.

That is rather discouraging news, since the money in those pension plans belongs to the pension plan participants and to nobody else. Those funds do not belong to the State. They do not belong to the municipal government. Those funds are owned by the workers and the retirees.

We are seeing a situation on the New York pension plan where the trustees, the union leaders, are faced with conflicting objectives, that of their current benefits who want increases in salary and a city which is having dire fiscal problems. And, at the same time, the retirees want to be sure of the solvency of their funds.

The fund itself is pressured to buy more of the securities of that city with considerable question as to the marketability of those securities.

The pension task force of the House Education and Labor Committee has conducted an extensive review of State and local retirement plans and that task force report is expected to be released shortly, perhaps as early as today.

Congressman Ehrlenborn told us last week that this report will show that the overwhelming majority of public pension plans are considerably short of full, actuarial funding. It is important to note that participants in many retirement plans receive substantial tax advantage. There are laws formulated by the Senate Finance Committee and the House Ways and Means Committee.

Employer contributions to many plans are not currently taxable to the employee. Ten-year income averaging is provided for certain lump sum distributions for many pension plans.

Estate and gift tax exclusions apply to certain retirement benefits.

In addition, the 1976 Tax Reform Act extended the 50 percent maximum income limitation to pensions and annuity income.

These tax advantages were provided for greater security of retirement for the American people and it is the responsibility of this pension subcommittee to see that that objective is being achieved.

We are also going to receive some testimony this morning on nonqualified deferred compensation plans. There are about 2,700 participants in the Texas public employees' deferred compensation plan, 73 percent of those participants earn less than $20,000.

Those individuals will be faced with a substantial tax increase if the regulations proposed by the Treasury Department are made effective.

Now, I realize that there have been some abuses, and some serious ones, on deferred compensation in both the public and the private sector, and I think it is our responsibility to try to put some parameters on that.

It is essential that we work out some reasonable standards to prevent tax windfalls but, at the same time, we have to avoid imposing a tax increase on many lower and middle income taxpayers.

I think we are going to have to take a serious look at nondiscrimination rule and contribution limitations.

The purpose of this hearing is to explore those issues so that the members of this committee and the Treasury Department can work together to formulate constructive legislation to strengthen our retirement system, provide adequate protection to senior citizens throughout this Nation and to see that those savings do not turn to dust as they reach their retirement.

Now, I will defer to my colleague, the Senator from Alaska, Senator Gravel.

Senator GRAVEL. Senator Bentsen, I would like to place my statement in the record as if I had read it, at this time.

Senator BENTSEN. Without objection.

[The prepared statement of Hon. Mike Gravel follows:]

INTRODUCTORY STATEMENT OF SENATOR GRAVEL

There is no more important issue for this Committee or the Congress than the assurance of adequate income for the retirement of elderly Americans. And yet, most people concede that Social Security payments are not sufficient to insure a minimal standard of living for retired workers. Americans need to accumulate a capital estate in order to assure themselves a supplement to government transfer payments in their later years. The accumulation of capital is not easy. With high state and federal tax rates it is difficult for the average taxpayer to save anything for retirement from his monthly paycheck. As a result we have developed ways for Americans to set aside a certain portion of their income and delay taxation until retirement. We do this through pension plans, Individual Retirement Accounts, and deferred compensation plans.

Recently, Treasury has attacked one of these methods of accumulating retirement capital: the deferred compensation plans. These plans allow an employee to set aside, tax free, a portion of his income for retirement. The employee must elect to set aside a portion of his salary for which he receives an unsecured claim against his employer for payment at retirement.

These plans have become very popular with state, county and municipal governments . . . and rightly so. They provide retirement security for employees at little or no additional cost to the employer government. The opportunities for abuse under the public plans are minimal. They are generally made available to all the employees of the sponsoring government. The participants are not highly paid and many would no otherwise be capable of accumulating capital for retirement.

Some 30 states have an interest in deferred compensation plans; many have plans in operation, others are contemplating the adoption of deferred compensation plans, and yet others do not themselves have plans, but have county and municipal plans in operation. In my own state deferred compensation plans have been adopted by both state and municipal governments. The state government has 1,250 employees participating in its plan. While that number may appear to be small it constitutes over 13% of Alaska's state employees. According to my information, Mr. Chairman, the State of Texas ahs some 2,700 participants in its plan. Many cities and counties have adopted deferred compensation plans of their own. For example, Anchorage, Alaska's largest city, has adopted a plan in which more than 10% of its employees participate.

The continued existence of these deferred compensation plans has been threatened by a proposed Treasury regulation which would require the taxation of the deferred income at the time of deferral. The regulation would reverse the long standing Treasury position that the deferred income is not taxable until received at retirement or other earlier payout. In response to this action by the Treasury, I have introduced S. 2627 which requires the Treasury to return to its original position. S. 2627 is designed to protect existing and contemplated public deferred compensation plans. It will require that income deferred under a public plan not be taxed until the employee receives it upon retirement or termination. It will apply both to existing plans and allow the adoption of new plans.

Mr. Chairman, today this bill has the co-sponsorship of 17 Senators. A comparable bill in the House sponsored by Congressman Waggonner has the support of over 50 members. I would hope that we might learn here how this Treasury action came about and what Treasury would propose to replace the plans which would be destroyed under this new regulation. If a satisfactory alternative is not forthcoming, I would hope that the Finance Committee will act favorably upon S. 2627.

Senator GRAVEL. And also, I will unfortunately have to absent myself because of a prior commitment, and I have some questions of Mr. Halperin, and if they could be responded to for the record in writing, I will submit these questions.

[The following was subsequently supplied for the record:]

DEPARTMENTAL RESPONSE TO SENATOR GRAVEL'S QUESTIONS

Senator GRAVEL. I am afraid I don't quite understand the tax theory underlying the proposed regulation on deferred compensation. As I understand our tax system it is based on an annual accounting of income, with only income paid during the year taxable to a cash basis taxpayer. Now, if a taxpayer in year one elects to defer income which would otherwise be due to him in year two (assuming he continues his employment) he cannot be treated as having received that income in year one. Is that correct?

When he enters year two he cannot affect the decision he made in year one to defer the income. Under the agreement with his employer he has no right to receive the income in year two. It seems to me that the theory of constructive receipt says that if a taxpayer has a right to receive money presently, but turns away from it he cannot avoid taxation currently.

But, in our example here, the employee has no right to receive the income in year two. He could not sue his employer and recover the deferred portion of his salary. All he has is an unsecured claim for payment at a later date. How this unsecured claim can be treated as a right to receive income currently is not clear to me. This seems to be a rather bold extension of the doctrine of constructive receipt. Is it not?

Mr. HALPERIN. Your question implies that constructive receipt cannot apply unless the employee has a right to immediate payment at the time he elects to defer receipt. We recognize that there are indications that the IRS has agreed with that conclusion in the past. We do not, however, believe that that result is appropriate. The proposed regulations apply to situations in which the employer is committed to the payment of compensation, provided the employee continues in service. In these circumstances, we do not believe it is material when the employee exercises his or her individual right to defer payment.

We don't think the doctrine of constructive receipt allows the employee in that kind of case to turn his or her back on compensation and, in effect, decide when it will be taxed.

Senator GRAVEL. Your history of the deferred compensation regulation is most interesting. I wonder if you could tell me why it took six years for Treasury to decide that the original ruling on deferred compensation was incorrect? Surely six years is not the normal period for review within Treasury. Why did this take so long?

Mr. HALPERIN. I certainly would hope that six years is not the normal period for review. In retrospect, of course, it would have been preferable to settle the matter virtually immediately. Unfortunately, in important and complex cases it is often difficult to reach a conclusion.

Senator GRAVEL. Could you or someone else at Treasury explain why this proposed regulation, which will effectively terminate deferred compensation plans, was promulgated just two weeks after the President's Tax Reform Package came to the Congress when a more positive approach to the problems you perceive could have been included in this package?

Mr. HALPERIN. Private rulings on salary reduction arrangements were suspended by the Internal Revenue Service for almost a year before the proposed regulations were published. The Service was under pressure during that time to take a position on its interpretation of the current statute. We therefore, were giving consideration to proposed regulations wholly independent of the Administration's Tax Reform proposals.

The grandfather provision in the proposed regulations allows covered plans to continue operating under the old rules while we give further thought to the issue with the help of the public's comments on them. It also allows time for Congressional consideration of the issue. Since few if any plans were put into effect without a private ruling, publication of the proposed regulations did not change the status quo except to move the matter into the open so we would come closer to a solution. We do agree, as I said in my testimony, that consideration of a change in the law on this point could be an appropriate part of an overall consideration of the treatment of employee contributions to tax-favored retirement and fringe benefit plans.

Senator GRAVEL. Do you have any data which would indicate that State or local deferred compensation plans are being operated on a discriminatory basis?

Mr. HALPERIN. Although we do not have any systematic data on this issue, we understand that at least some salary reduction arrangements are being operated on a nondiscriminatory basis, both with respect to the classes of employees who participate and with respect to the proportions of compensation withheld on behalf of participating employees. That is certainly a favorable development, but we think it leads to the question why an employer maintaining a plan on that basis cannot maintain a qualified plan. The answer in some cases may be that the employer would still wish to maintain a plan on a salary reduction basis, but that is precluded for new plans by section 2006 of ERISA. Since ERISA requires that plans for rank and file employees be funded, most employers could not avoid section 2006 by unfunded arrangements. Thus we question why a plan effectively prohibited by section 2006 might be acceptable where the employer is a State or local government.

Making these arrangements nondiscriminatory would be a good step forward, but, as my testimony indicated, it would not solve all the problems. For example, there has never been an attempt by the Service to impose limitations on the amount which can be set aside from an employee's salary. We would urge consideration of that type of limitation and other requirements described in the testimony. Moreover, elimination of discrimination also does not resolve the problem that participants in these arrangements are able, in effect, to deduct contributions to the arrangements, whereas participants in qualified plans are not entitled to deductions for their own contributions.

Senator GRAVEL. You seem to be saying that Treasury feels public retirement plans need comprehensive treatment. Wouldn't it make sense for Treasury to withdraw the proposed regulation on deferred compensation and come back to the Congress with a comprehensive proposal?

Mr. HALPERIN. As I indicated in my testimony, we are seeking to open discussion with the Congress and interested members of the public on what would potentially be a comprehensive proposal. In the meantime we are, of course, bound to observe the existing Internal Revenue Code enacted by Congress and interpreted by the courts. To that end, the hearing on the proposed regulations scheduled for May 4, 1978, will allow us to receive the benefit of any comments that might demonstrate that our proposed position is in error or is unclear in any respect. The proposed regulations will not affect any programs that have already received favorable private letter rulings for periods before adoption of regulations in final form.

Senator GRAVEL. I failed to see in your statement an explicit Treasury position regarding S. 2627. If you are opposed to the adoption of this legislation I would appreciate knowing, in some detail, what Treasury would recommend, assuming as I do, that the termination of deferred compensation plans for public employees is unacceptable?

Mr. HALPERIN. I outlined in my testimony requirements which we think should be applicable to a salary reduction arrangement if it is to be accorded favorable tax treatment. Most important, such an arrangement should be nondiscriminatory in both participation and employee contributions. Legislative action which just reverses the proposed regulations would continue tax-favored treatment without imposing any of those requirements. Therefore, we would oppose S. 2627 in its present form. However, as I also indicated in my testimony, final disposition of the salary reduction issue may be a logical part of the more comprehensive proposal which I mentioned earlier.

Senator GRAVEL. We adopted ERISA in 1974 to govern the status of qualified plans since the some 50 percent of our qualified plans have been terminated. But, you suggest that administratively inexpensive deferred compensation plans for public employees should be subject to these same requirements. Why wouldn't it be better to continue the existing treatment for deferred compensation plans until we have solved the problems of ERISA? Why shouldn't we expect the termination of half our State and local deferred compensation plans if they are subjected to the burdensome administrative requirements of ERISA?

Mr. HALPERIN. The Internal Revenue Service's statistics show that in the three calendar years since the enactment of ERISA, the Service has been notified of a total of 47,068 terminations of qualified plans. This is far less than one-half the total number of plans in existence. Moreover, during the same period the Service issued 92,000 determination letters for new plans. Thus, there would appear to have been a net gain in the number of plans since ERISA, although the ratio of new plans to terminations is significantly lower than it was prior to ERISA.

It has become almost axiomatic in some circles to blame ERISA for the shift in the pattern of net growth of qualified plans. However, it is not yet clear how many of the terminations were caused by ERISA. Moreover, although some terminations undoubtedly were caused by ERISA, it is not clear which parts of ERISA might be involved. For example, there should be serious concern if large numbers of plans have been terminated solely because of the administrative provisions of ERISA. However, the same view would not necessarily prevail with respect to plans which terminated because employers simply refused to conform to the participation, vesting, and funding standards enacted in ERISA. ERISA represents a judgment, in my opinion for the most part a valid one, that retirement plans are not deserving of favorable tax treatment unless they offer wider coverage and greater assurance that promised benefits will be paid. Some employers undoubtedly found these conditions too onerous and terminated their plans. But there is still a net social gain if of the plans that remain, the large majority, provide both greater security and greater equity in the distribution of the tax benefits. We would note that the General Accounting Office expects to publish the results of its studies on plan terminations in the near future, and the Service is continuing its efforts to determine the causes of post-ERISA terminations.

Senator GRAVEL. Let me just add that I want to commend you, not only for the hearings, which you do as your legislative task, but the imagination and the leadership that you are providing to bring about these corrections. I am very concerned about the tax impact, but I think you have gone broader than that and are concerned about the real worth of these programs to the beneficiaries that they are supposed to serve.

I want to associate myself with your remarks in that regard and to pledge to you assistance when the matter come before the full committee.

Senator BENTSEN. Thank you, Senator Gravel.

Our next witness will be Mr. Daniel Halperin who is the Tax Legislative Counsel for the Treasury Department.

Mr. Halperin.

Mr. Halperin, would you introduce your associates for the record?

Mr. HALPERIN. This is Mr. Tom McSweeney of the Office of Tax Legislative Counsel.

STATEMENT OF DANIEL HALPERIN, TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT; ACCOMPANIED BY TOM McSWEENEY, OFFICE OF TAX LEGISLATIVE COUNSEL

Mr. HALPERIN. Mr. Chairman, the issues raised today are not only important in themselves but they also have a direct bearing on the larger question of salary reduction arrangements and also, as you have indicated, the funding of Government plans, which have been troubling the Congress and the administration for a number of years.

We do have suggestions to deal with the problem of salary reduction as a whole which we would hope receives serious consideration and we are gratified from your opening statement that indicates that Treasury and you are thinking along the same lines in this matter.

It has seemed necessary to us to lay out the matter in some detail. I will try, in view of the opening remarks, to come as close as I can to the suggested time limit.

Perhaps, in view of the fact that I am dealing with two issues, I could be forgiven for taking a few extra minutes.

Senator BENTSEN. I am ringing the bell on you anyway, Mr. Halperin, and considering the importance of this issue, you may have further chance to testify.

Mr. HALPERIN. I will turn first to the provisions of Senator Stone's bill, S. 1587. As indicated, the bill would exempt a trust or other arrangement under a State and local plan from taxation. As indicated, the exemption from tax of a qualified plan achieves two goals. One, the fund itself is not taxed; and two, the tax treatment of the employees is more beneficial than it would otherwise be.

On the other hand, if the plan is not qualified, an employee is taxable immediately on employer contributions when these contributions are vested. That is, they cease to be subject to a substantial risk of forfeiture.

Thus, for example, if an employee is fully vested in employer-derived benefits under an unqualified plan, contributions by the employer are taxable to the employee at the time the contributions are made and, of course, the income of the trust under a nonqualified plan is generally taxable.

Now, a special situation does exist with respect to State and local governments. The Government's income itself, of course, is exempt from tax under section 115 of the Internal Revenue Code and the issue that is raised by Senator Stone's bill is whether this immunity from taxation should extend to the retirement plan itself.

As a temporary measure, the IRS has announced that, pending completion of a study, it will not seek to tax this trust; S. 1587 would make that result permanent by treating the trust as a tax exempt entity under the provisions of the code granting exemptions for charitable and other types of organizations.

We support that proposal. We think it is in the best interests of intergovernmental relations to make clear that the policy of tax exemption for governmental entities extends to their retirement funds.

It is important to note, however, that a granting of a tax exemption to a trust is not the same as automatically treating the plan as qualified. Favorable income and estate tax treatment for participating employees would not be available unless the plan becomes qualified.

I note in Senator Stone's testimony that he suggested that he would amend his bill to extend it to the favorable tax treatment of the employees. The keystone for this favorable tax treatment is that the plan not discriminate in favor of highly compensated employees. Preserving favorable tax treatment for plans that meet this goal furthers an important condition of social policy, assurance that employees at all levels of compensation will be provided with income protection after retirement.

At the moment, however, the IRS has announced that again, pending completion of a study, it will not deny qualified status to a Government plan when the only question involved is discrimination. It may insist, however, that the plan meet other qualification requirements and that includes the requirement for investments for the exclusive benefit of the employees, which was the subject of the hearing held last week on the New York City situation.

The Service has not completed its review of the discrimination question. We are not prepared to forecast the ultimate conclusion.

We believe, however, that it would be best if, taking into account the special problems and conditions of Government as compared to the private sector, a way could be found to discourage nondiscriminatory coverage to the fullest extent possible.

We are concerned, however, that if the IRS seeks to tax employees who have vested benefits under funded plans on the grounds that the plan is not qualified, the governmental unit may be motivated to switch to an unfunded plan. In the case of unfunded plans, in the absence of the constructive receipt issue, which I will get to in the second half of this testimony, it is clear that the employee is not taxed.

Special averaging for lump sum distributions and the estate tax exclusion will be lost, but this may be a small price to pay for the opportunity to discriminate by giving benefits to those employees that the employee chooses to. The benefit of deferral of income tax until retirement is retained.

For taxable employers, the price of unfunded plans is greater, in that the employer loses the tax deduction for the contributions if the plan is unfunded. Moreover, under ERISA, employers generally are required to fund retirement plans for rank and file employees whether or not the plan seeks special tax benefits. This requirement was not extended to governmental plans.

Mr. Chairman, you have referred to the report of the House Committee on Education and Labor. Representative Ehrlenborn's testimony here last week indicated the problem with the level of funding for the State and local plans.

I might pont out that the success of any Internal Revenue Service effort to impose nondiscrimination requirements may depend on the willingness of Congress to extend the ERISA requirement of funding to State and local plans. Otherwise, the result of any IRS action would be a switch to unfunding and even less security for employees of governmental units than exists today.

The second issue dealt with in S. 1587 is reporting to the Federal Government on behalf of governmental plans. The Service and the Department of Labor have worked together to develop a simpler filing form, a form that only has to be filed with one agency rather than two. They have also made special provisions for governmental plans.

As I have indicated in the appendix to my statement, Government plans are required to give only a portion of the information that other employers must give.

There is a need for this reporting in order to enforce the provisions of ERISA. We believe that the administrative burden on governmental plans is not onerous. We are opposed to the exemption suggested in S. 1587.

Let me now turn to the second issue for discussion today, the regulations on unqualified deferred compensation arrangements.

The proposed regulations are concerned with situations in which the recipient of compensation is given a choice of receiving compensation currently or in a later year. They apply to cases where compensation is fixed, such as by statute or contract, and the employer says to the employee, in effect, tell me when you want it paid.

Now, we do not suggest that these plans basically benefit high income people or do have large amounts of deferral for employees. As the chairman pointed out, however, there are some abuse cases here that definitely would have to be dealt with.

We also note in our testimony the history of this matter as applied to State and local plans. The first ruling on State and local plans was about 6 years ago at the normal ruling level in the Service. The case then was sent to the Service's Chief Counsel's Office for consideration with a view to publication of a public revenue ruling.

The Chief Counsel's Office considered the problem for a number of years and did conclude approximately 1 year ago that the original ruling was incorrect and this caused the matter to be referred to policy officials, which eventually led to the proposed regulations.

The regulations, of course, deal with the issue of constructive receipt. On a cash basis of accounting, a taxpayer is normally taxed only when he or she receives cash or its equivalent. However, under the doctrine of constructive receipt, the taxpayer may not deliberately turn his back on income and select the year for which he will report it.

Thus, income earned on a savings account is taxable whether or not a taxpayer withdraws it or has it entered on a passbook.

In the context of deferred compensation, however, the Service stated back in 1960 that it could not administer the law by speculating whether the payor, the employer, would have been willing to agree to an earlier payment.

However, in the cases that we are dealing with in the proposed regulation, there is no need to speculate. The amount of salary is fixed and it is clear that the employer would be required to pay it if the employee desired it.

We believe that the proposed regulations are consistent with the policy expressed by the IRS back in 1960. Now, it is true, as we indicated in the notice, that the proposed regulations are inconsistent with the conclusions, not only those reached in the private rulings that were issued, but also in the several published rulings.

But these rulings, we believe, were issued without full recognition of the impact and how far it can reach. You have a situation here where the employee is given investment selection, wh re there is effective segregation of the assets not being invested in the employer's business and, in addition, in the case of State and local governments, we do not have the discipline of the loss of tax deductions to the payor.

Nevertheless, we realized the potential impact of the proposed regulation on existing modes of conduct and we did not undertake their publication lightly. We did so only because we were firmly convinced that they were the proper interpretation of the law as it exists in the code today.

This does not mean that we could not be convinced otherwise. That is the purpose of the issuance of the regulations in proposed form and opportunity for comment in public hearings.

We intended, by the delayed effective date on existing plans, to allow existing plans to continue while this matter was under consideration, not only by the Treasury, but also, of course, to allow time for consideration by Congress.

The period for public comment is still open, so we have not made a full analysis to the responses to the proposed regulation. Therefore, we cannot predict what our final position will be.

As of now, however, we have not been persuaded that the position taken in the proposed regulations is incorrect under existing law.

I may add that we have scheduled a hearing for the first week in May in order to more fully hear comments on this issue.

Whatever the results of our deliberations under present law, we cannot, of course, close our eyes to the possibility of a legislative solution. We believe that the possibility of legislation raises two fundamental issues of tax policy.

First, as the chairman indicated in his opening statement, the necessity of restricting favorable tax treatment of compensation to benefits provided under some controls, and we believe the controls would be a nondiscriminatory distribution of benefits.

Second, the extent to which the favorable treatment should remain if the participation in the nondiscriminatory arrangement is at the choice of the employee. A question that has been troubling the Treasury and the Congress for several years is the subject of section 2006 of ERISA, now under consideration in the extender bill, which was recently reported out by the Finance Committee.

Let me turn first to the question of discrimination. Deferral of tax on the payment of compensation is inconsistent with the progressive nature of our income tax system. We believe it should only occur if it serves important public policy.

In the case of a retirement plan, this policy is assurance that employees at all levels will be adequately protected after retirement.

Since it is particularly difficult for employees at low-income levels to provide this protection, tax incentives for retirement plans are offered to encourage employers to provide for rank-and-file employees as well as highly compensated employees.

In the case of a taxable employer which maintains a qualified plan, this incentive is an immediate deduction from contributions while employees may defer taxation until they actually receive benefits.

In the absence of a qualified plan, the price of deferral of taxation for employees is a similar delay in the timing of the employer deductions. However, the ability to accelerate a deduction without inclusion of income by employees is not relevant to a tax-exempt entity.

As noted above, such an employer can, in effect, provide its employees with the deferral benefits of a qualified plan through an unfunded, nonqualified arrangement.

ERISA, however, prohibits unfunded plans for rank-and-file employees except for government and church plans. Surely, in relieving these entities of the requirements of funding, Congress did not intend to provide them with a unique opportunity to achieve tax deferral for their employees without regard to the restrictions or limitations of qualified plans.

The factual result of that is that a dollar of after-tax compensation under a qualified plan can be provided more cheaply by a State or local government than by other employers.

In other words, we do not believe that there is discrimination against State and local governments but, in effect, if they are allowed to continue these salary reduction arrangements on an unqualified basis, they have an advantage over other employers.

Second, the existence of these arrangements would undercut the policy favoring qualified plans on a broad base.

This leads us to the conclusion that if favorable tax treatment is to be granted for salary reduction arrangements, they should be subject to many of the same requirements as qualified plans. We have indicated in the statement some of those requirements. We shortly hope to set out this proposal in more detail and we certainly welcome discussions with the sponsors of State and local plans as to their reaction to these conditions and any modifications that they believe are desirable.

Such a legislative approach would have the practical effect of allowing deductible employee contributions to a plan. On the other hand, employees who participate in qualified plans, may not deduct their own contributions, even if these contributions are prerequisites to the accrual of benefits or to the employment itself.

This raises the much broader question of the tax treatment of so-called salary reduction arrangements. This is the broad question to which we suggest that the Congress and Treasury together begin to give serious consideration, leading toward an overall solution.

The problem has risen in numerous forms. The basic rule is that if something is called an employee contribution, it is taxable currently even if, as in the case with the Civil Service Retirement System, the employee is required to make the contribution as a condition of employment.

In salary reduction arrangements, such as the type covered by the proposed regulation, it is clear, generally, that the amounts involved are taken from the employee's compensation and the employee has a choice whether to receive it or not.

However, the tax treatment may be in dispute. Now the tax treatment has been in dispute over so-called cafeteria plans where the employee has the right to choose among various fringe benefits, such as medical or life insurance, which would be nontaxable if they were provided directly by the employer.

Other employees maintain so-called cash and deferred profit-sharing plans under which the employees can choose immediate payments or contributions to a qualified plan.

Existing revenue rulings allow a substantial degree of discrimination in these plans without the loss of qualification. As I indicated, cafeteria plans and cash and deferred profit-sharing plans are the subject of ERISA section 2006 which provides differing treatment, depending upon whether the plans were in existence on June 27, 1974.

This provision expired in January, but a 2-year extension passed the House and it has been reported out by this committee.

In its recent tax reform proposals, the administration supported continued nontaxability of benefits provided by cafeteria plans provided the tax-favored benefits are actually provided in a nondiscriminatory manner.

In the case of cash and deferred profit-sharing plans, the Treasury, in its comments on H.R. 8136, has recommended that tax deferral be precluded except for a limited grandfather rule. Different rules have historically applied to so-called teacher annuities under section 403(b) of the code. There, in accordance with legislative history, the regulations clearly permit salary reduction arrangements subject to the statutory limits.

I might add that the code neither requires nondiscrimination nor does it proscribe preretirement cash out of those annuities.

Finally, there are the proposed regulations for the treatment of nonqualified deferred compensation arrangements which are the subject of this hearing. Thus we have on our hands a situation not unlike that in which a rider jumped on his horse and galloped off in all directions

We think, therefore, this is an opportunity to begin consideration of the possibility of consistency in the treatment of these arrangements.

Leaving aside revenue for a moment, it seems to us that a uniform system could be deveolped in which amounts set aside at the employees' election are deductible or excluable if the arrangements are nondiscriminatory with respect to both coverage of employes and benefits or contributions actually provided. Not only do employees have a chance to get in on a nondiscriminatory basis, but the actual provision of benefits and the election to participate is on a nondiscriminatory basis.

In other words, we would say, let us forget the constructive receipt issue if the actual participation in the plan is on a nondiscriminatory basis.

A possible starting point would be expansion of the proposal concerning cafeteria plans in the President's tax reform program to both cash and deferred profit-sharing plans and salary reduction arrangements for Government employees affected by the proposed regulations.

Consideration should also be given to imposing nondiscrimination requirements on section 403(b) annuities.

We note that the revenue consideration is not one which can be easily set aside. To carry this to its logical conclusion, and allow employee contributions to qualified plans to be deducted, the potential revenue loss is over $3 billion annually.

Thus, we may be required to go slowly in order to prevent serious adverse revenue impact. Nevertheless, solution of this problem will be a meaningful step forward in the employee benefit area. We would welcome any suggestions that may be forthcoming to solve this problem which has been troubling us, as I indicated, for a number of years.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Halperin. It appears that the Treasury is not hard and fast in its decisions here. As you say, they will be subject to hearings.

One of the things that concerns me among many others in this proposal is its possible impact on the private sector.

I understand that Treasury says that it would not be of concern because the compensation package can be arrived at prior to the regulations going into effect and that the deferred aspect of the total compensation action having been fixed before an election is made. The factual determination, however, seems to bring up the same, very difficult administrative problems envisioned by the Service when it published Revenue Ruling 60-31.

Would you comment on that?

Mr. HALPERIN. I may say, Mr. Chairman, that I would hope and expect that any final regulations here would make it clear that we do not intend to go into the room where the negotiations take place and try to figure out whose idea it was to have the deferral. We are only trying to deal with situations where it is clear on its face, where the compensation is clearly available to the employee and the election is clearly available to the employee based on a written document, such as a statute or a contract.

I may also add that if we do get into legislative solutions to this problem, in the case of taxable employers, as I have indicated, there is a loss of tax deduction if one of these deferred compensation arrangements is entered into and the potential tax policy implications of it are less serious than those when we are dealing with tax-exempt organizations.

There is a benefit to these arrangements, otherwise people will not enter into them. In part, it may be a question of disclosure in that the employee has been given a tax benefit at the expense of the employer giving up a tax benefit. The compensation that is shown on proxy statements and otherwise does not reflect that tax benefit.

In part, it is an opportunity to get the more favorable treatment for investment income which corporations have as opposed to individuals, but essentially the tax loss to the Treasury in the area of taxable entities is not as serious as a potential loss with respect to tax-exempt entities.

Senator BENTSEN. I would appreciate your further commenting on your statement on page 8, that the practical result is that a dollar of aftertax compensation under a nonqualified plan can be provided more cheaply by a State or local government than by other employers?

Mr. HALPERIN. Well, Mr. Chairman, if we are dealing with fully taxable compensation, the Government is going to pay $1 to an employee and it would have to take in $1 in tax receipts. The taxable employer who was going to pay $1 to an employee would have to have sales revenue of $1 in order to cover it.

Senator BENTSEN. They would have to have what?

Mr. HALPERIN. They would have to have $1 of income in order to pay the $1 of compensation.

Senator BENTSEN. Sales revenue?

Mr. HALPERIN. Or income to the taxable employer. He would have to collect it in terms of his sales or other income—if we now get to these deferred compensation arrangements, since the Government is not subject to tax, if it takes in $1 of revenue it would be able to set aside $1 for an employee.

On the other hand, in the case of the taxable corporation, it could not do so. It would have to pay tax before it could set the money aside. It would have to take in $2. It would have to collect $2 from its customers in order to be able to pay the tax on it at an assumed rate of 50 percent for corporations and then have $1 left to set aside.

If it really had the $2 in the first place, it could pay the employee $2 in cash, the employee could pay the tax on it and have the dollar left.

Senator BENTSEN. Is it not just to the contrary? Is the employer actually getting a tax deduction there in an authorized plan? Is he not actually making a tax savings if he makes a contribution to it?

Mr. HALPERIN. Well, we are dealing here with unfunded, deferred compensation, Mr. Chairman, where it is assumed that the employer will not get a tax deduction for these amounts which are set aside. In order for the taxable employer to do it, then, it would need twice as much money as it plans to set aside. The Government only needs the same amount of money that it plans to set aside because it does not pay tax, of course, on its income.

So it is a little difficult to get it, and I do not think it is obvious on its face, but we have looked at this closely and we believe that it is quite correct and we would be glad to submit an example for the record to show why that is correct.

The tax exempt entity is under an unfunded arrangement, under an unqualified arrangement, so it is obtaining an advantage over the taxable employer.

Senator BENTSEN. Well, I can see several advantages that they have, but I cannot really see that one. I want to see the example.

[The following was subsequently supplied for the record:]

MARCH 21, 1978.

Hon. LLOYD M. BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for the opportunity of testifying on March 15, 1978, before the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Senate Finance Committee concerning S. 1587 and the recently proposed regulations on salary reduction arrangements.

At the hearing I agreed to submit an example illustrating the meaning of a statement contained in my testimony. The statement appears at page 8 of my prepared testimony and says, in effect, that the practical result under a nonqualified deferred compensation plan is that a dollar of after-tax compensation can be provided more cheaply by a state or local government than by other employers.

We can illustrate the point by a determination of how much income (or receipts in excess of expenditures in the case of a government) is required in order to set aside $100 for an employee under a non-qualified deferred compensation arrangement.

Let us assume that a taxable business is in the 50 percent income tax bracket and maintains a non-qualified, funded retirement plan. Such a taxable employer must generate $200 of income in order to set aside $100. Since the contribution is non-deductible, if $100 of profits were earned, the corporation would owe $50 in taxes and would not have enough left to meet its obligation. $200 of profits, on the other hand, enables it to make the contribution of $100 to the non-qualified plan and have an additional $100 available to pay the tax on the $200 profit.

In the case of a state or local government, only $100 of "profits" (that is, income in excess of other expenditures) would be necessary to make a $100 contribution to a non-qualified plan. Since the government is a tax-exempt entity, there is no need to generate the extra income to enable it to pay the tax after making the contribution to the non-qualified plan. The same principle would apply, of course, to any type of tax-exempt entity, not just a state or local government.

In the case of current compensation, despite the fact that the taxable corporation has a tax deduction, both entities are on an equal basis. Both need to generate $100 in order to pay $100 of compensation. True, the taxable employer only has a net out-of-pocket cost of $50, since in the absence of the salary payment it would have to pay $50 of tax. But this should not obscure the fact that it needed to generate $100 of revenue initially in order to pay $100 of salary.

You also indicated that you might be submitting further questions for our consideration. It was our intention to open a broad area of discussion as a result of my testimony, and we will be pleased to respond to any questions you might have.

Sincerely yours,

DANIEL I. HALPERIN,
Tax Legislative Counsel.

Senator BENTSEN. Now, the proposed deferred compensation in the regulation covers the situation where prospective employees—does it cover situations where prospective employees and employers negotiate a deferred compensation arrangement as a part of an inducement to future employment, commence employment, or to enter into new employment contracts? Does it cover those kinds of situations?

Mr. HALPERIN. It is not intended to cover those situations.

Senator BENTSEN. It would not cover irrevocable decisions to defer prior to earning compensation?

Mr. HALPERIN. If the agreement to defer was made at the same time that the compensation was fixed, it would not cover the agreement to defer. If there was first a fixed salary negotiated by contract and the employer said to the employee, you can decide that you want it paid, then it would cover it.

Senator BENTSEN. If you would have a substantial risk of forfeiture, would that defer recognition of compensation?

Mr. HALPERIN. If the substantial risk of forfeiture always existed, taxation is deferred until the condition lapses. If the employee is given the choice of taking $100 in cash or leaving the $100 with the employer subject to a substantial risk of forfeiture, then under the proposed regulations, that $100 would be taxable immediately, because the employee had the opportunity to obtain it without it being subject to a risk of forfeiture.

Senator BENTSEN. Does that change the rule on section 83 on restricted property or section 402 on distribution from a qualified plan?

Mr. HALPERIN. I do not believe so. I would think that those sections are dealing with cases where the employee does not have the opportunity to get the salary without its being subject to a substantial risk of forfeiture. Here, the employee is, in fact, self-imposing the risk of forfeiture.

Thus, under the arrangement, he or she would be able to get it without regard to forfeiture. The decision to take that risk would be the employee's alone.

Senator BENTSEN. You heard me comment earlier about some of the problems we heard on the New York pension plan and others. Do you think that we ought to take ERISA's disclosure standards and extend them to the State and local government plan?

Mr. HALPERIN. Well, of course, that is not a tax issue because the disclosure standards are part of Federal law which is under the jurisdiction of the Labor Department. But, we should find out what is going on and, to the extent that is a problem, it seems to me that it is a problem for all employers.

Senator BENTSEN. I commented about the differing objectives of the current employees of the city of New York and those of the retirees and the trustees trying to represent both, putting them, really, in a most difficult position.

Do you think the prohibited transaction rules in section 503(b) of the Tax Code could be an important deterrent to any potential breaches of the fiduciary obligation?

Mr. HALPERIN. Well, they would and, of course, under present law any breach of that obligation could cause the trust to be taxed; if the bill suggested by Senator Stone were enacted, that would not be the case and we would have a situation where the trust would become nonqualified in any event and current employees would be taxable on contributions made by the government to the plan. So they do, in effect, have a self-interest in not having the trust make a prohibited transaction.

So, it may make it easier to pay current salary but it would also mean that, to the extent that pension contributions are made on their behalf, they may be subject to current taxation on them.

Of course, under ERISA, we have gotten away from that sanction. The sanction under ERISA on private employers is an excise tax imposed on the people responsible for the breach. I am not so sure it is feasible to do that in the case of government.

Senator BENTSEN. No, of course, you cannot use that kind of leverage.

Mr. HALPERIN. So we are back where we were before by imposing the penalty on the trust or imposing the penalty on the employees who, of course, are in most cases, innocent parties in the transaction.

It is not clear what a sensible solution to that is.

Senator BENTSEN. In reading page 4 of your statement, I get the implication that you are saying, you are implying, that the assets of a State or local pension fund are an entity of the government. Do the workers and the retirees really own those funds?

Mr. HALPERIN. Well, I think that is true, but I think, perhaps, that the problem would be that, in order to impose a tax on that fund, the IRS is, in effect, dealing with the State and local government and it is difficult in the course of government relations problems for it to get into that position.

I think secondly, we have the problem that if unfunded arrangements are not taxed it is a little difficult to tax the funded arrangements.

But I recognize the position that you have stated, that if we think of this as having, in effect, left the governmental sector and become the property of the employees then it would seem to be reasonable, perhaps, to treat the funds as they are under present law, subject to the same restrictions as plans established by other employers.

We were just trying to balance the interests, in that regard.

Senator BENTSEN. Mr. Halperin, your testimony has answered a lot of questions and has raised a number of them. I am sure I am going to be back to you to ask for some further clarification and I will submit these additional questions in writing which I would like for you to respond to for the record.

[The following was subsequently supplied for the record:]

APRIL 10, 1978.

Hon. LLOYD M. BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you once again for the opportunity to testify at the March 15 hearings of the Private Pension Subcommittee of the Senate Finance Committee. This is in response to your letter on March 21, 1978, requesting responses to several questions for inclusion in the record of the hearing.

The questions and answers are enclosed. As I indicated in my testimony, we are seeking a broad-based discussion of the treatment of employee contributions to tax-favored employee benefit arrangements. We would be pleased to have a continuing dialogue with you and your staff on these issues.

Sincerely yours,

DANIEL I. HALPERIN,
Tax Legislative Counsel.

Enclosures.

Senator BENTSEN. Does the concept contained in the proposed deferred compensation regulations—that is, taxing a cash basis taxpayer when he exercises an election to defer the receipt of cash—apply to the sale of property? As an example, would the proposed regulations apply to a farmer who delivers his grain on December 30, 1977, and is paid on January 1, 1978?

Mr. HALPERIN. The proposed regulations address only the area of compensation for services, although they include services performed other than in an employment relationship as well as services performed for an employer. For example, if an independent contractor enters into an agreement to perform services for a stated fee, then subsequently enters into a second agreement to defer part of that fee, the proposed regulations would apply, even though there was no employer-employee relationship.

The proposed regulations themselves do not extend beyond the compensation question. However, the same principles should logically apply to other types of income, subject to similar limitations on their application. For instance, assume that the farmer in your example is a cash basis taxpayer and that only one agreement is involved. The farmer is agreeing to deferral of the amount paid for his grain, but the deferral agreement is part of the single agreement establishing the price for the grain. The example that you give can be clearly abusive, since a deferral of two days has no practical result except to postpone the payment of tax for a year. However, the effort necessary to distinguish between that and less abusive cases would be administratively unjustifiable.

On the other hand, assume the farmer delivered the grain on November 30, with the agreed upon payment to be made on December 15. Then, on December 15, the farmer and the purchaser enter into a supplementary agreement under which a portion of the purchase price is deferred until January 1. The deferred amount would be treated as if it were paid on December 15.

Senator BENTSEN. What is the substantive basis for the abrupt change in the administration of the deferred compensation rules? Could you please supply an analysis of the legal basis for the Treasury's change in position?

Mr. HALPERIN. There have been indications in the past that the Internal Revenue Service has taken the position that the doctrine of constructive receipt does not apply unless the employee has a right to immediate payment at the time he or she elects to defer receipt. We do not, however, believe that that result is appropriate. The proposed regulations apply to situations in which an employer or other payor is committed to the payment of compensation, provided the employee or other service provider performs the agreed upon services. In the circumstances, we do not believe it is material when the employee or other person exercises his or her individual right to defer payment. We don't think the doctrine of constructive receipt allows the person in that kind of case to turn his or her back on compensation and, in effect, decide when it will be taxed.

As I said in my testimony, the immediate cause of our consideration of the salary reduction issue was the decision by the Chief Counsel's Office that the original ruling to state and local governments was incorrect. Our reexamination of the state of the law in this area and our treatment of it as a significant policy issue was precipitated by the realization that salary reduction arrangements had become a major factor in the area of deferred compensation. In particular, since the last broad-based policy consideration of the issue, those arrangements had become widespread among various types of tax-exempt employers. In the case of a taxable employer, the prevalence of unfunded arrangements is kept in check because deferral of income for the employee also means deferral of a deduction for the employer. The tension between an immediate deduction and a delayed deduction is not present where the employer is tax-exempt. Thus, we felt that the overall problem had become more important and deserved reconsideration.

Senator BENTSEN. You have indicated that the proposed regulations may not have a significant impact on the private sector because the regulations only apply after the compensation package has been "fixed" and the deferred aspect of the total compensation package can be before an election is made. Won't this pose difficult administrative problems?

Mr. HALPERIN. The proposed regulations have created some unnecessary concern among the private sector. I think a description of some of the cases to which the proposed regulations do or do not apply would be helpful.

Assume that a potential employee enters into salary negotiations with his or her future employer. The resulting agreement provides for a fixed amount of compensation and a further amount to be paid on a deferred basis. In actuality, the employer might have been willing to pay the full deferred amount on a current basis as earned. However, consistent with Revenue Ruling 60-31, we have concluded that unless there is clear evidence that such was the case, it is not administratively worthwhile to try to determine the intentions of the parties. Hence, the proposed regulations would not apply.

Another case which would generally not be covered by the proposed regulations is negotiations for renewal of an existing employment contract. Once again, it may be true in actuality that deferral created under a second agreement is only for the convenience of the employee, and indications of that fact might be found. For example, if the second agreement provides for the same total compensation as the first employment contract but an increase in the percentage of deferral, the question is certainly raised. However, unless there is clear written evidence that deferral under the second employment contract is only for the convenience of the employee, the proposed regulations would not apply.

The result in each of the two preceding examples would be the same even if the employee involved were, for example, the sole shareholder of the corporate employer. However, it should be emphasized that the last example applies to a renewal of an expiring employment contract, not necessarily to a revision of a first employment contract which would be terminated before the expiration of its term. For example, such a revision of an existing contract before the expiration of its term would be, in effect, a salary reduction arrangement if it merely increased the percentage or period of deferral.

Assume in another case that a potential employee negotiates an employment contract with an employer resulting in a fixed amount of compensation. Some time later, further negotiations occur, and the previously agreed upon compensation is reduced, with the amount of the reduction being deferred as an unfunded obligation of the employer. The proposed regulations would apply whether the subsequent negotiations were instigated by the employer or the employee. In either instance, the first contract would indicate the willingness of the employer to pay the full amount of compensation as earned, and the entry into the second contracts by the employee indicate that he or she had the option to not defer simply by refusing to enter into the second agreement.

The proposed regulations would not apply in any case in which the deferral results from unilateral imposition by the employer. For example, if a pay increase or bonus is granted, with a portion of the amount deferred involuntarily from the point of view of the employee, the proposed regulations would not result in current taxation.

We realize that the result will be that some cases truly within the sphere intended to be covered by the proposed regulations will be missed. It is difficult, for instance, to distinguish salary negotiation situations from arrangements which are clearly salary reduction agreements on a conceptual basis, but we do not feel that the substantial administrative action necessary to sort out the salary negotiation cases would result in effective administration of the Code. In effect, such a case will be subjected to the proposed regulations only if there is clear written evidence that deferral was solely for the convenience of the employee.

Mr. HALPERIN. Thank you, Mr. Chairman. As I have indicated, we did intend to raise some questions and possible thinking about solutions that perhaps we have not raised in the past and we are hopeful that we will get comments, not only from the committee, but from interested outside parties as well.

Senator BENTSEN. Thank you.

[The prepared statement of Mr. Halperin follows:]

STATEMENT OF DANIEL I. HALPERIN, TAX LEGISLATIVE COUNSEL, OFFICE OF THE ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY

Mr. Chairman and Members of the Subcommittee, I am pleased to have the opportunity to appear before you today to discuss questions concerning retirement plans maintained by State and local governments. As you have requested, I will discuss S. 1587, which is a bill which would amend the Internal Revenue Code to exempt State and local government retirement plans from taxation and from certain reporting requirements. I will also discuss proposed regulations recently issued by the Internal Revenue Service on nonqualified deferred compensation plans. With your indulgence, I would like to discuss a broader question of the tax treatment of employee contributions to deferred compensation arrangements. This question concerns all employers, not just governmental ones. However, it is related, at least indirectly, to both of the items on which the Subcommittee had requested testimony.

S. 1587

I turn first to the provisions of Senator Stone's bill, S. 1587. The bill would clarify the law on one point and reverse the law on a second point.

With regard to the first question, the bill would cause a trust or other funding arrangement to be tax-exempt if it is maintained in connection with a retirement plan of a State or local government. The practical effect of this amendment would be to extend the tax-exempt character of the State or local government itself to the governmental retirement fund.

It is well established that a trust or other arrangement funding a retirement plan is tax-exempt if the plan meets the qualification requirements of the Internal Revenue Code, including the condition that the plan not discriminate in favor of higher paid employees. This applies whether the employer maintaining a plan is a governmental body, a tax-exempt organization, or a taxable corporation. Whether or not the plan is qualified also has a very important bearing on the taxation of the employees participating in the plan. If the plan is qualified, employees are taxable only as employer contributions are distributed or made available to them. Furthermore, the distribution may be subject to more favorable tax treatment than other types of income. For example, special ten-year averaging is available for a lump sum distribution. In addition, a death benefit may not be subject to estate tax. On the other hand, if the plan is not qualified, an employee is taxable on employer contributions when those contributions are vested (i.e., they cease to be subject to a substantial risk of forfeiture). Thus, for example, if an employee is fully vested in employer-derived benefits under a plan, contributions by the employer are taxable to the employee at the time the contributions are made.

A special situation exists if a retirement plan maintained by a State or local government does not meet the qualification requirements. As you know, the income of a governmental entity is generally exempt from tax under section 115 of the Internal Revenue Code. It is not clear whether a trust funding a nonqualified governmental retirement plan shares in the tax exemption granted by section 115. As a temporary measure, the Internal Revenue Service has announced that, pending completion of a study of the issue, it will not seek to tax such trusts. S. 1587 would make that result permanent by treating the trust as an exempt entity under the provision of the Code granting exemptions to charitable and other types of organizations.

We support this proposal. We think it is in the best interest of intergovernmental relations to make it clear that the policy of tax exemption for governmental entities extends to their retirement funds.

It is important to note, however, that the granting of a tax exemption to the trust funding a plan is not the same as automatically treating the plan as qualified. Favorable income and estate tax treatment for participating employees would not be available unless a plan becomes qualified. The keystone of qualification is the requirement that a plan not discriminate in favor of highly compensated employees. Reserving favorable tax treatment for plans that meet this condition furthers an important goal of social policy—assurance that employees at all levels of compensation will be provided with income protection after retirement.

At the moment, however, the Internal Revenue Service has announced that, pending completion of a study, it will not deny qualified status to a governmental plan if the only question involved is whether a governmental plan is discriminatory. It may insist, however, that the plan meet the other qualification requirements applicable to governmental plans. The Service has not completed its review of the discrimination question, and we are not prepared to forecast the ultimate conclusion. We believe, however, that it would be best if, taking into account the special problems and conditions of government as compared to the private sector, a way could be found to encourage nondiscriminatory coverage to the fullest extent possible.

We are concerned, however, that if the Internal Revenue Service seeks to tax employees who have vested benefits under funded plans on the grounds that the plan is not qualified, the governmental unit may be motivated to switch to an unfunded plan. Loss of special averaging for lump sum distributions and the estate tax exclusion may be a small price to pay for the opportunity to discriminate if the benefit of deferral of income tax until retirement is retained. For taxable employers the price is greater in that the employer loses a current tax deduction if the plan is unfunded. Moreover, under the Employee Retirement Income Security Act of 1974 (ERISA), employers generally are required to fund retirement plans for rank-and-file employees whether or not they are entitled to the special tax benefits of qualified plans. This requirement was not extended to governmental plans. We understand that a report on State and local plans being discussed today by the House Committee on Education and Labor may discuss the possible desirability of extending the ERISA funding requirements to governmental plans. The success of any Internal Revenue Service efforts to impose nondiscrimination requirements may depend on Congressional willingness to so extend the ERISA requirements.

The second issue dealt with in S. 1587 is reporting to the Federal government by or on behalf of governmental plans. The Code currently requires every funded plan of deferred compensation to file an annual report with the government. Under ERISA, this requirement applies to both qualified and nonqualified plans, and it further applies without regard to the nature of the employer maintaining a plan. The Service and the Department of Labor have worked together to develop a coherent set of standards for filing the annual report, Form 5500. As a result of this effort, only one form must be filed each year; it is filed with the Service, which then shares the information with other agencies involved in the administration of ERISA.

Special provisions have been made administratively for governmental plans. As is indicated in the appendix, the amount of information which must be contained in Form 5500 (or the equivalent form) has been substantially reduced. In addition, the filing date for the form has been extended until July 31, 1978 for returns due for 1975 and 1976 as well as for 1977.

The Federal agencies which are charged with enforcing ERISA have legitimate needs for annual reporting. These needs apply regardless of the nature of the employer involved. The administrative burden of preparing the forms is not onerous for a governmental employer. Therefore, we are opposed to this provision of the bill.

Proposed Deferred Compensation Regulations

I would like to turn now to the second issue for discussion today, the regulations on nonqualified deferred compensation arrangements proposed by the Internal Revenue Service on February 3, 1978.

The proposed regulations are concerned with situations in which the recipient of compensation is given the choice of receiving compensation currently or in a later year under a nonqualified deferred compensation arrangement. Qualified retirement plans are not affected. The proposed regulations apply to cases where the compensation is fixed, such as by statute or contract, and then the employer says to the employee, in effect, "Tell me when you want it paid." The proposed regulations provide that even if the employee elects deferral, the compensation will nevertheless be treated as received when the employee would have received it in the absence of an election to postpone payment.

The Internal Revenue Service generally does not inquire into the maximum percentage of compensation which may be deferred under a salary reduction arrangement, since there have been no limitations. However, the full extent to which a plan may be used is sometimes brought to its attention. In one such case, a physician performing services for a tax-exempt organization was able to defer 90 percent of his compensation for those services. In another, broaded case, an arrangement was made between a tax-exempt organization and 100 physicians, each of whom also maintained a qualified retirement plan. The total deferral under the arrangement was $1,533,882 for 1974 and $1,464,530 for 1975—an average of approximately $15,000 per person each year.

Although the proposed regulations apply to salary reduction arrangements and similar arrangements maintained by all types of employers, they will impact on some employees of State and local governments. In this light, some of the history behind the proposed regulations would be helpful. The first private ruling on a governmental plan of this type was issued about six years ago after approval at relatively low levels in the Service. The case was then sent to the Service's Chief Counsel for consideration with a view to publication of a public revenue ruling. In the meantime, having issued one favorable ruling, the Service continued to issue favorable rulings pending completion of consideration by the Chief Counsel's office. After lengthy deliberation, the Chief Counsel's office concluded that the original ruling was incorrect. This caused the issue to be referred to officials at the policy level in the Service and the Treasury Department. It also resulted in the Service's announcement on September 7, 1977, that it had suspended the issuance of rulings dealing with the income tax treatment of certain nonqualified deferred compensation plans established by employers (including State and local governments) pending completion of its review. The proposed regulations represent the conclusions reached as a result of this review.

The Service and the Treasury Department concluded that the private rulings already issued reflected an incorrect interpretation of the law as it now exists. A taxpayer on a cash basis of accounting is normally taxed only when he or she receives cash or its equivalent. However, "under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back on income and thereby select the year for which he will report it."* Thus, income earned on a savings account is taxable whether or not a taxpayer withdraws it or has it entered on a passbook. In the context of deferred compensation arrangements, the Service stated in Revenue Ruling 60-31 that it could not administer the law "by speculating whether the payor would have been willing to agree to an earlier payment." However, with arrangements of the type affected by the proposed regulation, no such speculation is required. If an employee is in complete control of the disposition of part of his or her compensation and the employer is willing to pay or withhold that amount at the direction of the employee, the fact that the employee elects deferral should not, in the absence of statutory authorization, result in exclusion of the amount from gross income. In similar instances, no exclusion would result if the employee directed the employer to withhold an amount from compensation and pay the amount into a savings account or as a premium on an annuity contract owned by the employee.

We realized the potential impact of the proposed regulations, and we did not undertake their publication lightly. We did so only because we were firmly convinced that they are the proper interpretation of the law as it exists in the Code today. This does not mean, however, that we cannot be convinced otherwise, for that is the purpose of the administrative procedure of publishing proposed regulations subject to public comment and a public hearing if one is requested.

The proposed regulations contain a grandfather provision for arrangements in existence on February 3, 1978. The regulations will not apply to the amount of any payment which the taxpayer has chosen to defer under such a plan or arrangement if the amount would have been payable, but for the taxpayer's exer-

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*Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, 178.

cise of the option to defer receipt, before a date 30 days following publication of final regulations. The effect of this transition rule is that amounts withheld before finalization of the regulations will not be subject to tax, but grandfathered plans will be subject to the new rules from that time forward. In the meantime, existing plans should be able to continue operation while consideration is being given to the proposed rules within the Service and the Treasury Department. This also allows time, of course, for consideration by the Congress. The period for public comment is still open, so we have not made a full analysis of the responses to the proposed regulations. Therefore, we cannot predict what our final position will be. However, as of now we have not been persuaded that the position taken in the proposed regulations is incorrect under existing law.

We cannot, of course, close our eyes to the possibility of a legislative solution, whatever the outcome of our deliberations under present law. We believe the possibility of legislation raises two fundamental issues of tax policy: first, the necessity of restricting favorable tax treatment of compensation to benefits provided in a nondiscriminatory manner; and second, the extent to which the favorable treatment should remain if participation in the nondiscriminatory arrangement is at the choice of the employee. The latter question has been troubling the Treasury and Congress for several years, and it is the subject of section 2006 of ERISA, now under consideration in H.R. 9251 (the so-called "extender" bill). But first, I want to discuss the question of nondiscrimination.

Deferral of tax on the payment of compensation disrupts the progressive nature of our income tax system. This disruption should occur only for the sake of implementing an important social policy. In the case of retirement plans, the goal is assurance that employees at all levels of compensation will be provided with protection after retirement. It is particularly difficult for employees at low income levels to provide this protection for themselves. This has led to the proposal in the Administration's tax reform program for improvements in the rules which allow qualified retirement plans to integrate with the Social Security system.

Tax incentives for retirement plans are offered to encourage employers to provide for rank-and-file employees as well as highly compensated employees. In the case of a taxable employer which maintains a qualified plan, this incentive is an immediate deduction for contributions, while employees may defer the taxation of those contributions and income earned on them. In the absence of a qualified plan, the price of deferral for employees is a similar delay in the timing of the employer deduction. However, the ability to accelerate a deduction in comparison to inclusion of income by the employees is not relevant to a tax-exempt entity. As noted above, such an employer can essentially provide its employees with the tax-deferral benefits of a qualified plan through an unfunded nonqualified arrangement. ERISA, however, prohibits unfunded plans for rank-and-file employees, except in the case of government and church plans. Surely, in relieving these entities of the requirements of funding, Congress did not intend to provide them with a unique opportunity to achieve tax deferral for their employees without regard to the restrictions or limitations of qualified plans (or even Individual Retirement Accounts or Section 403(b) annuities). The practical result is that a dollar of after-tax compensation under a nonqualified plan can be provided more cheaply by a State or local government than by other employers.

This leads us to the conclusion that if favorable tax treatment is to be granted, salary reduction arrangements maintained by governmental employers should be subject to many of the same requirements as qualified plans. This would mean, for instance, that the arrangement should be nondiscriminatory with respect to both the potential group of employees who may participate and the group of employees who actually do participate. Moreover, since the employee is deferring his or her own contributions to the plan, there should not be any possibility of forfeiture. The arrangement should be a funded plan, with the plan (rather than the employer) bearing the obligation to pay benefits to the employee. In order to prevent excessive deferrals, such arrangements should be subject to the overall limitations on contributions and benefits applied to qualified retirement plans, and perhaps a specific limitation should be imposed on a salary reduction arrangement itself. As is true in the case of a qualified pension plan, distributions during employment should be prohibited. If the arrangement does not meet these requirements, the amount of the salary reduction would be taxable to the employee as earned.

Such a legislative approach has the practical effect of allowing deductible employee contributions to a plan. On the other hand, employees who participate in qualified plans may not deduct their own contributions to a plan, even if those contributions are a prerequisite either to the accrual of benefits derived from the employer or to employment itself. This inequality in treatment, which would be the result of a combination of a legislative change for nonqualified salary reduction arrangements and a continuation of present law for employee contributions, raises a much broader question of the possibility of deductions and exclusions for employee contributions by way of salary reduction or otherwise to all types of tax-favored deferred compensation arrangements and fringe benefit plans. This is the broad question to which I suggest that we—the Congress and the Treasury together—begin to give serious consideration. A solution to the problem of salary reduction arrangements for governmental employees may well be a logical result of that consideration.

Overall Considerations of Salary Reduction and Deductions for Employee Contributions

This issue can arise in numerous forms. Initially, if an amount is designated as an employee contribution, it is taxable to the employee and a deduction is disallowed even if, as is the case with the Civil Service Retirement System, the employee is required to make the contribution as a condition of employment.* In a salary reduction arrangement such as the type covered by the recently proposed regulations, it is generally clear that amounts involved are taken from an employee's compensation and, hence, are effectively the same as employee contributions. However, the tax treatment may be in dispute. Employers have established so-called "cafeteria" plans under which a participating employee may elect an immediate distribution of cash or the application of part or all of the money to fringe benefits, such as medical or life insurance which would be nontaxable if they had been provided directly by the employer.

Other employers maintain so-called "cash and deferred" profit-sharing plans under which employees can choose immediate payment in cash or contribution to a qualified plan. Existing revenue rulings allow a substantial degree of discrimination in these plans without loss of qualification.

Cafeteria plans and cash and deferred profit sharing plans are the subject of a special provision of ERISA (section 2006) which provided differing treatment depending upon whether the plans were in existence on June 27, 1974. This provision expired on January 1, 1978, but a two-year extension is now under consideration. In its recent Tax Reform proposals, the Administration supported continued nontaxability of benefits provided by cafeteria plans, provided the tax-favored benefits are actually provided in a nondiscriminatory manner. In the case of cash and deferred profit-sharing plans, the Treasury in its comments on H.R. 8136 has recommended that tax deferral be precluded except for a limited grandfather rule. Different rules have historically applied to so-called "teacher annuities" under section 403(b) of the Code. There, in accordance with legislative history, the regulations clearly permit salary reduction arrangements subject to the statutory limits. Finally, there are the proposed regulations on the treatment of nonqualified deferred compensation arrangements which are the subject of this hearing. Thus, we have on our hands a situation not unlike that in which a rider jumped onto his horse and galloped off in all directions.

We think, therefore, this is an opportune time to begin consideration of the possibility of consistency in the treatment of these arrangements. Leaving aside for a moment the possible revenue effect, it seems to us that a unified system could be developed under which amounts set aside at the employee's election are deductible or excludible if the arrangements are nondiscriminatory with respect to both coverage of employees and benefits (or contributions) actually provided and where excessive deferral is not created. A possible starting point would be an expansion of the proposal concerning cafeteria plans contained in the President's tax reform program to both cash and deferred profit-sharing plans and salary reduction arrangements for government employees affected by the recent proposed regulations. Consideration could also be given to imposing nondiscrimination requirements on § 403(b) annuities.

The revenue consideration is not one which can be easily set aside. Deduction of current employee contributions to qualified plans could involve a revenue loss

*Under section 414(h)(2) of the Internal Revenue Code, contributions to a qualified plan which are otherwise designated as employee contributions but which are "picked up" by a governmental employer are treated as employer contributions. Therefore, the picked-up amount is excluded from income until it is distributed or made available. See Rev. Rul. 77-462, 1977-50 I.R.B. 20.

of over $3 billion annually. Thus, we may be required to go slowly in order to prevent serious adverse revenue impact. Nevertheless, solution of this problem would be a very meaningful step forward in the employee benefit area. We, therefore, welcome any suggestions which may be forthcoming from all interested persons.

I will be pleased to answer any questions which members of the Subcommittee might have.

APPENDIX

As a result of administrative action, the amount of information which must be contained in an annual report for a governmental plan is substantially reduced in comparison to the information required for most other plans. For instance, in Form 5500 (the annual reporting form for a plan with 100 or more participants) a governmental plan need complete only lines 1 through 7, 9, 10(a), (b), (c), and (d), 11, and 17. See the attached Form 5500 for 1977, on which each question which must be answered for a governmental plan is marked with an asterisk. Similar reductions in the amount of required information apply to Form 5500–C, the annual form for plans with fewer than 100 participants. In each case, a governmental plan is also excused from filing Schedules A, B, and SSA with the annual report.

Form **5500**
Department of the Treasury
Internal Revenue Service
Department of Labor
Pension and Welfare Benefit Programs
Pension Benefit Guaranty Corporation

Annual Return/Report of Employee Benefit Plan
(With 100 or more participants)

This form is required to be filed under sections 104 and 4065 of the Employee Retirement Income Security Act of 1974 and sections 6057(b) and 6058(a) of the Internal Revenue Code, referred to as the Code.

1977
This Form is Open to Public Inspection

For the calendar plan year 1977 or fiscal plan year beginning ...., 1977 and ending ...., 19

File original of this form, including schedules and attachments, completed in ink or type.

▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner employee participant do not file this form. File Form 5500–K instead.
▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants do not file this form. File Form 5500–C instead.
▶ Welfare benefit plans with 100 or more participants complete only items 1 through 16 and item 22.
▶ Pension benefit plans, unless otherwise excepted, complete all items. Annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 8, 9 and 10.
▶ Government plans and church plans (not electing coverage under section 410(d) of the Code) complete only items 1 through 7, 9, 10(a), (b), (c), (d), 11 and 17.
▶ Plan number—Your 3 digit plan number must be entered in item 5(c), see instruction 5(c) for explanation of "plan number."
▶ If any item does not apply, enter "N/A."

1 (a) Name of plan sponsor (employer if for a single employer plan)	1 (b) Employer identification number
Address (number and street)	1 (c) Telephone number of sponsor ( )
City or town, State and ZIP code	1 (d) Employer taxable year ends Month Day Year 19
2 (a) Name of plan administrator (if other than plan sponsor)	1 (e) Business code number
Address (number and street)	2 (b) Administrator's employer identification no.
City or town, State and ZIP code	2 (c) Telephone number of administrator ( )

3 Name, address and identification number of ☐ plan sponsor and/or ☐ plan administrator as they appeared on the last return/report filed for this plan if not the same as in 1 or 2 above ▶ ....

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☐ Single-employer plan (c) ☐ Multiemployer plan (e) ☐ Multiple-employer plan (other)
(b) ☐ Plan of controlled group of corporations or common control employers (d) ☐ Multiple employer-collectively-bargained plan (f) ☐ Group insurance arrangement (of welfare plans)

5 (a) (i) Name of plan	5 (b) Effective date of plan
(ii) ☐ Check if changed since last return/report	5 (c) Enter three digit plan number ▶

6 Check at least one item in (a) or (b) and applicable items in (c). Item (d) on page 2 must be completed:
(a) Welfare benefit plan: (i) ☐ Health insurance (ii) ☐ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☐ Other (specify) ▶ ....
(b) Pension benefit plan:
(i) Defined benefit plan—(Indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶ ....
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ Other money purchase
(E) ☐ Other (specify) ▶ ....
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization (section 403(b)(1) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Date ▶ .... Signature of employer/plan sponsor ▶ ....

Date ▶ .... Signature of plan administrator ▶ ....

(c) Other plan features: (i) ☐ Thrift-savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)
(d) Is this a defined benefit plan covered under the Pension Benefit Guaranty Corporation termination insurance program? . . . . ☐ Yes ☐ No ☐ Not determined

7 Number of participants as of the end of the plan year (welfare plans complete only (a)(iv), (b), (c) and (d)):
(a) Active participants (employed or carried as active) (i) Number fully vested . . ______
(ii) Number partially vested . ______
(iii) Number nonvested . . . ______
(iv) Total . . . . ______
(b) Retired or separated participants receiving benefits . . . . ______
(c) Retired or separated participants entitled to future benefits . . . . ______
(d) Subtotal, sum of (a), (b) and (c) . . . . ______
(e) Deceased participants whose beneficiaries are receiving or are entitled to receive benefits . . . . ______
(f) Total, (d) plus (e) . . . . ______

	Yes	No
(g) During the plan year, was any participant(s) separated from service with a deferred vested benefit? If "Yes," see instructions.		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was any amendment to this plan adopted in this plan year?		
(b) If "Yes," (i) And if a material modification, has a summary description of this modification—		
(A) Been sent to plan participants?		
(B) Been filed with DOL?		
(ii) Does any such amendment result in the reduction of the accrued benefit of any participant under the plan?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS with respect to such amendment?		
(c) Enter the date the most recent amendment was adopted . . ▶ Month Day Year		
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during this plan year or any prior plan year?		
(b) If "Yes," were all trust assets distributed to participants or beneficiaries or transferred to another plan?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		

10 (a) In this plan year, was this plan merged or consolidated into another plan or were assets or liabilities transferred to another plan? If "Yes," identify other plan(s):

except

(b) Name of plan(s) ▶	(c) Employer identification number(s)	(d) Plan number(s)

(e))

(e) Has Form 5310 been filed with IRS? . . . . ☐ Yes ☐ No

11 Indicate funding arrangement:
(a) ☐ Trust (benefits provided in whole from trust funds)
(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts
(c) ☐ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts
(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above
(e) ☐ Other (specify) ▶ ......
(f) If (b) or (c) is checked, enter the number of Schedule A's (Form 5500) which are attached . . . . ▶

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? . ☐ Yes ☐ No
If "Yes," furnish the following information:

a. Name	b. Official plan position	c. Relationship to employer, employee organization or person known to be a party-in-interest	d. Gross salary or allowances paid by plan	e. Fees and commissions paid by plan	f. Nature of service code (see instructions)

13 Plan assets and liabilities at the beginning and the end of the plan year (list all assets and liabilities at current value). If plan is funded entirely by allocated insurance contracts for which no trust is involved, check box and do not complete this item . . ☐

Note: *Include all plan assets and liabilities of a trust or separately maintained fund. (If more than one trust/fund, report on a combined basis.) Include unallocated, but not allocated, insurance contracts. Round off amounts to nearest dollar*

Assets	a. Beginning of year	b. End of year
(a) Cash: (i) On hand		
(ii) In bank: (A) Certificates of deposit		
(B) Other interest bearing		
(C) Noninterest bearing		
(iii) Total cash		
(b) Receivables: (i) Employer contributions		
(ii) Employee contributions		
(iii) Other		
(iv) Reserve for doubtful accounts		
(v) Net receivables, sum of (i), (ii) and (iii) minus (iv)		
(c) General investments other than party-in-interest investments:		
(i) U.S. Government securities:		
(A) Long term		
(B) Short term		
(ii) State and municipal securities		
(iii) Corporate debt instruments:		
(A) Long term		
(B) Short term		
(iv) Corporate stocks: (A) Preferred		
(B) Common		
(v) Shares of a registered investment company		
(vi) Real estate		
(vii) Mortgages		
(viii) Loans other than mortgages		
(ix) Value of interest in pooled fund(s)		
(x) Other investments		
(xi) Total general investments, sum of (i) through (x)		
(d) Party-in-interest investments:		
(i) Corporate debt instruments		
(ii) Corporate stocks: (A) Preferred		
(B) Common		
(iii) Real estate		
(iv) Mortgages		
(v) Loans other than mortgages		
(vi) Other investments		
(vii) Total party-in-interest investments, sum of (i) through (vi)		
(e) Buildings and other depreciable property		
(f) Value of unallocated insurance contracts:		
(i) Separate accounts		
(ii) Other		
(iii) Total, (i) plus (ii)		
(g) Other assets		
(h) Total assets, sum of (a)(iii), (b)(v), (c)(xi), (d)(vii), (e), (f)(iii) and (g)		
Liabilities		
(i) Payables: (i) Plan claims		
(ii) Other payables		
(iii) Total payables, (i) plus (ii)		
(j) Acquisition indebtedness		
(k) Other liabilities		
(l) Total liabilities, sum of (i)(iii), (j) and (k)		
(m) Net assets, (h) less (l)		
(n) During the plan year what were the:		
(i) Total cost of acquisitions for common stock?		
(ii) Total proceeds from dispositions of common stock?		

14 Plan income, expenses and changes in net assets for the plan year:

Note: *Include all income and expenses of a trust(s) or separately maintained fund(s). Round off amounts to nearest dollar.*

Income	a. Amount	b. Total
(a) Contributions received or receivable in cash from—		
(i) Employer(s) (including contributions on behalf of self-employed individuals)		
(ii) Employees		
(iii) Others		
(b) Noncash contributions (specify nature and by whom made) ▶		
(c) Total contributions, sum of (a) and (b)		
(d) Earnings from investments—		
(i) Interest		
(ii) Dividends		
(iii) Rents		
(iv) Royalties		
(e) Net realized gain (loss) on sale or exchange of assets—		
(i) Aggregate proceeds		
(ii) Aggregate costs		
(f) Other income (specify) ▶		
(g) Total income, sum of (c) through (f)		

Expenses	a. Amount	b. Total
(h) Distribution of benefits and payments to provide benefits—		
(i) Directly to participants or their beneficiaries		
(ii) To insurance carrier or similar organization for provision of benefits		
(iii) To other organizations or individuals providing welfare benefits		
(i) Interest expense		
(j) Administrative expenses—		
(i) Salaries and allowances		
(ii) Fees and commissions		
(iii) Insurance premiums for Pension Benefit Guaranty Corporation		
(iv) Insurance premiums for fiduciary insurance other than bonding		
(v) Other administrative expenses		
(k) Other expenses (specify) ▶		
(l) Total expenses, sum of (h) through (k)		
(m) Net income (expenses), (g) minus (l)		

	a. Amount	b. Total
(n) Change in net assets—		
(i) Unrealized appreciation (depreciation) of assets		
(ii) Other changes (specify) ▶		
(o) Net increase (decrease) in net assets for the year, (m) plus (n)		
(p) Net assets at beginning of year, line 13(m), column a		
(q) Net assets at end of year, (o) plus (p) (equals line 13(m), column b)		

15 Has there been any change since the last report in the appointment of any trustee, accountant, insurance carrier, enrolled actuary, administrator, investment manager or custodian?	Yes	No

If "Yes," explain and include the name, position, address and telephone number of the individual who left or was removed by the plan ▶

	Yes	No
16 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?		
(b) If "Yes," enter the maximum amount of loss recoverable ▶		
(c) Enter the name of the surety company ▶		
(d) Does the plan, or a known party-in-interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		

17 Information about employees of employer at end of the plan year (Plans not purporting to satisfy the percentage tests of section 410(b)(1)(A) of the Code complete only (a) below and see specific instructions).

(a) Total number of employees	
(b) Number of employees excluded under the plan—	
(i) Minimum age or years of service	
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining	
(iii) Nonresident aliens who receive no earned income from United States sources	
(iv) Total excluded, sum of (i), (ii) and (iii)	
(c) Total number of employees not excluded, (a) less (b)(iv)	
(d) Employees ineligible (specify reason) ▶	
(e) Employees eligible to participate, (c) less (d)	
(f) Employees eligible but not participating	
(g) Employees participating, (e) less (f)	

	Yes	No
18 Is this plan an adoption of a: (a) ☐ Master/prototype, (b) ☐ Field prototype, (c) ☐ Pattern or (d) ☐ Model plan? If "Yes," enter the four or eight digit IRS serial number (see instructions) ▶		
19 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code?		
(b) Have you requested or received a determination letter from the IRS for this plan?		
20 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
21 (a) Is this a defined benefit plan subject to the minimum funding standards for this plan year? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards? (If a waiver was granted, see instructions.)		

If "Yes," complete (i), (ii) and (iii) below:

(i) Amount of employer contribution required for the plan year under section 412 of the Code	
(ii) Amount of contribution paid by the employer for the plan year	
Enter date of last payment by employer ▶ Month .... Day .... Year	
(iii) Funding deficiency, excess, if any, of (i) over (ii)	

	Yes	No
22 The following questions relate to the plan year. If (a)(i), (ii), (iii), (iv) or (v) is checked "Yes," schedules of such items in the format set forth in the instructions are required to be attached to this form.		
(a) (i) Did the plan have assets held for investment?		
(ii) Did any non exempt transaction involving plan assets involve a party known to be a party-in-interest?		
(iii) Were any loans by the plan or fixed income obligations due the plan in default as of the close of the plan year or classified during the year as uncollectable?		
(iv) Were any leases to which the plan was a party in default or classified during the year as uncollectable?		
(v) Were any plan transactions or series of transactions in excess of 3% of the current value of plan assets?		
(b) The accountant's opinion is ☐ not required or ☐ required, attached to this form, and is— (i) ☐ Unqualified (ii) ☐ Qualified (iii) ☐ Adverse (iv) ☐ Other (explain)		

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	Yes	No
23 Complete this item only if you answered "Yes," to item 6(d)		
Did one or more of the reportable events or other events requiring notice to the Pension Benefit Guaranty Corporation occur during this plan year?		
If "Yes," complete (a) through (h) below.		
(a) Notification by the Internal Revenue Service that the plan has ceased to be a plan as described in Section 4021(a)(2) of ERISA or a determination by the Secretary of Labor of non-compliance with Title I of ERISA		
(b) A decrease in active participants to the extent specified in the instructions		
(c) A determination by the Internal Revenue Service that there has been a termination or partial termination of the plan within the meaning of Section 411(d)(3) of the Code		
(d) An inability to pay benefits when due		
(e) A distribution to a Substantial Owner to the extent specified in the instructions		
(f) An alternative method of compliance has been prescribed for this plan by the Secretary of Labor under Section 110 of ERISA		
(g) A cessation of operations at a facility to the extent specified in the instructions		
(h) A withdrawal of a substantial employer		

If additional space is required for any item, attach additional sheets the same size as this form.

Senator BENTSEN. Our next witness is Mr. William Welsh, American Federation of State, County & Municipal Employees, accompanied by Mr. Robert Kalman and Mr. Michael Leibig.

Gentlemen, if you will come forward and if you will limit your testimony to not in excess of 15 minutes and your full testimony will be included for the record.

STATEMENT OF WILLIAM B. WELSH, AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES, ACCOMPANIED BY ROBERT KALMAN AND MICHAEL LEIBIG

Mr. WELSH. Mr. Chairman, I am Bill Welsh, the executive director for governmental affairs of the American Federation of State, County, and Municipal Employees (AFSCME). Our union has over 750,000 members and, for bargaining purposes, represents about a million and a quarter State and local government employees across the country.

May I say at the outset, that we welcome your attention to this very critical and difficult question of the proper role of the Federal Government in assuming the protection of the pension rights of State and local government employees and retirees.

I think this is an area that has been long neglected by the Congress. But through the kinds of studies that are being conducted in the House by Congressmen Dent and Ehrlenborn's pension task force and the kind of initiative that your subcommittee has taken on this, we are seeing only the beginnings of a very close scrutiny by the Congress of the appropriate role that should be played by the Federal Government in the public pension area.

I would also say, Mr. Chairman, that the issues raised by the first witnesses, regarding the constitutional basis on which the Congress and the Federal Government can look into this area, are very much in question. If it would be helpful to the committee, we would be glad to add to our testimony a memorandum that would at least lay out what we believe are some of the constitutional bases on which the Congress can proceed, especially, since there was reference early in the first testimony to the *League of Cities* case and so on, as possibly obviating the necessity or the right of the Federal Government to act in this area.

Senator BENTSEN. I think that would be helpful.

[The following was subsequently supplied for the record:]

Additional Comments to Statement of William B. Welsh, American Federation of State, County and Municipal Employees, AFL–CIO

THE CONSTITUTIONAL QUESTION: THE NATIONAL LEAGUE OF CITIES V. USERY AND PUBLIC PENSION REFORM

In *The National League of Cities* v. *Usery* and *California* v. *Usery*, the United States Supreme Court ruled in 1976 that Congress exceeded its authority under the Commerce Caluse of the United States Constitution when it enacted legislation extending mandatory minimum wage and overtime provisions of the Fair Labor Standards Act to almost all state and local government employees.[1]

Since the *National League of Cities* decision, the debate over federal action to reform state and local pensions is too often sidetraced by the issue of Congress' authority to legislate in the area.[2]

Analysis of this issue must recognize the extent of federal power and responsibility remaining after the decision. Three points are especially important:

Congressional regulation of state and local activity based on the spending power, the taxing power, the Fourteenth Amendment, or other non-commerce powers present no *National League of Cities* problem.

Congressional regulation or guidelines which are not mandatory present no *National League of Cities* problem.

Even in cases where *The National League of Cities* issue is suggested, the question is one of whether a direct displacement of state sovereignty has occured. Unless Congress acts under the Commerce Clause "to directly displace state freedom to structure integral operation in areas of traditional governmental functions". *The National League of Cities* case is not a problem.

No system of public employee pension reform would mandate either the existence of a state or local pension program or the level of pension benefits provided. A state or local government is free, of course, to determine by itself what pension benefits it provides. The issues is whether a reform system should be established which would insure that benefits promised under a voluntarily adopted pension plan are paid, and whether the plan operates without discrimination, dishonesty, or abuse.

Consideration of federal public pension reform raises different issues, depending on the scope of reform discussed. Reform of reporting and disclosure requirements is different from reform which also includes strict fiduciary standards; which is quite different again from reform which adds participation, vesting, and benefit accrual rules; which is still different from adding mandatory funding requirements. Furthermore, reforms which require that a plan meet standards to qualify for a special tax treatment or other federal benefits differ from mandatory systems which seek enforcement through civil, or even criminal, penalties.[3]

Public pension reform consistent with *The National League of Cities* decision *can* clearly be achieved in most, of not all, of these areas.

The Federal Government can play an active role in the reform of public pension plans.

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[1] *The National League of Cities v. Usery* and *California v. Usery*, U.S. Supreme Court, No. 74–878, 44 Law Week 4977, June 24, 1976; See Michael Gordon, "The Politics and Perils of Reforming Public Employee Pension Plans," *Employee Benefits Journal*, Fall 1976, pp. 2–7 and 32–33; and 93 *BNA Pension Reporter*, July 5, 1976, p. A–17.

[2] See, for example, Gordon, note 1, above, and Dallas Salisbury, "Public Employee Benefit Plan Reform: A Non-Legislative Alternative," *Employee Benefits Journal*, Fall 1977, pp. 6–11 and 27.

[3] In *North Carolina v. Califano*, the United States Supreme Court unanimously affirmed a lower federal courts rejection of a *National League of Cities* based Constitutional attack on requirements of National Health Planning and Resources Development Act of 1974, 42 U.S.C. § 300k et seq., that any state, in order to qualify for financial grants under federal health program, must have a certificate of need program, applicable to both public and private health facilities, under which "only those services, facilities, and organisations found to be needed shall be offered or developed in the State"; even though North Carolina Constitution, as construed by state Supreme Court, forbids the certificate of need mechanism and, therefore, requires amendment to permit compliance with Act and to avoid loss of about 50 million dollars in federal aid. *North Carolina v. Califano*, No. 77–971, *aff'd*, 46 U.S.L.W. 3949 (U.S. April 18, 1978).

Mr. WELSH. Mr. Chairman, AFSCME is opposed to the spirit and intent of S. 1587. This bill would exempt State and local government pension plans from Federal tax qualification and disclosure requirements under the code and the reporting requirements under ERISA.

It is our position that Federal tax support should not be given to pension plans which discriminate in favor of highly paid individuals or are managed in an abusive manner. Federal policy must condemn pension discrimination and prohibited practices wherever they occur.

I would say, Mr. Chairman, in that regard, the committee needs evidence with regards to the difficulties which many of these plans face. We would refer you to the recent study by the 20th Century Fund under the authorship of Mr. Louis Kohlmeier, who has documented very carefully the widespread abuses in the management of public pension funds. I would simply say, we believe that this study provides adequate evidence warranting the continued concern of the Congress.

And also, Mr. Chairman, regarding the recent point that you made about the New York City funds, if it had not been for these provisions in the Internal Revenue Code when the crisis occurred in New York, the use of the funds and the protection provided to the trustees and others responsible for the very difficult decisions that they were faced with would not have been there.

I think, in retrospect, the importance that these rules and the protection they provided is obvious. It gave the Congress, and those trustees, a basis upon which to at least have some protection in the very difficult conflict that they were faced with in terms of the investment decisions that had to be made.

Let me say, Mr. Chairman, that the union has communicated with the IRS with regards to these rules. Attached to our statement is a communication from President Wurf to IRS Commissioner Kurtz, indicating our belief that the existing Internal Revenue Code qualification rules, originally designed for private plans, are not really designed to protect and adequately meet all of the problems that are presented by public plans. These rules should be modified and changed by the IRS in a way that would remove some of the most difficult aspects of public plan compliance with existing regulations. It is essentially in that regard that our letter recommended that the qualifications standards more realistically address the question of what Internal Revenue Code standards should be for public plans, within the framework of modifying the rules and not through legislative change of the present statutes.

Those suggestions have been forwarded to the Treasury Department and we are hopeful, as we indicated in our testimony this morning, that those modifications can be made.

Basically, the point we would like to leave with you this morning is that the issues raised by S. 1587 really are only one aspect of Federal policy towards State and local pension plans that must be thoroughly addressed by the Congress and the administration.

To date, it is obvious that there is no consistent, established national guidelines on reporting and disclosure, conflicts of interest, or funding and benefit enforcement for State and local plans. In that regard, we think it would be appropriate for the committee to set aside S. 1587 and proceed with its own study in conjunction with the kinds of congressional studies that are underway by the House Labor

Standards Subcommittee's Pension Task Force, the suggestions by the President that shortly may very well result in the creation of a major commission studying retirement policy, and the kinds of studies that are underway by the Civil Service Commission, HEW, and the Department of Labor, which are focusing on such fundamental issues as full social security coverage for State and local employees.

It is in this total context that we believe that Congress can look at, and have, the background information to formulate a much broader, consistent policy as to the appropriate role which the Federal Government should play in protecting State and local plans and their participants and beneficiaries.

It would be a mistake, we believe, for Congress to consider various aspects of the public pension problem separately and independently from the broader problem. It would be more prudent to evaluate each public pension issue in the context of the entire public pension problem and the significant impact that public pensions have on State and local fiscal problems as well as on employees and beneficiaries who participate in these plans.

Mr. Chairman, it is clear to us that, as the Congress deals more and more with various aspects of the fiscal urban crisis; as State and local governments appear before your committee requesting support as we do for revenue sharing and special antirecessionary countercyclical aid, that in that total concern of Congress with the fiscal well-being of our State and local governments, there is an equal need to be concerned with public pension plans, which have proven to be a very important aspect of the fiscal well-being of State and local governments.

There is no question in our mind that many States and cities have unfunded plans. In a matter of a decade, these State and local governments are going to be faced with meeting extraordinary current liability obligations out of their operating budgets to simply maintain the payments under their plans. And, if the New York fiscal crisis is an example of what we will be going through, when you confront a major city or State with a completely unfunded plan and look at the potential impact that that would have on the fiscal well-being of that community 5 and 10 years from now, when those obligations become due, then it seems to me that now is the time for the Congress and the administration to start planning and looking at the problem in a much broader context.

So we would hope that, as you proceed with this issue, you begin to treat this problem in the context of the appropriate responsibility of Congress in dealing with the fiscal well-being of cities and States, as you would other proposals for direct Federal aid that come before your committee.

With regard to the other subject of the hearing, Mr. Chairman, nonqualified deferred compensation plans, AFSCME believes that the tax deferral features of these plans should be retained. IRS' February 3d proposed regulation would foreclose this as one of the few opportunities moderate-income workers now have to further their retirement income security through deferred compensation, which is so often dominated by the wealthier segments of our society.

Therefore, AFSCME believes that this committee should give serious consideration to Senator Gravel's bill, S. 2627, which would retain the tax deferral features of these plans for public employees.

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Mr. Chairman, this concludes the summary of our testimony which we have filed with the committee, and I would be glad to answer any questions that the committee has in terms of our views of the bill or the broader issues.

Senator BENTSEN. Thank you very much, Mr. Welsh.

When I look at the situation on the New York City pension plan where they have, just by July, having about 35 percent of those assets invested in securities of the city of New York, at the tough spot the trustees have been placed in, and how the pension plans have been used, to say that we should have, you know, that that is none of our business. I cannot help but think that if those funds become insolvent, the next thing we will find, you will find delegations down here talking about the Federal Government extending the guarantees to the pensions, as we have done to the plans under ERISA, it seems to me that we, too, have certain obligations, if tax advantages accrue, in trying to see that these pensioners are protected.

In that regard, I concur with your statement.

Mr. WELSH. Mr. Chairman, regarding the dilemma that the trustees are placed in, I think it is accurate to say that the majority of those trustees of the New York plan were not union officials, but the union officials obviously were equally involved in the decision processes and so on. But the dilemma that they were placed in, and that they continue to be placed in, that very difficult situation, is one which no one would want to have been in themselves.

And the Congress, I think, now more clearly understands that difficulty than they did 2 or 3 years ago when this was not carefully looked at in the New York financing plan. And I would hope that, in the total effort this year by the Congress, as it considers the administration's proposals and so on, that one of the principal concerns, as you have indicated, would be the protection of the employees, the existing employees and the pensioners' rights under those plans so that we are not, in effect, further risking those benefits that are so key and important.

One of the interesting things that Senator Stone might be aware of is that there is a very substantial number of retired New York City employees living in his State. These retirees have an incredibly genuine interest in the viability of those plans and therefore, we would hope that, as the Senator considers this bill, he would be aware of the fact that the implications go far beyond just the immediate State employee plan in Florida or other local plans there. They directly affect many people living in Florida because many retirees there rely on the New York City plans and other public plans back in their home States for their income security.

Senator BENTSEN. The chairman of this subcommittee has come to the reluctant conclusion that I am going to have to support the extension of Public Law 94-236, but trying to find a way to exercise a discipline that will expedite a working out of those securities from those plans as early as can reasonably and feasibly be done is not an easy one.

I appreciate your testimony very much.

Mr. WELSH. We would support you, Senator, and want to work closely with you as we try to extract ourselves from that unfortunate situation.

Thank you, very much.

[The prepared statement of Mr. Welsh follows:]

STATEMENT OF WILLIAM B. WELSH, EXECUTIVE DIRECTOR FOR GOVERNMENTAL AFFAIRS OF THE AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES, AFL-CIO

SUMMARY

1. AFSCME is *opposed* to the spirit and intent of S. 1587. This bill would exempt state and local government pension plans from federal tax qualification and disclosure requirements under the Internal Revenue Code and certain reporting requirements under ERISA.

2. It is AFSCME's position that federal tax support should not be given to pension plans which discriminate in favor of highly paid individuals or are managed in an abusive manner. Federal policy must condemn pension discriminaton and prohibited practices whenever they occur.

3. Historically, IRS has not enforced Internal Revenue Code pension rules in the public sector. Until recently, public plans generally have been ignored by IRS.

4. Last year, IRS apparently began to take its obligation to public plans seriously, taking the position that state and local plans must file annual returns, Form 5500 and 5500-C, with the IRS—the same ones ERISA requires private plans to file.

5. There is no question that the language of ERISA, as it applies to IRS' obligations, does not contain an exception for public plans.

6. These recent initiatives by IRS have generated considerable opposition by public employers and public pension fund money managers. These are the groups that support S. 1587. Do they fear that if public plans were required to file annual reports with IRS, the reports will show that many public plans do not comply with Internal Revenue Code qualification standards?

7. Jerry Wurf, President of AFSCME, explained our position on IRS enforcement of these rules in the public sector in a letter last September to IRS Commissioner Kurtz.

(*a*) Our position, President Wurf stated, is clearly in favor of IRS enforcement of anti-discrimination and anti-abuse rules in the public sector.

(*b*) However, AFSCME believes that existing Internal Revenue Code qualification rules, originally designed for private plans, should recognize more fully public plan problems. Current regulations do not always recognize or reflect the unique features that differentiate public from private plans.

(*c*) Therefore, President Wurf recommended that qualification standards more realistic than present rules be designed for public plans and vigorously enforced by IRS.

(*d*) IRS hs forwarded our proposal to the Treasury Department's Tax Legislative Counsel for further consideration.

8. The issue raised by S. 1587 is but one aspect of federal policy toward state and local plans that must be addressed thoroughly by Congress. To date, there is no consistent, established national guidelines on reporting and disclosure, conflicts of interest, or funding and benefit enforcement for state and local plans.

9. Deferral of S. 1587 is essential when so many broad studies of the public pension issue are underway. These include the activities of the House Labor Standards Subcommittee's Pension Task Force, President Carter's Retirement Policy Commission, and HEW's study of universal Social Security coverage.

10. These activities are important prerequisites to the development of a coherent national policy on public pension plans. It would be a mistake to consider each issue separately, including the issue of S. 1587.

11. It would be more prudent to evaluate each public pension issue in the context of the entire public pension problem and the significant impact which public pensions have on state and local fiscal problems, as well as on the employees and beneficiaries who are covered by these plans.

12. With regard to the other subject of this hearing, nonqualified deferred compensation plans, AFSCME believes that the tax deferral feature of these plans should be retained.

13. IRS' February 3 proposed regulation would foreclose this as one of the few opportunities moderate income workers now have to further their retirement income security through deferred compensation, which is so often dominated by the wealthy. Therefore, AFSCME believes that this committee should give serious

consideration to Senator Gravel's bill, S. 2627, which would restain the tax deferral feature of these plans for public employees.

STATEMENT

Mr. Chairman and members of the subcommittee, I am William B. Welsh, Executive Director for Governmental Affairs of the American Federation of State, County and Municipal Employees (AFSCME). Our union currently has over 750,000 members and represents over 1.2 million state and local government employees.

Accompanying me today are Robert W. Kalman, Assistant Director of our Public Policy Analysis Department and Michael T. Leibig, an attorney with our General Counsel's office.

We are pleased to be here today to discuss S. 1587 and certain deferred compensation plans with the Subcommittee. We feel these are important issues that deserve the most careful attention and deliberation by this committee.

We are opposed to the spirit and intent of S. 1587. This bill would exempt state and local government pension plans from federal tax qualification and disclosure requirements under the Internal Revenue Code and certain reporting requirements under the Employee Retirement Income Security Act of 1974 (ERISA). These rules are designed to insure that special tax treatment is afforded only to pension plans which meet certain federal requirements. These requirements are designed to prevent plans from discriminating in favor of highly paid individuals and to prohibit abuse by those who control the plans.

You will recall that last week at this committee's hearings on New York City's fiscal situation, serious consideration was given to a limited exception to one of these rules with respect to the City's pension funds. The serious nature of the issues raised at those hearings underscores the profound implications of granting a blanket approval of public pension discrimination and prohibited practices, as proposed in S. 1587.

The Internal Revenue Code rules have been vigorously enforced in the private sector. The Internal Revenue Service recognized in a 1972 Missouri case (Revenue Ruling 72–14 (1977) that they also apply in the public sector. Historically, however, IRS has not enforced these rules in the public sector. Until recently, public plans generally have been ignored by IRS.

It is AFSCME's position that Federal tax support should not be given to pension plans which discriminate in favor of highly paid individuals or are managed in an abusive manner. Federal policy must condemn pension discrimination and prohibited practices whenever they occur.

Last year, IRS apparently began to take its obligation to public plans seriously. In April 1977, it took the position that state and local plans must file annual returns, Form 5500 or Form 5500–C, with the IRS. These forms are the same ones ERISA requires private plans to file with IRS. There is no question that the language of ERISA, as it applies to IRS' obligations, does not contain an exception for public plans.

In August 1977, prior to the first filing deadline, IRS reduced the reporting requirements for state and local plans. The remaining requirements are minimal, requiring only that public plans report their name, number of participants, and a few other matters. Since that time, the deadline for filing has been extended by IRS from December 1977 until mid-1978.

These recent initiatives by IRS have generated considerable opposition by public employers and public pension fund money managers. These are the groups that support S. 1587. Do they fear that if public plans were required to file annual reports with IRS, the reports will show that many public plans do not comply with Internal Revenue Code qualification standards?

This outcry of opposition also has overtones of "federal encroachment" into state and local government business. Major proponents of S. 1587 are representatives of plan management and the private financial community.

Jerry Wurf, President of AFSCME, explained our position on IRS enforcement of these rules in the public sector in a letter last September to IRS Commissioner Kurtz. A copy of this letter and IRS' response are attached to our written statement.

Our position is clearly in favor of IRS enforcement of anti-discrimination and anti-abuse rules in the public sector. However, as President Wurf pointed out to Commissioner Kurtz, AFSCME strongly believes that existing Internal Revenue Code qualification rules, which were originally designed for private sector plans, should recognize more fully public plan problems. Current regulations do not always recognize or reflect the unique features that differentiate public sector plans from private plans. Therefore, President Wurf has recommended that qualification standards more realistic than present rules, be designed for public plans and vigorously enforced by IRS. IRS has forwarded our proposal to the Treasury Department's Tax Legislative Counsel for further consideration.

Enactment of S. 1587 would represent an act against the reform of public employee pensions.

Mr. Chairman, the issue raised by S. 1587 is but one aspect of federal policy toward state and local plans that must be addressed thoroughly by the Congress. To date, there is no consistent, established national guidelines on reporting and disclosure, conflicts of interest, or funding and benefit enforcement for state and local pension plans. The Internal Revenue Code's tax qualification and plan disclosure rules are one of the few protections available to public pension plan participants.

The IRS is currently studying methods of making their qualification rules more realistic. The problems of state and local pension plans are being examined elsewhere in the federal system. Federal jobs programs, such as the Comprehensive Employment and Training Act (CETA), face complicated questions with regard to participation by CETA workers in state and local plans. ERISA requires the development of fair regulations by the Labor and Treasury Departments which at least define "governmental plan" so that public plans will know whether or not they are subject to certain provisions of this pension law. Each of these problems and many others, including the impact of public pension plans on the viability of state and local governments, requires increased federal understanding of these plans.

ERISA requires the Congress to undertake a thorough study of these plans to evaluate whether federal regulation of public pensions is needed. A major study of these plans is forthcoming by the House Labor Standards Subcommittee's Pension Task Force. Mr. Chairman, we understand that concurrent with this hearing, the House Labor Standards Subcommittee is meeting to consider approval of the Task Force's report, one segment of which covers the applicability of Internal Revenue Code rules to the public sector.

President Carter also has recognized the problems of federal policy toward public plans and, therefore, is forming a Retirement Policy Commission to make a thorough review of them. Most recently, a study of the related issue of universal Social Security coverage by the Secretary of Health, Education and Welfare was mandated by the 1977 Social Security Amendments.

Deferral of S. 1587 is essential when so many broad studies of the public pension issue are underway.

Mr. Chairman, we feel that these activities are important prerequisites to the development of a coherent national policy on public pension plans. We welcome your Committee's interest in this policy debate. The Committee should consider all the issues that relate to public plans. It would be a mistake to consider each issue separately, including the one raised by S. 1587. It would be more prudent to evaluate each public pension issue in the context of the entire public pension problem and the significant impact which public pensions have on state and local fiscal problems, as well as on the employees and beneficiaries who are covered by these plans.

Mr. Chairman, before closing, I would like to comment briefly on IRS' February 3, 1978 proposed regulation on nonqualified deferred compensation plans—"Deferred Tax Treatment of Amounts of Compensatory Payments".

The purpose of nonqualified deferred compensation plans is to give workers an opportunity to enhance their retirement security by voluntarily deferring part of their income to these plans. After a plan has received a favorable ruling from IRS, workers have been permitted to postpone the federal tax liability on their contributions to these plans until retirement or whenever else they are entitled to receive the benefits of the plan.

These plans have grown in popularity during the past few years, especially among public employees. As a result, more than 35 states and many local governments have implemented these plans.

Mr. Chairman, IRS' February 3 proposed regulation would foreclose one of the few opportunities moderate income workers now have to further their retirement income security through deferred compensation, which is so often dominated by the wealthy. IRS' proposed deferred compensation regulation would eliminate an opportunity for these workers to enhance their own income security. Therefore, we believe that your committee should give serious consideration to Senator Gravel's bill, S. 2627, which would retain the tax deferral feature of these plans for public employees.

Mr. Chairman, this concludes my testimony. I would like to thank you for this opportunity to present our views and concerns here today.

AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES,
Washington, D.C., September 9, 1977.

Mr. JEROME KURTZ,
Commissioner, Internal Revenue Service,
Washington, D.C. 20224

DEAR COMMISSIONER KURTZ: I understand that the Internal Revenue Service is reviewing issues concerning discrimination and taxability of the income of trusts relating to state and local government employee retirement plans. This consideration includes the reevaluation of IRS' position with regard to reporting and disclosure of governmental plans.

In April, 1977, the Internal Revenue Service took the position that governmental employee pension benefit plans must file annual returns, Form 5500 or Form 5500–C, with the IRS. On August 18, 1977, the Internal Revenue Service announced an extension of the due date and reduced the reporting requirements for governmental plans. The remaining reporting requirements are minimal, requiring only that governmental plans report their name, number of participants, and a few other matters. Nevertheless, this action has generated considerable discussion in the press and elsewhere.

On August 26, 1977, a story appeared in The Wall Street Journal by Mitchell C. Lynch, entitled "Confrontation Nearing Over Tax Status of Local, State Employee Pension Funds". Lynch reported opposition to IRS' interest in reporting and disclosure of public employee pension plans. He cited criticism by the State of Massachusetts; by Carmen Elio, Chairman of the Massachusetts Retirement Law Commission; and by the Municipal Finance Officers Association. The article, also, indicated that IRS was considering a retreat from its strong position in defense of the interests of public employee plan participants and beneficiaries.

On August 27th, a column on state and local government plans, by Neal Peirce, appeared in the Washington Post and followed a similar line.

I note that the criticism which IRS had been receiving with regard to its increasingly responsible position concerning reporting and disclosure and qualification of public employee pension plans emanates almost entirely from representatives of public employers, pension fund professionals, and pension money managers. It is important that in looking at this issue, IRS also consider the paramount interest of public employee participants and beneficiaries of these plans.

The employer and money manager interests exaggerate the consequence of meeting a simple reporting and disclosure requirement. Futhermore, the general tax policy theory of reporting and qualification standards exists in order to achieve a clearly proper federal policy; that is, tax policy support for retirement income security. These tax policies were developed to protect working Americans in their later years, and should be administered primarily with a view toward affording such protection.

Naturally, I am very concerned that IRS, in reviewing or reevaluating its decisions with regard to reporting and disclosure in the public sector, consider the interests of public employee pension plan participants and beneficiaries.

With regard to the qualification standards themselves, it has been widely recognized that application of the traditional IRS tax qualification standards to public plans has been less than fully realistic because of the unique features that differentiate public and private sector pension plans. I might add that enforcement of these standards in the public sector also has been inconsistent.

The proper posture for IRS is one which would entail the development of qualification standards that more adequately reflect the true condition of public employee pension plans, rather than the wholesale application to public plans of present qualification standards, which were developed to deal with private "corporate" plans. The tax policies which current qualification standards were designed to carry out can be protected in the public sector by realistic and modern standards designed expressly for public plans. Such standards clearly lie within the authority of IRS and could be issued as a subsection of the current standards for private plans. If we could be of assistance to IRS in the development of these standards, please let me know.

I appreciate the responsibility with which the IRS has entered the public employee pension area and trust that it is indicative of a new trend by IRS to meet the problems of public employee pension plans with realism and maturity. I look forward to your future initiatives in this area.

Sincerely,

JERRY WURF,
International President.

INTERNAL REVENUE SERVICE,
DEPARTMENT OF THE TREASURY,
Washington, D.C., January 31, 1978.

Mr. JERRY WURF,
President, AFSCME,
Washington, D.C.

DEAR Mr. WURF: This is response to your letter of September 9, 1977, to Commissioner Kurtz concerning discrimination and taxability of the income of trusts maintained by governmental retirement plans and reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 (ERISA) with regard to such plans.

In your letter, you indicate that you believe that the reporting and disclosure requirements of ERISA should apply to governmental plans. With respect to qualification of governmental plans, you recommend that, in lieu of applying its qualification standards which were developed for private plans to governmental plans, the Service develop specific qualification standards which apply to governmental employee benefit plans.

Your comments and recommendations on these matters are greatly appreciated and will be considered during our review of the general question of the impact of ERISA on governmental plans. Since, you have made specific recommendations for change in the tax code, we are forwarding your letter to the Tax Legislative Counsel.

Sincerely yours,

A. D. FIELDS,
Chief, Employee Plans Technical Branch.

Senator BENTSEN. Our next group of witnesses will be a panel consisting of Mr. Michael Mett, supervisor, Milwaukee County Board of Supervisors; State Senator Paul E. Hanaway of Rhode Island; Mayor Richard Garver, Peoria, Ill.

I understand Mr. Mett will be spokesman, and if you would limit your—I understand Mayor Waldmeier will be substituting there.

Gentlemen, we are delighted to have you. Please proceed.

STATEMENT OF R. MICHAEL METT, SUPERVISOR, MILWAUKEE COUNTY, WIS.

Mr. METT. Mr. Chairman, thank you for this opportunity for appearing, allowing us to appear. My name is Michael Mett. I am a county supervisor in Milwaukee, Wis., and chairman of the Interim Pension Task Force authorized by the National Association of Counties Board of Directors in 1976 to study the status of county pension plans and the impact of proposed Federal regulations. The national association represents 1,700 counties.

I am delighted to participate on this panel with State Senator Hanaway and Mayor Waldmeier. My background in public finance—and I will summarize my statement, Mr. Chairman—stems, in part, from my experience as counsel and the acting securities commissioner from the State of Wisconsin and my service as an elected local official since 1973.

Last summer the National Association of Counties passed a resolution urging Congress to pass legislation introduced by Senator Stone, S. 1587, which exempts public employer retirement systems from Federal income tax liability and the burden of what we believe to be unnecessary reporting requirements.

This resolution is attached to my statement.

County officials are increasingly concerned about adverse rulings that adversely affect county, State, and city finances. These rulings have been issued without notification to the public interest groups and, in our opinion, with all due respect, they are based on policies which, we believe, are beyond the Treasury Department's statutory and constitutional authority.

For instance, the IRS view that ERISA mandates the filing of annual returns by State and local governmental benefit plans represents, in our opinion, a major State, Federal, and local jurisdiction determination. An examination of the language of ERISA and the Internal Revenue Code by Legislative Counsel Robert Doty from the Municipal Finance Officers Association, we believe, offers compelling evidence that ERISA does not apply, in this respect and in other respects, to State and local government plans.

Points cited by Mr. Doty include instances in which Congress directly and indirectly indicated in ERISA that State and local government plans are not covered. Titles I and IV and sections 6057(a), we believe, disclose a congressional intent to avoid any regulation of State and local plans through ERISA.

The Supreme Court has repeatedly required specific statements of congressional intent before States and municipalities can be subjected to any congressional regulation. This conclusion, we believe, is reinforced by the existence of section 115 of the code, the general exemption of State and local governments. The section refers to the exemption regarding income derived from the exercise of any essential governmental function.

Since we believe the provision of retirement benefits to government employees must be deemed an essential governmental function, the argument of the IRS as to taxation of income of the plans, we believe, is quite weak. Even more important, our constitutional system forbids taxation of State and local government by the Federal Government.

The absence of regulatory intent is also indicated by the definition of governmental plans, section 414(d), which was added by ERISA to the Internal Revenue Code. The argument that the plans are separate entities from the governments and therefore may be regulated thus is seriously undercut by the use of section 414(d) terminology—namely, "governmental"—and by the failure of the Congress to specify an intent to avoid the governmental function from taxation stated in section 115.

I might point out an aside, Mr. Chairman, it was interesting to see the statement of Mr. Halperin this morning that, from his point of view, the Treasury Department could reach these issues only through the States, rather than through the plans as separate entities or through the plan beneficiaries. So it appears that the Treasury Department still views the entity being dealt with here as the governmental body rather than the plan itself or the beneficiary.

A further important indicator of legislative intent, we believe, is provided by title III of ERISA authorizing a study to analyze the necessity for Federal regulations and standards. We believe it would be inconsistent for Congress in the same act to both legislate and to authorize a study on the need for legislation.

Representative John Erlenborn from Illinois, ranking minority member of the House Committee on Education and Labor, Subcommittee on Labor Standards, testified before your subcommittee during oversight hearings on the New York City pension plan investments. In his remarks, as we recall, he stated, "Because of my position on the subcommittee, I was deeply involved in the drafting of the Employment Retirement Income Security Act, ERISA, which sets requirements. ERISA applies"—and I left part of the quote out here—"ERISA applies mainly to pension plans in the private sector. It has little effect on plans covering Federal employees."

Mr. Chairman, public pension plans represent an increasingly significant factor in the management of county government. NACO opposes Federal interference of this important function because Federal regulation threatens the ability of local elected officials to carry out mandates given them through their local electoral processes.

County elected officials are still obligated to assess whether their own systems are adequately funded to meet suggested payments of retirees.

Secondly, they need to be able to assess the potential impact of State and Federal actions on their employees and their budgets. For this reason, a special session was held by the NACO Labor/Management Steering Committee Pension Task Force during our annual legislative conference—which, incidentally, ends today—to explore a number of policy options.

The result of these discussions will lead to recommendations to our full membership expanding our policy in this area for the association. I should point out here, too, that I understand that following these hearings, Mr. Chairman, our subcommittee will hold hearings on deferred compensation plans and we would like to offer the following attached resolutions which were not attached to our statement presented for your committe yesterday.

Senator BENTSEN. We will be pleased to have them.

Mr. METT. They were passed by our board yesterday.

Essentially, we feel also, in conclusion, Mr. Chairman, that counties with home rule charters are beginning, themselves, to look at pension reforms and have made some significant changes in their system. Some examples are cited in our remarks.

Again, Mr. Chairman, we support S. 1587 and the companion, H.R. 9118, introduced by Representative Cunningham of Washington and, with your help and with the help of your colleagues, we can work together on the passage of this legislation and the proper management and operation of our State and local plans.

We appreciate this opportunity to appear before you today; and if you need any supporting data, we would be very happy to satisfy your any request.

Thank you very much, Mr. Chairman.

Senator BENTSON. Thank you very much.

My first political office was one of county judge down in Texas, and that is the role, generally, of the administrative officer of the county. I well understand some of your responsibilities and your concern, but I also see some very serious abuses that are quite, quite of considerable concern to me, and they can materially affect the soundness of retirement policies of those funds.

We are trying to find a way which we can bring about a greater degree of responsibility and prudence of the administration of these.

Mr. METT. We believe that we share your objective.

Senator BENTSEN. Thank you very much.

Our next witness will be Gaynor Kendall, legal counsel——

Mr. HANAWAY. Senator? May we have the opportunity of speaking for ourselves and our own organizations?

Senator BENTSEN. I had been told Mr. Mett would speak for all of you. If that is not the understanding, we are still within the time limitations, please proceed.

STATEMENT OF PAUL E. HANAWAY, STATE SENATOR FROM THE STATE OF RHODE ISLAND, AND VICE CHAIRMAN, PENSIONS TASK FORCE, NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. HANAWAY. My name is Paul Hanaway. I am a State senator from the State of Rhode Island. I have been in the general assembly since about 1971. I chaired the Retirement Study Commission in the State of Rhode Island and completely revised our retirement system.

It is my pleasure to be here before you today. Currently, I am serving as vice chairman of the Pensions Task Force of the National Conference of State Legislatures. The National Conference of State Legislatures is the official representative of the country's 7,600 State legislators and staff.

The speaker of the Texas Legislature, Bill Clayton, was unable to appear here today. However, he has just sent you a letter on this matter and has asked me to request that upon its receipt that it will be entered into your record.

Senator Stone and others have recognized an area of law which is extremely vague with respect to the regulation requirement issue before us today. It is rather unfortunate that those of us who are elected State and appointed government officials must spend a good deal of our time, and your time as well, to deal with unnecessary administrative burdens imposed on State and local governments.

Although the pension plan reporting requirement being required by the IRS may appear to be a single technical issue in the public pension plan area, let me assure you that it is a significant matter. These regulations and congressional action with respect to these regulations, will call into question a fundamental policy issue in our Federal system of Government. The ability of the Federal Government to regulate the affairs of State government, either with clear congressional intent or as in this case where there is an absence of such authority, is a fundamental issue to the 50 sovereign States.

As a State legislator in Rhode Island, I recognize that there are many instances where our legislature, or even the U.S. Congress, enacts legislation which is vague and can therefore tend to cause confusion. The reason you will hear different interpretations of the law today is because Congress was not clear in its original intent.

We are asking your committee and the Congress to enact clarifying legislation—namely, S. 1587—so the desires of Congress can be fully understood by everyone.

There are at least two major issues before us today. The first is the specific requirement that State and local governments report to the IRS on their public pension plans. Secondly, we must also consider why the IRS wants this information and how they intend to use it.

The two major justifications used by the IRS to support their regulation of State and public pension plans are, one, the Internal Revenue Code; and two, the Employment Retirement Income Security Act; namely, ERISA.

Since the adoption of the Internal Revenue Code provisions relating to pensions, neither State nor local governments were required to comply with the code. The tax code sought to regulate private pension plans.

The Treasury Department, which up to 1972 did not regulate public employee pension plans, is now seeking to claim jurisdiction to State and local governments under the Internal Revenue Code. Assuming that the code does not regulate pension plans, we must then examine the applicability of ERISA.

None of the four titles in ERISA authorize Federal regulation of State and local government pension plans. On the contrary, Congress recognized the difference between private and public pension plans both legally and operationally, and authorized, under title III, the Joint Pension Task Force Study of this matter.

Congress specifically deleted language from the draft ERISA proposals which would have applied to State and local governments. There is further, no indication in the legislative history of the code or ERISA, that the State and local governments ought to be regulated.

Why does the IRS want the information which can be gleaned from these reports?

I doubt that it would be an efficient use of the tax dollars to have thousands of local, State, and Federal employees spend their time gathering this information for the sole purpose of producing a listing of all public pension plans. The House Education and Labor Subcommittee on Pensions is already producing a similar compilation.

It is therefore our assumption that the IRS wants these reports so that they can begin to regulate public pension plans. Certain IRS officials have already maintained that public pension plans must qualify under the same provisions of the code applicable to private pension plans.

These assertions on the part of the IRS call into question the exercise of governmental functions by a State or municipality as exemptive activities from Federal taxation. If governmental plans do not qualify in the eyes of the IRS, this could possibly jeopardize both the tax-exempt income earned by these trusts as well as the tax status—and I repeat, the tax status, of public employees covered by these pension plans.

The legal nuances of Federal preemption has been far more exhaustively and eloquently stated than is possible for me to do today in the statement.

Senator BENTSEN. Senator, we will have to take the rest of your statement for the record. We just have quite a list of witnesses, and we have been precluded from going past 12 o'clock.

Mr. HANAWAY. Fine. I appreciate your time.

Senator BENTSEN. Mr. Mayor, if you would make your comments?

STATEMENT OF WILLIAM L. WALDMEIER, MAYOR, PEKIN, ILL.

Mr. WALDMEIER. I am William L. Waldmeier, mayor of Pekin, Ill., and a member of the board of directors of the National League of Cities. Today I am testifying on behalf of the National League of Cities and the U.S. Conference of Mayors which together represent more than 15,000 city governments.

The National League of Cities and the U.S. Conference of Mayors are pleased to have this opportunity to testify in favor and support of S. 1587. I think, with your permission, I will move down to more important things.

I want to emphasize that this is not a remote, technical issue, but rather one of great concern to elected city officials. In each of the last 2 years, the National League of Cities has adopted a resolution first supporting the idea of legislation along the lines of S. 1587 and then this past December, supporting the bill explicitly, and that resolution is attached to that.

The history of our involvement with this issue is relevant. Three years ago, NLC and USCM heard reports that IRS field officers were declaring local pension plans nonqualified and when a staff member of the organizations inquired of the Washington office whether or not this represented a national policy, the answer was no. When asked whether or not the Internal Revenue Service intended to interpret ERISA to give IRS authority over public pension plans, the IRS' answer was no.

Subsequently, individual IRS agents in one State made tax ruling against beneficiaries and their estates, but it was our impression at that time, Mr. Chairman, that these events were aberrations resulting from IRS' decentralized style of operation, and we frankly felt that they would come into a generalized approach, getting all of the sections of the country together.

We were quite surprised, therefore, when on April 21 a year ago, a press release announced that IRS was requiring reports from Government pension plans, and we were alarmed at signs that IRS would proceed more generally and aggressively declare public pension plans nonqualified.

Due, in part, to the insistence of State and local officials, the IRS has delayed both actions. Given the confusion and uncertainty that now exists, we think that a resolution of the matter by clarifying legislation is required.

I want to emphasize that S. 1587 is, in our opinion, clarification of legislative decisions already made and not a new initiative. For more than 20 years, IRS accorded public pension plans automatic qualification on either end by virtue of their status of State and local government entities. This was consistent with the relevant provisions of the tax code, and no legislative action since then has altered the statutory grant of authority.

In 1974, Congress had the opportunity to legislate regulation of State and local government plans when ERISA was considered and approved, but Congress did not. The issue now is not whether or not Congress should have decided differently but whether or not IRS can choose to reverse Congress' decision by regulation.

This is an especially important issue, given the general assumption of tax exemption for State and local government and government entities, and the usual demand for strong statutory base for any regulation of State and local government.

I think, Mr. Chairman, that I may just go away from this at this time. You have had something very similar. For the purposes of time, I would put it in one sentence, the idea of the position of the National League of Cities and the U.S. Conference of Mayors is simply that we do believe this is simply a congressional action, that there have been changes in policy which we do not believe are in the purview of the original intent of the Congress and, for that reason, we believe it should and we are in support of S. 1587.

Senator BENTSEN. Thank you very much, Mr. Mayor. We are very pleased to have your testimony.

Gentlemen, let me emphasize again the limitations of time that we have here in trying to meet this deadline of the Senate that the leadership has imposed on us.

[The prepared statements of the preceding panel follows:]

STATEMENT OF HON. R. MICHAEL METT, SUPERVISOR, MILWAUKEE COUNTY, WISC., ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

Mr. Chairman and distinguished members of the subcommittee, I am Michael Mett, supervisor, Milwaukee County, Wisconsin, and chairman of the Interim Pension Task Force authorized by the NACo [1] Board of Directors in 1976 to study the status of county pension plans and the impact of proposed Federal regulations. I am delighted to participate on this panel with Senator Hannaway and Mayor Carver.

My background in public finance and pension matters stems in part from my experience as counsel and acting commissioner for the Wisconsin Securities Commission between 1968 and 1971 and my service as an elected local official since 1973. I have also served on the staffs of several State and Federal agencies in my 16 years of public life. I am a member of the State Bar of Wisconsin and the American Bar Association and have taught securities analysis and portfolio management in the University of Wisconsin system.

On behalf of NACo and Milwaukee County, I am pleased to have the opportunity to appear before you as you consider legislation which would correct an administrative interpretation by the Internal Revenue Service regarding reporting requirements and tax liabilities of public employee pension plans under the Employee Retirement Income Security Act of 1974 (ERISA).

The National Association of Counties passed a resolution last year urging the Congress to pass legislation introduced by Senator Stone (S. 1587) which exempts public employee retirement systems from Federal income tax liability and the burden of unnecessary reporting requirements. The resolution is attached to my statement.

Mr. Chairman, county officials are increasingly concerned about IRS rulings that adversely affect county, State and city finances. These rulings have been

[1] NACo is the only national organization representing county government in America. Its membership includes urban, suburban, and rural counties joined together for the common purpose of strengthening county government to meet the needs of all Americans. By virtue of a county's membership, all its elected and appointed officials become participants in an organization dedicated to the following goals:
Improving county government;
Serving as the national spokesman for county government;
Acting as a liaison between the Nation's counties and other levels of government; and
Achieving public understanding of the role of counties in the federal system.

issued without notification to the public interest groups and in our opinion they are based on policies which we believe are beyond the Treasury Department's statutory and constitutional authority.

On April 21, 1977, the Internal Revenue Service (IRS) issued a press release which, for the first time, stated the IRS position that Government employee pension benefit plans are within the purview of the Employee Retirement Income Security Act (ERISA). The IRS view is that ERISA mandates the filing of annual returns by State and local government benefit plans. This represents, in effect, a major Federal/State and local jurisdictional determination.

Since the issuance of that press release, the public interest groups and individual county, city and State elected officials have persuaded the IRS to delay the deadline for reporting until July, 1978. On January 10, 1978, however, the Internal Revenue Service made official their press release by issuing proposed regulations to require State and local governments to file Form 5500.

An examination of the law's language and its legislative history by Mr. Robert Doty, general counsel to the Municipal Finance Officers Association offers compelling evidence that ERISA does not apply to State and local governments. Points cited by Mr. Doty which support the exemption of public pension plans from ERISA include:

> The instances in which Congress directly and indirectly indicated in ERISA that State and local government plans are not covered. Titles I and IV and Section 6057(a) disclose a congressional intent to avoid any regulation of State and local plans through ERISA. The technicality of Section 6058(a) can be viewed as a mere oversight in this regard. The Supreme Court has repeatedly required specific statements of congressional intent before States and localities can be subjected to any Federal regulation.
>
> This conclusion is reinforced by the existence of Section 115, the general exemption for State and local governments. Section 115 refers to the exemption regarding income derived from "exercise of any essential governmental function." Since the provision of retirement benefits to Government employees must be deemed an "essential governmental function," the argument of the IRS as to taxation of income of the plans is quite weak. Even more important, our constitutional system forbids taxation of State and local governments by the Federal Government.
>
> The absence of congressional regulatory intent is also indicated by the definition of "governmental plans" in Section 414(d), which was added by ERISA to the code. The argument that the plans are separate entities from the governments, and therefore may be regulated, thus is seriously undercut by the use of the Section 414(d) terminology, i.e., "governmental," and by the failure of Congress to specify an intent to avoid the general exemption from taxation stated in Section 115.
>
> A further important indicator of congressional intent is provided by Title III of ERISA, authorizing a study to analyze the "necessity for Federal legislation and standards." It would be anomalous for Congress in the same act both to legislate and to authorize a study on the need for legislation.

As you well know, there has been tremendous opposition by State and local government officials throughout the country to the filing requirement. They are concerned, not only because they disagree with the internal revenue service's interpretation of ERISA and its applicability to public plans or because of the sudden and inconsistent manner in which they were notified, but more importantly because they know that legislative changes with respect to public plans are almost certain to take place as a result of congressional action. Congressman Dent, chairman of the congressional pension task force stated that "enforcement of the filing requirement now would result in a needless waste of tax dollars and would produce unnecessary confusion in the public sector." The house pension task force has been gathering information about public pension plans and is expected to release its report by the end of the month. The NACo pension task force will review this report and provide testimony at the appropriate time.

Representative John N. Erlenborn of Illinois, ranking minority member of the House Committee on Education and Labor's Subcommittee on Labor standards testified before your subcommittee during oversight hearings on New York City pension plan investments. In his remarks he stated "Because of my position on the subcommittee, I was deeply involved inthe drafting of the Employee Retirement Income Security Act (ERISA), which sets requirements for reporting and disclosure for private pension plans. It also sets standards for fiduciaries, vesting funding, and participation of employees; and insures participants' benefits in case of plan termination. ERISA applies mainly to pension plans in the private sector, it has little effect on plans covering public employees."

Mr. Chairman, public pension plans represent an increasingly significant factor in the management of county governments, NACo opposes Federal interference with this important function because Federal regulation threatens the ability of local elected officials to carry out mandates given to them through the electoral process.

County elected officials are still obligated to assess whether their own systems are adequately funded to meet projected payments of retirees. Secondly, they need to be able to assess the potential impact of State and Federal actions on their employees and their budgets. For these reasons a special session was held by the NACo Labor Management Steering Committee and Pension Task Force during our annual legislative conference which ends today to explore a number of policy options that county officials must consider in the public pension area. The results of those discussions will lead to recommendation by the steering committee to the NACo board of directors expanding our policy in this area for the association.

Mr. Chairman, counties with home rule charters are also beginning to look at pension reform and some have made significant changes in their systems. Montgomery County, Maryland just completed a major study of their public retirement system and is recommending integration of the social security system with their public employee retirement system. Most counties however, participate in statewide retirement systems and are beginning to urge state legislatures to enact bills to implement sound funding of all pension benefits, strong fiduciary standards, prudent investment practices and equitable vesting requirements. Many states are acing now oward achieving these goals.

Mr. Chairman, again we support S. 1587 and H.R. 9118 the companion bill introduced by Representative Cunningham of Washington and with your help of your colleagues, we can work together on the passage of this legislation.

We appreciate this opportunity to present our position on this important matter and I'd be happy to answer any questions that you have. If you need any supporting data please have your staff contact Ann Simpson, NACo legislative representative.

RESOLUTION ON TAX EXEMPTION OF STATE AND LOCAL PENSION PLANS BY THE INTERNAL REVENUE SERVICE

Whereas the provisions of the Internal Revenue Code pertaining to pension trust qualifications for tax exempt status were created to cover private systems; and

Whereas State and local government systems have automatically received immunity from taxation and reporting under section 115 of the Internal Revenue Service (IRS) code: and

Whereas an IRS district office has alleged in at least one State that State and local public employee retirement systems are subject to the IRS jurisdiction and that public plans must comply with IRS guidelines in order to receive favorable tax treatment; therefore, be it

Resolved, that the National Association of Counties urge Congress to pass legislation introduced by Sen. Stone (D-Fla.), S. 1587, which:

(1) Exempts public employee retirement systems from Federal income tax liability and the burden of unnecessary reporting requirements; and

(2) State that the public plan participant is to be afforded tax treatment comparable to that of a private sector employee who is participating in a qualified plan.

STATEMENT OF STATE SENATOR PAUL E. HANAWAY, RHODE ISLAND, VICE-CHAIRMAN, PENSIONS TASK FORCE, NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. Chairman, it is my pleasure to appear before you and the Senate Finance Subcommittee on Private Pension Plans and Employee Fringe Benefits. Currently, I serve as vice-chairman of the pensions task force of the National Conference of State Legislatures. The National Conference of State Legislatures is the official representatives of the country's 7,600 State legislators and staff.

I want to thank you for convening this hearing to discuss S. 1587 as introduced by Senator Richard Stone.

The Speaker of the Texas Legislature, Bill Clayton, was unable to appear here today. However, he has just sent you a letter on this matter and has asked me to request that upon its receipt that it will be entered into the record.

Senator Stone and others have recognized an area of the law which is extremely vague with respect to the regulation requirement issue before us today. It is rather unfortunate that those of us who are elected State and appointed government officials must spend a good deal of our time, and your time as well, to deal with unnecessary administrative burdens imposed on State and local governments.

Although the pension plan reporting requirement being required by the IRS may appear to be a single technical issue in the public pension plan area, let me assure you that it is a significant matter. These regulations and congressional action with respect to these regulations, will call into question a fundamental policy issue in our Federal system of government. The ability of the Federal Government to regulate the affairs of State government, either with clear congressional intent or as in this case where there is an absence of such authority, is a fundamental issue to the fifty sovereign States.

As a State Legislator in Rhode Island, I recognize that there are many instances when our legislature or even the U.S. Congress enacts legislation which is vague and can therefore tend to cause confusion. The reason you will hear differing interpretations of the law today, is because Congress was not clear in its intent. We are asking your committee and Congress to enact clarifying legislation (S. 1587) so that the desires of Congress can be fully understood by everyone.

There are at least two major issues before us today. The first is the specific requirement that State and local governments report to the IRS on their public pension plans. Secondly, we must also consider why the IRS wants this information and how they intend to use it.

The two major justifications used by the IRS to support their regulation of State and local public pension plans are: (1) the Internal Revenue Code and (2) the Employee Retirement Income Security Act (ERISA).

Since the adoption of the Internal Revenue Code provisions relating to pension, neither state nor local governments were required to comply with the code. The tax code sought to regulate private pension plans.

The Treasury Department, which up until 172 did not regulate public employee pension plans, is now seeking to claim jurisdiction over state and local governments under the internal revenue code. Assuming that the code does not regulate pension plans, we must then examine the applicability of ERISA. None of the four titles in ERISA authorize Federal regulation of State and local government pension plans. On the contrary, Congress recognized the difference between private and public pension plans—both legally and operationally and authorized, under title III, a joint pension task force study of this matter. Congress specifically deleted language from the draft ERISA proposals which would have applied to State and local governments. There is, further, no indication in the legislative history of the code or ERISA that State and local governments are to be regulated.

Why does the IRS want the information which can be gleaned from these reports? I doubt that it would be an efficient use of tax dollars to have thousands of local, State and Federal employees spend their time gathering this information for the sole purpose of producing a listing of all public pension plans. The House Education and Labor Subcommittee on pensions is already producing a similar compilation. It is therefore our assumption that the IRS wants these reports so that they can begin to regulate public pension plans.

Certain IRS offices have already maintained that public pension plans must qualify under the same provisions of the code applicable to private plans. These assertions on the part of the IRS call into question the exercise of governmental functions by a State or municipality as exempt activities from Federal taxation. If governmental plans do not "qualify" in the eyes of the IRS, this could possibly jeopardize both the tax-exempt income earned by these trusts, as well as the tax status of public employees covered by these pension plans.

The legal nuances of Federal pre-emption have been far more exhaustively and eloquently stated than is possible for me to do in this statement. Nonetheless, I feel compelled to describe two major precedents which should be considered today. The Supreme Court has held that there must be a clear congressional mandate before States and localities will be subject to Federal regulation.

The Supreme Court expressed itself clearly on this issue in *Parker* v. *Brown* 317 U.S. 341 (1943). That case has become the landmark on Federal regulation of States and their political subdivisions. In my view it echoes the philosophy expressed in the Federalist papers. At 351 the court declares, "In a dual system of government which under the Constitution the States are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a State's control over its affairs and agents is not lightly to be attributed to the Congress."

Again at 359, "the governments of the States are sovereign within their territory save only as they are subject to the prohibitions of the Constitution or as their action in some measure conflicts with powers delegated to the National Government, or with congressional legislation enacted in the exercise of those powers. This Court has repeatedly held that the grant of power to Congress by the commerce clause did not wholly withdraw from the States the authority to regulate the commerce with respect to matters of local concern, on which Congress has not spoken."

Even if Congress were to give this specific direction to a federal agency we must recognize that the Supreme Court has placed limitations on the authority of the Federal Government to intervene in state and local employee relation.

In *National League of Cities* v. *Usery* (426 U.S. 833, 1976) the U.S. Supreme Court stated:

That when Congress seeks to regulate directly the activities of states as public employers, it transgresses an affirmative limitation on the exercise of its power akin to other commerce power affirmative limitations contained in the Constitution.

The matter before your subcommittee today, is clearly an attempt by the Federal Government to interfere with the benefits provided by states and localities to their employees.

It is good public policy to protect individual interests in pension plans. The need to regulate pension plans has been demonstrated and our governments, federal, state and local, have accepted these responsibilities. At the same time your subcommittee is considering problems with respect to private pension plans —state legislatures are legislating improvements to the public pension plans administered by state and local government.

Despite the pressures during 1978 of budgetary sessions and election year concerns, public pension plan reforms continue high on the list for state legislatures. At least five more states are considering the creation of permanent pension commissions, this is in addition to eleven commissions already in existence. Legislator concerns for maintaining the financial stability of their pension systems have been evidenced by the type of legislation enacted. With a majority of states implementing pension studies over the past few years, we can realize that legislaters are aware of pension problems and are anxious to implement sound funding of all pension benefits.

The National Conference of State Legislatures has long been interested in the financing and benefit structure of state retirement systems. Our concern was formalized two years ago with the creation of a task force on public pensions to examine the state systems and to make recommendations to improve the quality and soundness of the state retirement plans. The task force recently adopted a series of reform principles and a copy is attached for your review.

The Federal Government intervention in state and local pension plans might result in more harm than good. Federal regulation may tend to complicate an already complex situation. Public pension plans are funded and operated by governmental entities and should therefore not be considered as the equivalent of private profit making companies. The officials who design public pension plans are responsible to the governmental processes. They are publicly accountable to their employees and to the voters. State and local governments are demonstrating the importance of public pension plan reform. No single solution will work in the states and thousands of municipalities. However, each and every state is certain to protect the soundness of their pension plans and the welfare of their public employees.

STATEMENT OF HON. WILLIAM L. WALDMEIER, MAYOR OF PEKIN, ILL., ON BEHALF OF THE NATIONAL LEAGUE OF CITIES AND UNITED STATES CONFERENCE OF MAYORS

I am William L. Waldmeier, Mayor of Pekin, Illinois, and a member of the Board of Directors of the National League of Cities. Today I am testifying on behalf of the National League of Cities and the U.S. Conference of Mayors which together represent more than 15,000 city governments.

NLC and USCM are pleased to have this opportunity to testify in favor of S. 1587. I realize Mr. Chairman that you and the members of the subcommittee and the full Finance Committee have a great many important issues on your agenda. Your willingness to take up this bill, one that has not hit many front pages but is quite important for state and local governments, is greatly appreciated. I am not here to add to your workload. Nor do I want simply to deliver information that will be handled competently and completely by the experts. What I want to emphasize is that this is not a remote, technical issue but rather one of great concern to elected city officials. In each of the last two years, the National League of Cities has adopted at its national convention a resolution, first supporting the idea of legislation along the lines of S. 1587 and then this past December, supporting the bill explicity. That resolution is attached to my statement.

The history of our involvement with this issue is relevant. Three years ago NLC and USCM heard reports that IRS field officers were declaring local pension plans non-qualified and when a staff-member of the organizations inquired of the Washington office whether or not this represented a national policy, the answer was no. When asked whether or not the Internal Revenue Service intended to interpret the Employee Retirement Income Security Act (ERISA) to give IRS authority over public pension plans, the IRS answer was no.

Subsequently individual IRS agents in one state made tax rulings against beneficiaries and their estates. But, it was our impression that these events were aberations resulting from the IRS's decentralized styles of operation; and we expected them to be resolved in the field.

We were quite surprised, therefore when on April 21 a press release announced that IRS was requiring reports from government pensino plans. And we were alarmed at signs that IRS would proceed more generally and aggressively to declare public pension plans non-qualified. Due in part to the insistence of state and local officials the IRS has delayed both actions. Given the confusion and uncertainty that now exists we thing that a resolution of the matter by clarifying legislation is required.

I want to emphasize that S. 1587 is, in our opinion, clarification of legislative decisions already made and not a new initiative. For more than 20 years IRS accorded public pension plans automatic "qualification" by virtue of their status as state and local government entities. This was consistent with the relevant provisions of the tax code and no legislative action since then has altered the statutory grant of authority.

In 1974 Congress had an opportunity to legislate regulation of state and local government pension plans when ERISA was considered and approved. But it did not. The issue now is not, whether or not Congress should have decided differently, but whether or not the IRS can choose to reverse Congress's decision by regulation. This is an especially important issue given the general presumption of tax-exemption for state and local government entities; and the usual demand for a strong statutory base for any regulation of state and local governments.

Provisions that would have authorized the regulation of public pension plans were dropped from ERISA during its consideration. There is no support in the legislative history for the claim that ERISA was intended to apply in any report to state and local plans. Those involved thought that it did not, and decisions on public pension plans were deferred pending a comprehensive study. And there it stood until the April, 1977, IRS press release. The IRS counter-claim concerning its authority to require public plan reports rests on the weak observation that state and local governments are not specifically excluded from Title II of ERISA, and are therefore included.

Given the weak legal base for its actions the almost casual style with which IRS has attempted to carry out its aim has been surprising and disturbing. The original press release was not preceded by nor accompanied by regulations as ERISA required for new reporting requirements. Necessarily, therefore, though the action announced was a sharp break with previous policy, and would produce a great impact on state and local governments there was no review by or consultation with the organizations representing state and local governments as is ordinarily required in such cases. Following this first press release, which was sent to few state and local governments directly, several others were issued which reduced the amount of information required on the reporting form and twice delayed the deadline for reporting. In the confusion at least one local pension plan—a one man plan, I believe—received a notice of fine which was later rescinded.

This turmoil has attracted a great deal of attention and as a result IRS has now issued regulations and we have assumed that the delay of the reporting deadline until July 31 represent a desire on the part of IRS to receive from Congress exactly what we are seeking, a conclusive, legislative resolution of this issue.

S-1587 would provide this by explicitly reaffirming the legislative intent of ERISA. Unless it is made clear that Congress in passing ERISA chose to not regulate government pension plans and did not intend to reverse 20 years of IRS practice, then the status of thousands of state and local government pension plans is in doubt, with the possibility of a multi-billion dollar tax bill coming due; and the retirement income of millions of public employees is under a cloud.

The National League of Cities and the U.S. Conference of Mayors urge the resolution of this uncertainty through favorable action on S-1587.

Resolution No. 5

EXEMPTION OF PUBLIC PENSION PLANS FROM THE REPORTING REQUIREMENTS OF THE INTERNAL REVENUE SERVICE

Whereas the Internal Revenue Service has determined that state and local governments and their instrumentalities must make certain reports to it on public pension funds; and

Whereas such determination is contrary to the intent of Congress to exempt public pension systems from the purview of the law and is in violation of the federal structure of government; and

Whereas Senator Stone of Florida has introduced S. 1587 which clearly removes public pension systems from the jurisdiction of the Internal Revenue Service: now, therefore, be it

Resolved, That the National League of Cities supports the immediate enactment of S. 1587; and be it further

Resolved, That the United States Department of the Treasury and the Internal Revenue Service be urged to take no precipitant action relating to public pension funds or other public funds without prior consultation with representatives of state and local governments; and be it further

Resolved, That the National League of Cities does not support the creation of any Federal Agency to regulate State and Local Government Pension Funds, nor does it support the intrusion of the Federal Government into State and Local Government Pension Funds.

(Approved by the Membership of the National League of Cities, Annual Business Meeting, December 7, 1977, San Francisco.)

Senator Bentsen. We have a panel here consisting of Mr. Gaynor Kendall, who is legal counsel for the Texas Municipal Retirement System and the Texas County and District Retirement System; Mr. Robert Kennedy, Jr., State retirement director of Florida, accompanied, apparently, by representatives from a number of States.

Would you give your names for the record, please?

Mr. Kendall. Mr. Chairman, I am Terrence Kendall. My father and I are the legal counsel for the Texas Municipal Retirement System and the Texas County and District Retirement System. Also with me here today is the actuary for those systems.

I would like, at the start, to state that we are also authorized to state that the Texas State Employment Retirement System of the State of Texas is in favor of passage of Senate bill S. 1587 as are the two retirement systems we represent directly.

I am going to attempt to be brief, in view of the chairman's request, and will therefore stray somewhat——

Senator Bentsen. We will take your entire statement, all of you, for the record.

Mr. Kendall. Thank you, Mr. Chairman.

We will stray, therefore, from it to sort of attack the subject that I believe the Chair has been directing its comments at.

STATEMENT OF TERRENCE KENDALL, LEGAL COUNSEL FOR THE TEXAS MUNICIPAL RETIREMENT SYSTEM AND THE TEXAS COUNTY AND DISTRICT RETIREMENT SYSTEM; AND ROBERT KENNEDY, JR., STATE RETIREMENT DIRECTOR OF FLORIDA

Mr. KENDALL. The purpose of Senate bill 1587, as I understand it, is really to get us out of the tax area, avoid taxing these retirement benefits that would be paid to the various retired employees by recognizing what we have considered to be the law up to now, to wit, that the retirement system such as we represent, being subdivisions of the State, are exempt organizations for tax purposes.

Such public retirement systems are not subject to reporting requirements of ERISA amendments to section 6058 of the Internal Revenue Code and that, for purposes of the code, such State and local retirement systems shall be treated as if they met all requirements for qualification under section 401 of the code.

I would note, Mr. Chairman, that there may be a reason or a purpose or a function for congressional oversight of retirement systems. I think New York has represented a situation where that would be appropriate.

Our main point, and one of the primary reasons we are in favor of this particular bill, is that the way to do it is not through taxation of advance funded systems. All that serves to do is to lower the benefit that would otherwise be payable to the beneficiaries.

As an example, our systems have a certain amount of money to invest. They invest that basically in U.S. Government bonds or other Government-guaranteed obligations in order to earn income and be able to pay a benefit to our members upon retirement. If this money is taxed, it takes away the incentives from systems we represent for the advance fund to invest this money and this lowers the benefit that, in the long run, would be payable to our retired members.

I think that the Internal Revenue is attempting to get around the congressional intent of ERISA and all of these other things which have been discussed today and, in a back door sort of way, get to a point where there would be taxation of these local and State retirement systems.

This is a bad way to raise a constitutional question. We consider it a very grave constitutional question as to whether State and local public pension plans could be taxed for reasons that have been stated by earlier speakers, and I will not go back through those again.

I would note that we are in favor of all of the provisions of this proposed bill, or of the bill. We believe that otherwise the Internal Revenue Service's position as it appears to be discourages plans from advance funding by seriously taxing the returns. Taxation does lower the benefit eventually payable to the retired members. I believe, in addition to that, that the bill accomplishes two other purposes. It would keep plans for having to file reports in Washington. That is already available in existing public records and reports and reports would be asked to file under the Internal Revenue Service's position simply add to the cost at both the State and Federal levels.

Also, we feel that the bill would have another, unofficial purpose. It would grant to persons covered under State pension plans the same treatment as persons covered under qualified plans of private employers.

In other words, in effect, we say that this is a good bill because it tries to prevent taxation being a penalty for those systems—taxation of all systems being a penalty for those systems such as possibly New York that have a poor funding plan.

Senator BENTSEN. Let's probe that a little bit, now. If I understand the Treasury position, they are talking about if certain minimum standards of reporting and nondiscrimination are met, that all of the tax advantages are preserved.

Now, what is wrong with that, when they ask for disclosure for the pensioners? When I am told time and time again that some of these plans cannot even tell the current value of their assets on the yearend report for the pensioners.

Mr. KENDALL. Mr. Chairman, as to whether or not disclosure of information is advisable, I am all in favor of disclosure of information. I believe that the pensioner or that the active member prior to retirement is entitled to all the information possible to enable that person to understand that he has a good, solid retirement ahead of him.

The question, rather, relates to whether the penalty of taxation in the event you do not do it is the correct approach to getting that information to this person. The plans I represent, to the best of our knowledge and belief, would be perfectly capable of being qualified at this point in time, but in the event that the Internal Revenue Service subsequently down the line were to make changes and start saying, well, here are other things you would have to do by an Internal Revenue Service position, we do not want to be in the position of, down the line, having other requirements imposed on the system.

Senator BENTSEN. You view this as a first attempt?

Mr. KENDALL. Mr. Chairman, we view this as the foot in the door.

Senator BENTSEN. You are concerned that this may lead to something far beyond that?

Mr. KENDALL. Mr. Chairman, we are quite concerned about that, yes.

Senator BENTSEN. Are there other comments?

Mr. KENNEDY. I am Robert Kennedy, State retirement director of the State of Florida and also, as such, I serve as the head of the State agency for social security coverage of public employees; and, Mr. Chairman, if I may, I was under the impression that Senator Byrd's bill, S. 1967, may come up today, and I have filed with the subcommittee staff a statement in support of that, and I trust it will be available when this bill is heard.

But, with respect to Senate bill 1587, I believe that—I have with me Fred Walker who is the president of our National Association of State Retirement Administrators, and Carl Blechinger who is head of the State Retirement System of California. They have flown quite a way to be here.

Senator BENTSEN. I hate to interrupt there, but were you referring to Senator Gravel's bill on your first point?

Mr. KENNEDY. No. I said Senate bill 1587 which is the one, I believe—Senator Stone's bill, is it not?

Senator BENTSEN. Were you referring to it as Senator Byrd's bill?

Mr. KENNEDY. No; I was referring to Senator Byrd's bill regarding social security problems. If I may elaborate just a little bit, I will explain.

It is the same problem with the State agencies and local governments are having with Federal rules being adopted which cost the States millions of dollars and cause them all kinds of administrative problems, and I merely file this trying to get it with the committee, showing our deep concern about it, because it is a very important problem; and it is the same type of situation that we face in this hearing regarding the Federal bureau's adopting policies and rules which vitally affect the fiscal and administrative problem of State and local government.

I would like to sort of pass over the first item in S. 1587 since the IRS seems to be agreeable to exempt the State retirement systems from taxation, to the reporting requirements under ERISA, and I want to leave a few minutes for those who came so far to at least have a few words before the committee.

I would say it has been adequately stated that ERISA was never intended to cover public retirement systems, and it is rather ironic that this bill did include reporting requirements which did not specifically exempt public plans, and so the IRS, after 2 years, decided that we were required to file.

Well, they finally got the form down so that it is just the filing of an information plan and there is not any full disclosure on the report that we have to file now. I have filed two, the first one under protest and the second one because I had asked for qualification under 401(a), and if I can describe to the committee just what kind of problems you have got when you are dealing with the field offices as well as the central offices of IRS.

Senator BENTSEN. Let me say that your comments on the social security bill, we would not be able to put them in the record on this bill other than your oral comments you have made. Your prepared comments, we would prefer that you would keep those until the hearings on that proposed legislation.

Since time is running out, you say you have some gentlemen who have come a long way. Would you gentlemen, one of you, care to speak?

STATEMENT OF FRED WALKER, DIRECTOR, RETIREMENT SYSTEM OF THE STATE OF MISSISSIPPI, AND PRESIDENT, NATIONAL ASSOCIATION FOR STATE RETIREMENT ADMINISTRATORS

Mr. WALKER. Well, as president of our national association which does represent all the State and would cover State and local employees, we have become very concerned about this, Mr. Chairman, and we think that we cannot understand why the Internal Revenue Service all of a sudden starts changing their regulations when we know of no act by Congress—and we think Congress should pass the laws that regulates the sovereign States or their retirement systems.

We know that throughout the history of this Nation that acts are not passed by Congress to apply to another sovereign unless it is very clear in that act. We know of none, and we cannot figure out now why the Internal Revenue Service all of a sudden starts making different regulations that applies to us and the same thing on our deferred compensation, that we are so vitally interested in.

And so we hope and pray that you do take this issue to heart and will relieve us of these type of regulations by the Internal Revenue Service.

Of course, we would like to have further input as you get into this study in the future of, if you are getting to the disclosure or other features of regulatory provisions or the State systems.

My name is Fred Walker. I am the director of the retirement system of the State of Mississippi and president of our National Association for State Retirement Administrators.

Senator BENTSEN. Sir?

STATEMENT OF CARL BLECHINGER, EXECUTIVE OFFICER, CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM

Mr. BLECHINGER. My name is Carl Blechinger. I am the executive officer of the California Public Employees Retirement System, Mr. Chairman. We do have a statement to insert in the record, so I will spare you all of that.

Senator BENTSEN. We would be pleased to have it.

Mr. BLECHINGER. I would refer to a statement that the present chairman made in 1973 which we feel is very pertinent at this time. This is in connection with the introduction of your pioneer bill in this field, S. 1179, the Comprehensive Private Pension Security Act in 1973.

This bill, as you recall, would include a specific exemption of plans administered by State and local governments from is positions. At that time—and it is in the Congressional Record—you said:

> State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and State employees. These are questions of State and local sovereignty and the Federal Government should not interfere.

Now, times have changed, and obviously the Congress should have the opportunity to look at these plans. What we are concerned about is an arm of the Federal Government, based on admittedly very loose terms trying to impose reporting requirements on a system like ours that is open reporting, full disclosure and everything else. We have 2,200 local political subdivisions.

The only money that is going to come out of this is from paying benefits, Senator.

The other aspect is that we feel obliged to file a suit against IRS to prevent this. We want to avoid the cost to our pension system of the suit, so we hope the Congress will take action in this area, and soon.

Senator BENTSEN. Of course, I have heard of your plan, buttressed what you said about the administration. Unfortunately, that is not the case in all plans. We have some goats in the crowd, too.

Mr. BLECHINGER. That is correct, and it is just a question of whether you throw the baby out with the bathwater, Senator.

Senator BENTSEN. No; I am not for that.

Mr. BLECHINGER. I suggest the Senator might want to question this 70-percent figure that is floating around. For example, we have problems in establishing the market value of our securities where we do a substantial amount of private placements.

As you know, from your experience in a private area, it is very difficult to arrive at a market value at a fixed point in time with these private placements. There are other areas in Government securities, and so forth, there is a ready market to these, so these statements that are floating around about 70 percent of the plans not knowing the market value of their plans should be examined very closely, and I are sure you will do it, Senator.

Senator BENTSEN. Thank you very much for your comments.

Mr. HOLLISTER. Mr. Chairman, if I may.

Senator BENTSEN. We have exceeded our time, so if you would limit it very briefly.

STATEMENT OF ROBERT HOLLISTER, DIRECTOR OF RETIREMENT SYSTEMS FOR THE STATE OF WASHINGTON, ON BEHALF OF THE MUNICIPAL FINANCE OFFICER'S ASSOCIATION

Mr. HOLLISTER. I am Robert Hollister. I am the director of retirement systems for the State of Washington, and I am also speaking on behalf of the Municipal Finance Officer's Association. We have a written statement for the record, sir.

I would like to address briefly a point that you have raised in part of your question earlier, what is wrong with qualifications. Well, qualification is a very virtuous term. However, as it was noted earlier, the rules for qualification followed by IRS were designed for the private sector, not the public sector, and I would like to illustrate very quickly——

Senator BENTSEN. I do not recall saying that. I said: What is wrong with reporting and nondiscrimination?

Mr. HOLLISTER. We would submit, nothing, sir. Nothing wrong with that.

Senator BENTSEN. So I did not say the other, to my knowledge.

Mr. HOLLISTER. Excuse me, sir. I think they are related, though, because it goes to this question of qualification.

Senator BENTSEN. You know, this question of relationships, the question is how far you stretch it. So do not attribute to me what I did not say.

Mr. HOLLISTER. I beg your pardon, sir.

Let me illustrate quickly. We think, under our State laws, we do give full disclosure, so we have no problem with that area of it.

For qualification, one of the requirements is that in a pension plan, the disability and death benefits must be incidental, and incidental is defined as being of little consequence.

Virtually all police and fire plans in the Nation have substantial disability and death benefits in them, and for that reason, we have been told that our plan is not qualified. Now, you link that—at our State level, we have six plans, and the indication is that if any one of them is disqualified, they are all disqualified.

Now, in the private sector, it is possible for companies to qualify their plans if they are not initially qualified. In the public sector, by a Supreme Court decision in our State, once a pension benefit is granted, it may never be removed except as to prospective employees.

Therefore, for example, now, in our fire plan, we are not qualified because we do not meet the test of inconsequentialness for our disability and death benefits, and there is no way that we can remove those from our plan, even if we wanted to. So we could not qualify.

Yet, we feel we are making full disclosure. We have actuarily funded plans, and we do not feel we should be subject to taxation because we cannot meet this issue of qualification.

In our case, about two-thirds of our pension benefits are provided by our investment income. If we were to be taxed on that investment income because we cannot qualify, it would virtually double our contributions that the State would have to make that would make up the tax.

Senator BENTSEN. I am going to have to ask that the rest of your statement be for the record, because we have so many waiting.

Thank you, gentlemen, very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF ROBERT L. KENNEDY, JR. ON BEHALF OF THE STATE OF FLORIDA

I appreciate the opportunity to appear before this Subcommittee in support of Senate Bill 1587 introduced by Senator Stone. I am appearing on behalf of the State of Florida and as Administrator of the Florida Retirement System. As a member of the National Conference on Teacher Retirement and the National Association of State Retirement Administrators, I would like to appear in their behalf, also, in the event the official representatives of these organizations are not provided time in which to make their own presentations. So that the positions of these two organizations are made clear, I am attaching copies of the resolutions adopted by each of these organizations at their last annual meeting, which urge Congress to take action to clarify the IRS Code in the manner provided by Senate Bill 1587. Due to the active support of Senate Bill 1587 by these two organizations, the Municipal Finance Officers Association and other organizations, the Internal Revenue Service announced on August 10, 1977 (IR-1869) that it is reconsidering whether the statutory prohibition against discrimination in coverage and contributions or benefits under Section 401(a) of the Internal Revenue Code applies to public plans and also stated that the IRS had under consideration whether the trusts relating to such plans are subject to tax on their income. The passage of Senate Bill 1587 would settle these matters in an expeditious manner.

The purpose of Senate Bill 1587 is very simple and should not be controversial at all. Since I assisted Senator Stone's office in the preparation of this bill, I believe that I can state its intent rather simply. The first change that this bill makes in existing law is to simply state by statute which we think the Constitution already provides and that is that the federal government cannot tax the income of public retirement systems sponsored, administered and funded with local tax funds, whether or not it meets the qualification requirements under Section 401(a) of the Internal Revenue Code. It is obvious to most readers that the qualification requirements of a retirement plan, as set forth in the IRC, were never intended to be applied to public plans since the governmental units contributing to public retirement plans are not subject to federal taxes in the first place. A reasonable person would assume that there is no need to amend Section 501(c)(11) to specifically exempt public retirement systems or trusts from the threat of federal taxation. This, however, has become necessary since the Internal Revenue Service has taken the position in certain districts that any system, whether private or public, which fails to meet the qualifications required under the Code shall be subject to tax. All this change in the Internal Revenue Code does is to make sure that any public system whose legislative body fails to make the changes in their retirement system or plan which may be necessary to meet the qualification requirements under Section 401(a), IRC, will not be assessed any federal taxes, which would in most cases throw those systems out of business or into bankruptcy. There is presently an exemption for certain teacher retirement fund associations of a purely local character under certain enumerated circumstances. It is only logical to make it abundantly clear to the Internal Revenue Service that public retirement systems are also specifically exempt from the assessment of federal taxes. This bill would reaffirm the doctrine of intergovernmental tax immunity and further clarify Section 115 of the Code.

The provisions of Senate Bill 1587 would not prohibit the public retirement systems from seeking a determination letter from the IRS in order that their membership may receive the tax benefits provided by "qualified plans." In fact, the State of Florida has recently applied for and received a determination letter. Although this letter was supposed to be favorable, it was "provisional" and contingent upon future events. It is contingent upon the enactment of certain amendments to the retirement law by the Florida Legislature and further contingent upon the approval of the National IRS office with respect to any discriminatory provisions which may exist in the system. It appears that the IRS is having a study made to determine how to apply the nondiscriminatory provisions (which were apparently designed for private plans) to public plans. In light of the recent actions of the IRS to tax public retirement systems which do not meet the qualification requirements of Section 401(a), Senate Bill 1587 provides the assurance Florida (and other public retirement systems) needs that it will not be taxed on the income of its retirement system in the event the Legislature does not amend the trust instrument to effect the changes necessary to satisfy local IRS representatives or if the IRS National Office determines that the Florida Retirement System does not meet the nondiscriminatory provisions and demands major changes in the retirement law which the Legislature refuses or fails to make.

The Committee should be aware of the undesirable, detrimental and sometimes disastrous effects a federal tax on public retirement systems income could have. In a pension system, the rate of return on its investments is of major significance. Currently, Florida is receiving 7.87 percent return on its investment portfolio in which taxable corporate bonds make up three-fourths of its assets. Should the interest on these bonds be subject to federal taxes, the net return on the portfolio would shrink drastically unless a shift was made to non-taxable municipal and government bonds. The magnitude of such a shift, if Florida and other public retirement systems were forced to do so to escape federal taxation, could result in chaos in the security markets. Wholesale conversion from corporate to municipals could force the governmental pension systems to unload corporates at sacrificial prices and increase the demand for government and municipal bonds so that they would bring premium prices, resulting in low yield. Taxing the income of pension systems with their vast holdings of taxable corporate bonds and large holdings of common stock and mortgages could have a tremendous impact on the stock, bond and mortgage markets, and would inevitably reduce the income of retirement and pension trust funds. Most pension systems would find it necessary to increase their contribution rates in order to stay in business. Thus, the incidence of the federal tax on the system would be shifted to the local governments or contributing employees, or to both.

The other change in the IRC which Senate Bill 1587 would accomplish is to clarify the legislative intent of the Employees Retirement Income Security Act, enacted by Congress in 1974. It has become apparent from my research that when the ERISA legislation was passed it was never intended to cover and be applicable to public retirement systems. Indeed, most sections of that legislation specifically exempted public retirement systems except certain sections which amended the IRC. I think the legislative intent that the provisions of that law applied only to the private sector is underscored and emphasized by the fact that this law established a Joint Pension Task Force to make a two-year study to determine the effects and desirability of bringing all state and local retirement plans under ERISA, the effects on benefits and costs of integrating social security benefits with the benefits payable under retirement plans, and the necessity for federal legislation and standards with respect to public plans. Although this study has been under way since September 17, 1975, when the first hearings were held by the Joint Pension Task Force, its report is just now ready for release. I testified before the Pension Task Force on September 17, 1975 in behalf of the National Governor's Conference and I am supplying this Committee with the statement I presented to the Task Force for what benefit it may be in your deliberations.

It is indeed ironic that the sponsors and administrators of public retirement systems are saddled with the mandatory reporting requirements with its severe penalties for noncompliance resulting from amendments to the IRC, enacted as a part of ERISA which specifically exempts and is not applicable to public plans in the first place. I am sure that the Pension Task Force Report, when it is released, will show that there are certain weaknesses, inequities, and considerable fiscal weaknesses in many public retirement plans, but, as I testified before the Joint Pension Task Force, the states and local governments do not need the assistance of federal law in trying to cope with these problems. In fact, I suggested that the federal government concentrate its efforts and devote its energies to resolving the inequities and funding problems of social security, the Civil Service Retirement System, the Railroad Retirement Act, and scores of other federal retirement systems. The provision of Senate Bill 1587, which exempts public retirement plans from the mandatory filing of the reports required under Section 6058, does not prohibit the voluntary filing of such reports. In fact, the State of Florida has filed such reports twice. The first report was filed under protest since we did not feel that the mandatory reporting provisions enacted with ERISA were ever intended to cover public retirement plans. The last report we filed was filed without protest since we had requested a determination letter under the provisions of Section 401(a) and had received a tentative provisional qualification.

In summary, the changes made by Senate Bill 1587 are simply to clarify the Code with respect to public retirement plan does not elect or in some way fails to qualify under the provisions of Section 401(a) of the Internal Revenue Code, the retirement system or trust fund will not be assessed any federal taxes. Second, Section 6058 of the Code is amended so that the mandatory filing requirements with its attendant severe penalties are not applicable to public retirement systems.

QUALIFICATION OF PUBLIC EMPLOYEE RETIREMENT PLANS

Whereas the provisions of the Internal Revenue Code pertaining to pension trust qualifications for tax exempt status were created to cover private systems; and

Whereas State and local government systems have automatically received immunity from taxation and reporting under section 115 of the Internal Revenue Code; and

Whereas the Internal Revenue Service district office has alleged in at least one state that state and local public employee retirement systems are subject to Internal Revenue Service jurisdiction and that public plans must comply with Internal Revenue Service guidelines in order to receive favorable tax treatment; now, therefore, be it

Resolved, That the National Council on Teacher Retirement take action to clarify the Internal Revenue Code such that there would be no doubt about the following:

1. Public Employee retirement systems are not required to file trust information returns. (Information could be filed voluntarily.)
2. By virtue of being a public trust, the earnings of the trust are tax exempt.
3. The public plan participant is to be afforded tax treatment comparable to that of a private sector employee who is participating in a qualified plan.

PENSION TASK FORCE STUDY

Whereas the Employees' Retirement Income Security Act of 1974 provided for a Congressional study of public retirement systems with recommendations to be made by December 31, 1976; and

Whereas the Pension Task Force of the Subcommittee on Labor Standards of the Committee on Education and Labor, House of Representatives, undertook such a study, developing a lengthy questionnaire designed to create a data base on all major state and local retirement systems; and

Whereas the provisions of the Internal Revenue Code pertaining to pension trusts qualifications for tax exempt status were created to cover private systems,

Whereas State and local government systems have automatically received immunity from taxation and reporting under Section 115 of the Internal Revenue Service (IRS) Code, and

Whereas an IRS district office has alleged in at least one state that state and local public employee retirement systems are subject to IRS jurisdiction and that public plans must comply with IRS guidelines in order to receive favorable tax treatment, therefore, be it

Resolved, that Congress should take action to clarify the IRS Code such that there would be no doubt about the following:

(1) Public employee retirement systems are not required to file trust information returns. (Information could be filed voluntarily.)

(2) By virtue of being a public trust the earnings to the trust are tax exempt.

(3) The public plan participant is to be afforded tax treatment comparable to that of a private sector employee who is participating in a qualified plan.

Respectfully submitted.

BERT HUNSAKER, *Chairman*.

The motion was seconded by Joseph Iannelli, Rhode Island, and passed.

TESTIMONY OF TERRENCE KENDALL OF AUSTIN, TEX.

Mr. Chairman and members of the committee: My name is Terrence Kendall, of Austin, Texas. I appear before your Committee to speak for the Board of

Trustees of the Texas Municipal Retirement System and for the Board of Trust ees of the Texas County and District Retirement System in support of S. 1587.

The Texas Municipal Retirement System is an agency of the State of Texas established by law for the purpose of operating and administering retirement, disability and death benefits for employees of any Texas city voluntarily electing to participate in the System. The System has 348 participating cities, and covers approximately 48,000 employees of such cities.

The Texas County and District Retirement System is likewise an agency of the State of Texas, established by law for the purpose of operating and administering retirement, disability and death benefits for employees of any Texas County or special district (other than school districts) electing to participate in the System. This System has 262 participating counties and special districts, and covers approximately 44,500 of their employees.

Both systems maintain reserves for benefits which are considered by our consulting actuaries to provide adequate funding for benefits promised. These reserves are of course invested, pending expenditure, in conservative securities whose net earnings are dedicated to payment of the benefits promised.

Our interest in enactment of S. 1587 lies in the fact that it establishes expressly three matters that had been (until recently) considered to be undisputed, viz.:

(1) that retirement systems, trusts of funds of a State, political subdivision or agency or instrumentality of a state or political subdivision are exempt organizations for income tax purposes;

(2) that retirement plans maintained by a State, political subdivision of a State, or agency or instrumentality of a State or its political subdivisions are not subject to the reporting requirements of the ERISA amendments to Section 6058 of the Internal Revenue Code; and

(3) that for purposes of the Internal Revenue Code, such State and local systems shall be treated as if it met all requirements of qualification under Section 401 of the Code.

1. Congress should make clear that retirement plans maintained and operated by States, or by their subdivisions, are exempt organizations

We feel sure that the Committee already knows that within the past two or three years some of the local offices of the Internal Revenue Service have started contending that the qualifications sections of the Internal Revenue Code (Section 401 et seq.) apply to pension and retirement plans operated by States and by political subdivisions of States. In consequence, some of these officials argue further that unless such plans seek and obtain approval as conforming to the requirements adopted by IRS, the earnings derived by such plans from investment of their reserves are subject to tax.

Had such an interpretation of the Code been the Congressional intention, it harly seems likely that that intention would have been undiscovered until so recently, and only in certain regional offices of IRS. Whether the IRS will take that position officially is not known, but it has now taken the position that state and local governments are required to file Form 5500 or Form 5500-C under the provisions of the ERISA amendments. These actions presage an attempt by IRS to subject state and local retirement plans to the qualification requirements of the Code, under penalty of tax levies on investment earnings in event of failure to comply. That course of action should be forestalled by Congressional action.

I am sure that the Committee is aware of the serious constitutional questions which are presented if the Code is construed as subjecting state and local governmental retirement plans to federal taxation. The most recent case in this area is *National League of Cities* v. *Usery*, 96 S. Ct. 2465 (1976) holding that Congress could not regulate state and local government employer-employee relationships by requiring such governmental units to pay minimum wages to their employees.

It is not our purpose here to brief or argue this question at length; rather we wish here only to make the point that a confrontation between the federal government on the one side, and state and local governments on the other, should not be allowed to arise from a belated and specious construction of long-existent language contained in the 1954 Code.

Of course the matter could be settled by enactment of legislation clearly undertaking to regulate (or to tax) state and local pension plans: and if that were the Congressional intent, the matter should be so resolved. We think that such a course was not, however, the Congressional purpose, and that there are many sound policy reasons (apart from the constitutional questions mentioned) why S. 1587 should be enacted.

As the Committee is aware, there are two basically-different types of governmental pension or retirement plans: the first, like social security, is one in which the benefits are provided for and paid out of current appropriations; the other, is one in which the cost of future benefits is anticipated and contributions are made in advance to accumulate the reserves needed at retirement to pay such benefits.

While it may be argued persuasively that advance funding is unnecessary in an almost universal plan such as social security, it hardly is open to argument that where the employer is a relatively small city (or even a state) advance funding provides the only real assurance that promised benefits will be paid. Moreover, advance funding has benefits from the taxpayer's side, too, in that the requirement of current payment of installments required for future benefits tends to restrain the making of benefit promises that are too generous. We are all aware of the danger that one administration may allow increased or more generous benefits if additional current tax revenue is not required to pay the cost; but if the costs are not funded in advance, even more oppressive rates of contribution at a later date will often be the only alternative to default on benefits.

The short of the matter is that history has taught us that proper advance funding of anticipated future pension benefits is (with the possible exception of universal pensions) the safest and best way of assuring (1) that the promised benefits will be kept within bounds; and (2) that the promised benefits will be paid.

I make these observations because the course which the IRS apparently intends to follow in now interpreting the income tax laws as imposing such taxes on the interest received by state and local pension plans from investment of the reserves established for payment of future benefits will at least discourage such pension systems from establishing and maintaining such reserves. Assuming (contrary to fact) that such interpretation of the present laws is correct, it is obvious that the imposition of such taxes would adversely affect only those plans which do maintain and invest reserves; indeed, that the better pre-funded the anticipated benefits are, the more onerous the tax would be. So, if the federal government has the power to take and does take approximately half of the earnings which state and local plans receive on investments of pension reserves, one solution might well be to eliminate the reserves and return to an unfunded plan for pensions. We do not believe that Congress ever intended to prejudice advance funding of pension benefits: rather, one of the prime purposes of enactment of ERISA was to promote better funding of benefits undertaken by plans of private employers.

It is no answer to say that what is proposed is not really to tax earnings received by state and local governments on investment of reserves held for their pension plans, but is instead to require those plans to subject themselves to review by IRS officials, and if the plan meets certain tests (adopted by IRS) to grant exemption from taxation to those plans who are so blessed. While that is a lesser penalty than unconditional taxation would be, it is still a penalty; and it still applies only to plans which attempt to provide advance funding of benefits, and encourage state and local plans to discontinue advance funding.

In making these observations, I would make plain that the Systems for which I speak, the Texas Municipal Retirement System and the Texas County and District Retirement System, would have no problems whatsoever in qualifying for exemption under existing rules and regulations. The Boards of Directors of each of the Systems has considered applying for letters of qualification, despite the fact that we do not think we are subject to any tax or can obtain any tax benefit, but solely because qualification would result in more favorable estate-tax-treatment of certain benefits payable on death of a member. Our election not to apply is due to the decision that it would be inappropriate to surrender to Internal Revenue Service officials the power to decide what changes we would be required to make to keep qualified. In other words, we do not believe that I.R.S. should be placed in a position where it could tell a retirement system such as those we represent how to run its pension plan.

So, if the Congress believes the federal regulation of state and local governmental pension plans is necessary, and that the federal government has power to regulate and govern such plans, we submit the taxation of earnings derived from investment of pension reserves is the wrong approach. Suffice it to say that such a tax penalty for failure to comply punishes most the workers who retire under such plans. This is especially true of joint-contributory, defined contribution plans such as those for which I speak; there, the monthly benefit is calculated on the basis of using the accumulated contributions (i.e. employee-employer contributions, plus the amounts earned on their investment) as a single premium for determining the amount of annuity which can be paid. If the federal government takes away approximately half of the earnings on invested funds, it is obvious that benefits are necessarily reduced from what would otherwise be allowable.

So, if the federal government undertakes to regulate state and local pension plans, the regulations should apply to all plans alike: not to those alone which already (and without federal compulsion) are advance funded plans. Moreover, penalty for failure to comply should be visited not upon the persons who have or who will draw benefits from such plans, but upon these officials who design or operate the plan.

2. The provisions exempting such plans from reporting requirements should likewise be enacted

We would submit that if the federal government is not going to regulate pension plans operated by state and local governmental units, administrators of such plans should not be required to make annual reports to IRS or other federal agencies on forms designated (and revised and "simplified" annually by the form desingers).

Unless the federal government is engaged in regulating such plans, there is little excuse for requiring administrators of the plans to make annual reports to some designated federal department or bureau. The only purpose that such reporting could be said to serve is that information concerning such plans is thereby made more readily available for inspection by persons in Washington. It should be held in mind, however, that the information is already compiled in public records available for inspection at the situs of the plans. Furthermore, it costs public money at the federal level to design such forms, and to collect and store such information; and it costs public money at the state and local levels to review such forms, to recompile information into the required format, to forward it to Washington, and to keep copies of the information furnished in both the form required by the federal regulation and that in which the data is maintained for plan usages.

3. Pension plans of States and of their political subdivisions should be accorded the same treatment as "qualified" private plans

Until the last two or three years, most local IRS offices considered public pension plans as entitled to automatic qualification status. S. 1587 would have the effect of extending this treatment nationwide.

The primary importance of this provision of S. 1587 is that the individuals who are members of, and benefit recipients under State and local pension plans are accorded the same tax treatment as are members or beneficiaries of qualified plans operated by private employers. Unless States and their subdivisions are subject to federal taxation on the plans they operate, the provision clearly confers no new benefit on the employer.

From the standpoint of the members of the Systems for which I speak, this provision of the bill is of particular significance, since the provision would extend to them the same treatment for federal income and estate tax purposes, as is now given to members of approved plans operated by private employers. We submit that there is no valid policy reason why the federal government should treat the two groups differently.

Statement by Fred M. Walker, President, National Association of State Retirement Administrators

Mr. Chairman, my name is Fred M. Walker. I am the Executive Secretary of Public Employees' Retirement System of Mississippi and President of the National Association of State Retirement Administrators and a member of the Executive Committee and the Legislative Committee of the National Council on Teacher Retirement.

Accompanying me here today are Mr. Robert L. Kennedy, Jr., Director, Florida Division on Retirement and Mr. Carl Blechinger, Executive Officer, California

Public Employees' Retirement System, who are members of the National Association of State Retirement Administrators and other national organizations.

The NASRA organization consists of directors and administrators of the state retirement systems throughout the country, with associate members from the actuarial and investment professions, who have an interest in the preservation of retirement benefits for all public employees of the states and political subdivisions.

At the last meeting of NASRA on August 26, 1977, at Lake Ozarks, Missouri, a resolution in reference to Senate Bill No. 1587 was adopted as follows:

"Whereas the provisions of the Internal Revenue Code pertaining to pension trusts qualifications for tax exempt status were created to cover private systems.

Whereas State and local government systems have automatically received immunity from taxation and reporting under Section 115 of the Internal Revenue Service (IRS) Code, and

Whereas an IRS district office has alleged in at least one state that state and local public employee retirement systems are subject to IRS jurisdiction and that public plans must comply with IRS guidelines in order to receive favorable tax treatment, therefore, be it

Resolved, that Congress should take action to clarify the IRS Code such that there would be no doubt about the following:

(1) Public employee retirement systems are not required to file trust information returns. (Information could be filed voluntarily.)

(2) By virtue of being a public trust the earnings of the trust are tax exempt.

(3) The public plan participant is to be afforded tax treatment comparable to that of a private sector employee who is participating in a qualified plan."

Mr. Chairman, we are appearing here today to offer the testimony on behalf of NASRA concerning the Internal Revenue Code to exempt state and local government retirement systems from taxation and regulatory rules and regulations of the IRS.

Various IRS officers take the position that State and Local Governments can be taxed on investment income for funds maintained by them under non-qualified Employee Retirement Plans and that State and Local Governments are required, under the provisions of Section 401 et seq. of the Internal Revenue Code, to file Form 5500 or Form 5500-C in accordance with the provisions of ERISA. The Tenth Amendment to the Constitution of the United States reserves to the States the powers not delegated by the Constitution to the United States or which by its provisions do not prohibit the exercise of such powers by the States. The long recognized general rule of law that a legislative act does not apply to a sovereign unless by the terms of the act itself the intent that the act apply to the sovereign is made clear, is particularly applicable in this case. The Supreme Court of the United States in the case of Parker v. Brown, 317 U.S. 341 (1943), stated, we find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and its agents is not lightly to be attributed to Congress. 317 U.S. at 350-51."

In 1976, National League of Cities v. Usery, 96 S. Ct. 2465, the Supreme Court held that Congress could not regulate state and local governments to the extent of requiring them to pay minimum wages to their employees. Section 115 of the Internal Revenue Code excludes income derived from essential governmental function and accruing to a State or any political subdivision thereof.

The Public Employee Retirement Systems constitute agencies of the State and act in the capacity as agent for the sovereign. Numerous cases hold that a State cannot tax an instrumentality of the Federal Government and have likewise held that the immunity of State and Local Governments from taxation is a viable constitutional principle which should not be violated.

The Amendments which IRS now contend authorizes the levy of a tax and exercise of control over a non-qualified system, not only do not contain provisions granting such authority to IRS but require a strained interpretation in order to contend that the statutes could be applied to non-qualified Public Employee Retirement Systems.

We take the unqualified position that there is simply no jurisdiction in the Service to take regulatory action regarding State and Local Governments. However, it now would appear to be clear that absent additional Federal legislation prohibiting such acts by IRS that IRS will attempt to impose regulations and tax on the State and Local Governmental Units under the provisions of the Internal Revenue Code, and thereby require extensive and expensive litigation on the part of the State and Local Governments in defense thereof.

In closing, we feel taxation and regulatory control of State Retirement Systems by the IRS or any agency of the Federal Government would be contrary to the constitutional principle of non-taxation by the Federal Government of State property and income and it would hinder and threaten the continuation of these plans. We urge the Senate Finance Committee to review and to approve S.B. 1587 since the future security of millions of state and local employeers is at stake.

Mr. Chairman, as representatives of NASRA, we wish to thank you and the committee for extending to us the courtesy of expressing our position on this vital subject.

STATEMENT OF CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, ROBERT F. CARLSON, PRESIDENT, BOARD OF ADMINISTRATION, CARL J. BLECHINGER, EXECUTIVE OFFICER

Mr. Chairman and members: The California Public Employees' Retirement System (PERS), which also Administers the California Legislators' Retirement System, is in strong support of Senator Stone's Bill, S. 1587.

PERS is on the two largest state and local government systems in the country, and includes in its membership employees of over 2,000 local public agencies. At the last count, local agncies have 31 possible options they can obtain by amendment to their contracts with PERS. To meet the reporting requirements by IRS for a system of this type with constantly changing statutory and contractual provisions would substantially impact funds currently used to pay benefits, since Administrative costs of PERS are paid from these funds. We do not believe it was the intent of Congress to impose such onerous and costly burdens on us without first getting the reports from its committees contemplated by Section 3031 of ERISA of 1974.

Recently, we spent a weekend reviewing the massive 3 volume, 5,322 page legislative history of the ERISA of 1974 (Public Law 93-406) prepared in 1976, by the Subcommittee on Labor of the Senate Committee on Labor and Public Welfare. Very early in this outstanding compendium (page 220), the chairman of this subcommittee (Senator Bentsen) set the tone of our concern over IRS involvement in the affairs of state and local retirement systems. His remarks were entered in the Congressional Record of March 13, 1973, in connection with the pioneer effort in the field represented by his Bill, S 1179, the "comprehensive private pension security Act of 1973," a bill which included a specific exemption of plans administered by state and local governments from its provisions. Senator Bentsen said at that time: "State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and state employees. These are questions of state and local sovereignty and the Federal government should not interfere."

In Report No. 93-383, dated August 21, 1973, on this same Bill S 1179, as shown on page 1176 of the legislative history of ERISA of 1974, the Senate Committee on Finance made an observation that is repeated several times in the legislative history in connection with other bills. The committee noted "At the same time, it must be recognized that the natural tendency is for the (internal revenue) service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the provisions of exemption provisions. Similar concern has been expressed in the past over the service's Administration of the tax law relating to exempt organizations."

To keep this statement as brief as possible, we will not cite the many other references we noted in the legislative history along the same lines as the above quotes. However, one aspect of our review of this over 5,300 page EPIC had a singular impact on us—the complete lack of statements of congressional intent, whether it be in committee statements, in debate or statements by Members of Congress, or in the provisions of the bills themselves, to impose reporting requirements on the state and local retirement systems, other than to the Congressional Committees set up for the purpose of studying such systems. On the latter point, we have cooperated fully with the House pension task force in its comprehensive study currently under way.

Although it is very difficult to prepare a legal-type statement when Administration is by news releases, as is the case of the attempt by IRS to obtain the filing of forms 5500 by governmental plans, we hope the following will be of assistance to the subcommittee in its deliberations.

I

S. 1587, Stone, is merely declaratory of existing law. As will be more fully argued, it is our considered opinion that governmental plans are not obligated to file forms 5500 or form 5500–C under authority of ERISA or any other law. Enactment of SB 1587, HR 9118, HR 9462, HR 9691, HR 10308 or HR 10869, would clarify both legislative intent and present law. As was stated by the Honorable "Jack" Cunningham, and as we noted above, the legislative history of ERISA indicates a clear intent to exempt governmental plans "from both reporting and taxation."

II

ERISA does not include Governmental plans within its ambit. Information we received during the discussions and taking of testimony which resulted in the enactment of the Employees' Retirement Income Security Act of 1974 (ERISA) was carefully detailed to convey a legislative intent that the function of ERISA was to provide Federal control over private pension plans only. We were led to believe that because of potential constitutional issues which would arise if the law were to be extended to governmental plans, Congress carefully excluded governmental plans from ERISA. We were led to believe that Congress did not wish to risk the loss of the ERISA bill itself—which was a clear probability if governmental plans were included. This impression was reinforced by the specific mandate that various studies should be made before Congress will consider extension of ERISA to public plans or the enactment of a new law quite separate and aparts from ERISA. It is interesting that IRS "discovered" that ERISA requires public plans to make reports to the service so long after the actual enactment of ERISA. In any event, it is our opinon that ERISA should not and does presently include governmental plans within its reporting requirements.

It is apparent that IRS considers ERISA to contain the authority for its demands for reporting and disclosure. In the initial news release, IR 1798, in April 1977, it said, "prior to ERISA, most governmental and church plans were not required to file annual returns." We are not sure that we fully understand what authority it is that IRS asserts constitutes the specific authority for its demands. Our attorneys tell us that the courts require clear and specific authority before they will consider the interference by a Federal agency with the operation and conduct of the respective State governments. This clear and specific legal authority is completely absent in ERISA, and all other related Federal laws. The reason for its absence is that it would be unconstitutional in any event.

We understand that IRS readily concedes that ERISA specifically exempts governmental plans from the operation of Title I therein which includes the regulatory provisions relating to reporting and disclosure. The service would argue, however, that "ERISA only excludes governmental plans from the obligation of reporting to the Secretary of Labor," and "ERISA did not specifically say that governmental plans don't have to report to IRS." We submit, that it was the intent of the Congress in enacting ERISA that governmental plans should not be required to report to any Federal administrative agency for purposes of ERISA, and unless ERISA provides clear and specific authority for the IRS position, there is no authority for it.

It seems to me that the service is acutely aware of the very thin ice it is walking on. Else why the long delay, after enactment of ERISA in 1974 until now, in enforcing its position? Why so many extensions of time for filing 1975 and 1976 information? As you know, there are also very serious constitutional issues which bear on the authority of the service, and I shall touch on them very briefly before I close.

III

Whether or not IRS' arguments are valid, the filing of form 5500 would constitute an idle act. I am informed that the law never requires the performance of idle acts.

IR 1911 reduced reporting requirements so that only lines 1 through 11 (excluding lines 8 and 10(e)) of form 5500 need to be completed. Even then, there is no apparent purpose for obtaining this information as it may relate to ERISA. You will recall that title I does not apply to governmental plans, and title I includes not only the reporting and disclosure provisions, but also those provisions which relate to participation and vesting, funding, and fiduciary responsibility.

Present minimal reporting requirements are clearly designed to obfuscate the real issues.

IV

A. IRS has established reporting requirements which constitute little more than "name, rank and serial number." Such information is obviously of no real current benefit to IRS or to any other agency.

B. In our opinion, IRS has delayed promulgating its regulations with respect to reporting requirements quite deliberately, to the end that it is not immediately apparent that the service is really attempting to get its camel nose into the public retirement systems' tent. This is apparent from a brief comment by the service in its ruling to the effect that present reporting requirements may be enlarged upon for the next fiscal year.

C. In that ERISA specifically exempts public systems from title I of the act, and in light of its position with respect to reporting, we can't help but speculate that the service plans to gradually assert that governmental plans are subject to the funding and fiduciary responsibility sections of ERISA via some general authority in the Internal Revenue Code. Do you believe that this is what Congress intended? This appears to be a flagrant extension of authority over governmental plans, which Congress clearly did not intend, yet is it a very reasonable extension of its asserted power to require reporting.

V

The income of governmental plans is clearly not reportable under section 115 of the Internal Revenue Code. However, we hear rumors that the service plans to tax employer contributions at the time of payment, as a punishment to public systems which fail to concede to the authority of the service. That is, it plans to punish employees because their governmental plan refuses to report to IRS. We cannot believe that Congress will tolerate such inequitable enforcement tactics.

VI

The constitutional issues

A. The service is interpreting ERISA in such manner that the act is void under the tenth amendment to the Constitution as an unconstitutional burden, and trespasses upon the sovereign powers and essential governmental functions of the respective States.

(1) The service would in the immediate future require monumental bookkeeping, accounting and reporting requirements which will be a heavy, unnecessary, and unconstitutional burden upon the State governments or upon the individual governmental plans.

(2) Aside from the constitutional issues, such costs constitute an inequitable and improper use of trust funds which have been set aside to pay death and retirement benefits to public employees and their beneficiaries.

(3) When the service implements its other assumed authorities, they will be of such sweeping character as to effectively take over control of governmental plans and to deprive the respective States of their constitutional and basic authority to regulate the compensation of their own employees and of the employees of their political subdivisions.

(4) The Constitution is a compact between sovereigns. It is not within the constitutional powers of Congress to burden governmental plans which are an exercise of an essential sovereign function of government to the extent of fixing and controlling the compensation of their officers and employees. Retirement benefits have been construed by the courts to represent deferred compensation.

VII

Currently a lawsuit is in preparation by the California Attorney General on behalf of all of the state governmental plans in California challenging the service's position with respect to reporting. However, a final decision could take several years and will involve much cost both to the State of California and other states expected to join it, and to the Federal Government. Enactment of S 1587, or one of its companion bills, would obviate the necessity for this expensive and time-consuming litigation, and the issue would become moot. As indicated above, it is the considered opinion of our legal staff that S 1587 is merely declaratory of existing law in any event and not a change in law. Therefore, its enactment should proceed as expeditiously as possible, in order to promptly clarify the situation for the service and for all governmental plans.

VIII

The service should not be permitted to exercise any control over state retirement systems unless and until such control is related to a comprehensive plan for Federal supervision. The matter of reporting even minimal information to IRS should await the enactment of such comprehensive legislation, if that is what Congress wishes, to the end that the reporting will be of real purpose, value, and be of beneficial effect.

In conclusion, I would recommend to you the wisdom expressed by Senator Javits in the statement on ERISA he inserted in the Congressional Record of September 30, 1977, along the same lines as Senator Bentsen in 1973. For your convenient reference it is attached to these remarks.

Thank you for your consideration and courtesy.

PENSION REFORM FOR STATE AND LOCAL SYSTEMS

When the Congress passed ERISA, we realized that there were serious problems with state and local pension systems. We excluded governmental plans from Title I, however, because we simply did not have sufficient information on which to act.

Since ERISA's passage in 1974, we have been assembling information on public pension plans. Some time this year, the House Pension Task Force is expected to release the final version of its comprehensive study. The staff of the Senate Human Resources Committee will also release its report in the near future.

Even though these studies may demonstrate a need for federal legislation, I believe we should not take immediate action on a Public Employee Retirement Income Security Act (PERISA), I still consider the perfecting of ERISA as the highest legislative priority with respect to pensions. There is much that needs to be done with ERISA, and we should finalize the legal framework for private pension plan regulation.

I also think the states and their subdivisions have started getting their shops in order and should be given the chance to do the job without federal intervention. Over one-half of the states have started comprehensive reviews of their pension systems. In 1976, for example, New York State passed the Coordinated Escalator Retirement Plan. This law provides, among other things, for integration with Social Security and requires employee contributions of 3 percent of salary. It is estimated that these two measures will save approximately $2 billion in the course of the next decade.

In addition, President Carter has announced his intention to establish a blue-ribbon retirement commission which will study public pension systems. It would be very useful to have the input of the commission before we enact a public pension reform law. It is my understanding that the Administration presently views the proposed commission as an ongoing entity which will itself set deadlines for the study of various pension issues. I, for one, am not interested in spending years waiting for the proposals of such a commission, and I recommend that the Administration set reasonable deadlines for the completion of the Commission's studies. If such time limits are not set, I do not think the Congress will delay legislative action indefinitely.

Finally, I am concerned about the implications of The National League of Cities v. Usery which held that the extension of minimum wage coverage to state employees was unconstitutional. The Congress must be extremely wary of imposing responsibilities on the states.

STATEMENT BY DR. ROBERT L. HOLLISTER, JR., DIRECTOR, STATE OF WASHINGTON, DEPARTMENT OF RETIREMENT SYSTEM ON BEHALF OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION

My name is Robert Hollister. I am Director for the State of Washington, Department of Retirement System. This testimony is given on behalf of the Municipal Finance Officers Association, a professional organization of State and local finance officials.

We appreciate the opportunity to appear in these public hearings concerning S. 1587 which would clarify the absence of regulatory authority on the part of the Internal Revenue Service over state and local governments in respect of their pension plans. We also wish to speak to the deferred compensation issue. I respectfully request permission to file a more detailed statement in the record immediately following these comments.

S. 1587 is a very important piece of legislation. The Internal Revenue Service has acted on a broad front respecting state and local government pension plans. We do not believe that the IRS has the authority, either in a statutory or in a constitutional sense to undertake its actions. Nevertheless, short of lengthy judicial proceedings and a great deal of confusion for ourselves and our personnel, we have no means to defend ourselves.

Several aspects of IRS activities are discussed in a paper which is attached, entitled "Why the IRS Lacks Regulatory Authority over State and Local Government Pension Plans". This paper was prepared by Robert W. Doty, General Counsel to our Association. It is attached to our written testimony.

Briefly, the problems which we have encountered respecting our pension plans are threefold:

1. The Internal Revenue Service is seeking through regulations proposed last month to require a filing of a Form 5500 or a Form 5500–C by state and local governments in respect of their pension plans. Such a requirement is highly expensive and inconvenient. Although the Supreme Court repeatedly has required that Congress specifically indicate any intention to regulate state and local governments before legislation will be held to apply to them, and although there is nothing in Section 6058(a) of the Internal Revenue Code which mentions state and local governments, the Service has chosen to ignore this well-established doctrine of statutory interpretation. Further, even were Congress to attempt this regulation, we do not believe that such an action would be upheld as constitutional under the Tenth Amendment.

2. The Internal Revenue Service has in the past taxed state and local governments in respect of their investment income under their pension plans. For the present, the Service has deferred further taxation pending study. But it easily could reassert its prior position. Section 115 of the Internal Revenue Code specifies that such taxation is not to be undertaken. And the exemption of state and local governments from taxation also is a well-established constitutional doctrine even broader than the technical provisions of Section 115.

3. The Service is attempting to control state and local governments in respect of the provisions which they have in their pension plans through the assertion of the right to tax beneficiaries as if such plans were not "qualified" under Sections 401 et seq. of the Code. There is nothing in the Code indicating that Congress intended such regulation, and we do not believe it to be constitutional. The practical consequences of this would be extreme. Our police and fire officers, our sanitation personnel, our clerical personnel, in short, most state and local employees would be assessed taxes of large amounts of funds which they do not receive. This result would be unconscionable.

In summary, these actions constitute the assumption by the Internal Revenue Service of unprecedented regulatory license, not authorized by Congress and not permitted under the Constitution. The notion asserted by the Service that the plans are entities distinct from the governments is no more than fiction. These plans are a vital part of our operations.

S. 1587 would clarify Congressional intent on this matter, and we urge you to adopt the bill. It is essential for the continuance of our federal system of government.

With respect to deferred compensation, the Internal Revenue Service, in a complete chance from prior positions, has prohibited a vital source of compensation for many state and local employees. These people are not highly paid executives. Rather, they are the personnel who are essential in the day-to-day operations of our governments. We need these skilled personnel. If we cannot attract them, our governmental efficiency will be reduced greatly. We urge you to prepare and to adopt legislation similar to H.R. 10746, sponsored by Representative Waggoner. This would cure the problem.

Thank you for the opportunity to present our views. I shall be happy to answer any questions which you might have.

WHY THE IRS LACKS REGULATORY AUTHORITY OVER STATE AND LOCAL PENSION PLANS

(By Robert W. Doty [1])

I. INTRODUCTION

During the past couple of years, state and local governments have been surprised and disturbed to discover that various local offices of the Internal Revenue Service are taking the position that the qualification sections of the Internal Revenue Code of 1954 (Section 401 et seq.) apply to those state and local governments. The problem began in 1972 with Revenue Ruling 72-14, in which the Service ruled that a teachers' retirement system was subject to those requirements. Although the qualification sections and their predecessors have existed for many years, the IRS had never previously made this assertion. Indeed, in many instances, local offices took the position that state and local governments had pension plans which were "qualified" automatically by virtue of their being state and local governments. This was a long-standing interpretive gloss on the statute, and Congress was aware of this status.

The problem escalated during Spring 1977 when the Washington office of the IRS for the first time took the position in a press release, which went unnoticed by state and local officials and organizations for several weeks, that state and local governments are required to file Form 5500 or Form 5500-C under ERISA, a statute which had been in effect for three years prior to this action. Due to the communications received by the Service from state and local governments responding to this new development, and due to other factors, the Service postponed the original filing deadline to December 31 and shortened the forms for the current filing year. These actions will have no direct effect for subsequent filing years.

II. ERISA AND THE TAX CODE

ERISA consists of four titles: Title I relates to regulation by the Department of Labor; Title II relates to regulation by the Department of the Treasury; Title III relates to the Congressional Joint Pension Study which is to be completed in the near future; and Title IV relates to the Pension Benefit Guarantee Corporation. In Titles I and IV, specific exemptions are stated for state and local governments. Title III states that the Joint Pension Task Force is to study, among other subjects, "the necessity for Federal legislation and standards with respect to [state and local pension] plans." These are the only titles in connection with which there is any discussion of regulation of state and local governments.

Title II deals with the qualification sections of the Code, which had been applied to state and local governments only in Revenue Ruling 72-14. Title II adds a requirement in Section 6057(a) of the Code that plan administrators for certain plans to which Title I applies are to file "registration statements" with the IRS.

Section 6058(a) of the Code also is added to provide that "annual returns" are to be filed with the Department of the Treasury "stating such information as the Secretary or his delegate may by regulations prescribe with respect to the qualification, financial condition, and operations" of plans. These annual returns are to be filed by employers and plan administrators, except that employers may be relieved from stating in their returns "any information which is reported in other returns." Presumably, this aids employers when plan administrators have filed the data, although employers must still file some return.

Unlike Section 6057(a), Section 6058(a) relates to plans "described" in the qualification sections of the Code. These sections do not "describe" nonqualified plans, although the Service has taken the position that they do so because there are a very few abbreviated tangential references in those sections to the treatment of beneficiaries of nonqualified plans.

There is no indication in Section 6058(a) or in the qualification sections of the Code that state and local governments are covered by them. Neither is there any indication in the legislative history of the Code or of ERISA that state and local governments are covered by those sections or that their employees are not entitled to deferred tax treatment by failure of the governments to meet all the qualification requirements.

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[1] General Counsel, Municipal Finance Officers Association, Washington, D.C.

III. IRS POSITIONS

The IRS now asserts that state and local governments are to be treated the same as any other employer for purposes of the qualification sections of the Code and for other purposes. This position creates the following difficulties for state and local governments:

1. Forms 5500 and 5500-C purportedly are being required by the IRS to be filed by state and local governments, regardless of whether their pension plans are qualified or nonqualified.

2. Various IRS offices have taken the position that state and local governments could be taxed on investment income for funds maintained by them under nonqualified plans. Some governments actually have been taxed. For the present, the Service has deferred this treatment pending further study. But the strong possibility, indeed perhaps even the probability, remains that the Service will reactivate its policy. Precise estimates of taxes which would be payable by state and local governments under such a policy are impossible to derive, but it is obvious that in any case the amounts would be extremely high.

3. Employees of state and local governments and their estates are being denied the tax benefits of qualification by some IRS offices when the governments do not meet all the qualification requirements. Such a result is extremely onerous, and this policy would be catastrophic if applied on a national scale. Except for postponement of enforcement of the discrimination provisions, relating to varying benefits for different categories of employees, the Service has not relented in its position on this matter. Even the postponement regarding the discrimination provisions is only temporary, pending further study.

An additional complexity is created by the variances in IRS procedures from region to region and even district to district and auditor to auditor. Due to the centralization of a number of policy-making functions, this has been alleviated somewhat. But it continues with respect to the treatment of state and local government employees. Consequently, while communications have improved, it still is difficult to determine exactly what IRS positions are in this respect and to defend state and local governments on a policy level.

IV. ABSENCE OF IRS REGULATORY AUTHORITY

The following is a listing and a brief discussion of the reasons why the Internal Revenue Service lacks authority to regulate state and local governments. A more complete legal investigation is possible. Consequently, the following should not be deemed to be the "last word" on the subject.

(a) *Absence of statutory amendment*

Since the beginning of preferred tax treatment for beneficiaries of pension plans meeting certain requirements, existing at present in the form of "qualification" requirements, state and local governments had been treated until 1972 by the Service as automatically meeting the requirements by virtue of their status as state and local entities. Even after 1972, many, if not most, IRS offices continued the earlier policy. This longstanding regulatory gloss reflects recognition by the Service of the implicit congressional intent in the enactment of the various forms of requirements.

A reading of the requirements makes it obvious that they were not intended to apply to governmental entities. The discrimination provisions are an excellent example of this. These obviously were drafted to prevent profiteering by private corporate officials. Such an opportunity for profiteering does not exist in like measure within governmental entities, which are, of course, subject to state and local legal prohibitions and to political realities in that respect. At the same time, excellent reasons exist for different treatment of judges, executive officials, legislative officials, department heads, and operational employees. In no place in the legislative history of the Code or of ERISA has any intent ever been expressed by Congress to use such statutory enactments as a means of controlling state and local government compensation arrangements.

The Service had ample opportunity to obtain a congressional reversal of its long-standing interpretation of 1974 when ERISA was enacted. But it did not do so. Early drafts of the legislation would have provided for regulation, but all such references were deleted after state and local governments objected. All concerned voiced assurances that ERISA did not relate in any respect to the governments except to the extent that exemptions were stated and that a study would be made. Present attempts by the IRS to regulate state and local governments are therefore a serious breach of faith and a violation of congressional intent.

(*b*) *The necessity for a specific statement of congressional regulatory intent*

Over the years, in many important legislative areas, the Supreme Court has considered assertions that state and local governments are covered by various forms of enactments. Clear precedents have been established by the Court which require that there be a specific indication of congressional intent before states and localities will be held to be subject to statutory schemes. One such area is that of the antitrust laws. In *Parker* v. *Brown*, 317 U.S. 341 (1943), the Court stated:

"We find nothing in the language of the Sherman Act or in its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature. In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may Constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and its agents is not lightly to be attributed to Congress. 317 U.S. at 350–51."

In another basic policy area, that if the Civil Rights Act, the Court held in *Monroe* v. *Pape*, 365 U.S. 167 (1961), that the definition of a "person" covered by the Act did not include states and localities because they were not specified in that definition.

In the labor area, *see Employees* v. *Department of Public Health & Welfare*, 411 U.S. 279 (1973). And in the securities area, *see* three appellate decisions: *Brown* v. *Kentucky*, 514 F. 2d 993 (6th Cir. 1975) (per curiam), *cert. denied*, 423 U.S. 839 (1975); *Yeomans* v. *Kentucky*, 513 F. 2d 333 (6th Cir. 1975); and *Green* v. *Utah*, reprinted in [1976–77 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,677 (10th Cir. July 29, 1976).

If the Supreme Court so holds in such fundamental policy areas as the civil rights laws, it is inconceivable that the Court would hold otherwise as to the tax code.

(*c*) *Absence of congressional regulatory power*

In *National League of Cities* v. *Usery*, 96 S. Ct. 2465 (1976), the Supreme Court held that Congress could not regulate state and local governments to the extent of requiring them to pay minimum wages to their employees. This important Tenth Amendment protection is squarely in point in this instance. While Justice Blackmun, one of the majority in the five-four decision, stated a willingness to use a balancing test of the constitutional validity of legislation, that balancing test would not result in regulatory authority in matters regarding employee relations. The type of legislation appropriate under that balancing test is legislation having an interstate impact, such as environmental legislation to eliminate pollution crossing state lines. The provision of benefits to employees is strictly a local matter and has little, if indeed any, interstate consequences.

The historic implicit recognition by the IRS of state and local governments as exempt and as having qualified plans indicates a recognition by the Service that the Code provisions were not intended to regulate state and local governments and that Congress does not believe it has power to act in this area. The failure of Congress to legislate regarding state and local governments when it has had numerous opportunities to do so and when it has regulated private employers for decades confirms this absence of congressional power.

(*d*) *Absence of authority to tax state and local governments*

Section 115 of the Code excludes from gross income "income derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof". In today's world, it is essential that state and local governments make reserves for the payment of pensions to their employees. And it would violate fiduciary responsibilities if these funds were not invested. Thus, Section 115 constitutes a statutory prohibition upon taxation on the income from these investments.

The Service argues that the plans are entities which are separate from the governments themselves. It is true that for many purposes such a fiction is given breath in the Code. But we are not dealing with technical considerations. We are dealing with vital matters of public policy surrounding the problems of intergovernmental accommodation in a federal system, and under such circumstances a technical view of a plan as separate from the government is incorrect. For purposes of Section 115, the plans are necessary instrumentalities of the governments, and are a part of those governments.

But analysis only begins with Section 115. The statute, however clear, is not the primary prohibition upon taxes imposed on state and local governments. Raher, in our dual system of government, the federal government lacks any power whatsoever to tax state and local entities. Section 115 merely expresses a facet of that constitutional doctrine.

The principle was first stated in *McCulloch* v. *Maryland*, 4 Wheat. 316, 4 L.Ed. 579 (1819), in which the Supreme Court held that a state could not tax an instrumentality of the federal government, and stated:

"That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance, in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied."

In *Collector* v. *Day*, 11 Wall. 113, 20 L.Ed. 122 (1871), the Court stated the converse respecting taxation by the federal government of a state judicial officer.

"The general government, and the states, although both exist within the same territorial limits, are separable and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former, in its appropriate sphere, is supreme; but the states within the limits of their powers not granted; or, in the language of the 10th Amendment, "reserved," are as independent of the general government as that government within its sphere is independent of the states. . . . Such being the separate and independent condition of the states in our complex system, as recognized by the Constitution, and the existence of which is so indispensable, that, without them, the general government itself would disappear from the family of nations, it would seem to follow, as a reasonable, if not a necessary consequence, that the means and instrumentalities employed for carrying on the operations of their governments for preserving their existence, and fulfilling the high and responsible duties assigned to them in the Constitution, should be left free and unimpaired; should not be liable to be crippled, much less defeated by the taxing power of another government, which power acknowledges no limits but the will of the legislative body imposing the tax."

Collector v. *Day* was reversed in *Graves* v. *O'Keefe*, 306 U.S. 466 (1939), but only "so far as [it] recognize[d] an implied constitutional immunity from income taxation of the salaries of officers or employees of the national or a state government or their instrumentalities." Id. at 486. Thus, the immunity of state and local governments from taxation is a living and viable constitutional principle which would be violated squarely by taxation of income on investments by state and local governments in the satisfaction of their pension obligations.

(e) Necessity for prescribing forms by regulation

Section 6058(a) requires that information to be reported in annual reports be prescribed by regulation. For almost a year, the Service purported to require filings of Form 5500 and 5500–C pursuant to a press release. Finally, after state and local governments persisted in pointing out that regulations are required even under the Service's own statutory interpretation, proposed regulations were issued in February 1978. But these proposed regulations do not comply with the statutory intent due to a lack of specificity. They speak only in general terms regarding the items to be included in the Forms, and they leave a large amount of discretion in the Washington and district offices of the Service to require more information outside the regulations. State and local governments cannot live with regulation by personal whim. Congress did not intend that anyone, whether in the public or private sector, do so.

(f) Failure to follow OMB Circular A–85 and proposed Executive Order of the President

OMB Circular A–85 requires governmental departments to provide to the ACIR proposed regulations which have a substantial impact upon state and local governments so that those proposals may be furnished, before they are published, to various organizations representing state and local governments. This gives those organizations an opportunity to comment on their own behalf and also benefits the federal government by giving it access to the information which thereby can be provided. The procedures for publishing regulations and receiving public comment have not been deemed adequate for these purposes. Th IRS has not followed this process on this matter, even though its actions have a substantial adverse impact upon state and local governments.

Further, in a proposed Executive Order, the President has indicated that all departments of the federal government should consult with representatives of state and local governments before taking regulatory actions which affect them. Since no regulations have been proposed, there have been no consultations on such regulations.

Due to its failure to follow these required procedures, the actions of the Service regarding state and local government pension matters are improper.

(*g*) *Coverage of section 6058(a)*

Section 6058(a) applies to plans "described" in the qualification sections of the Code. If those requirements are read closely it is obvious that they do not "describe" nonqualified plans. At the most, no more than very brief indirect references are made to the tax treatment for employees receiving benefits under nonqualified plans. Since the Service now is making assertions which imply that in its view virtually all state and local governments have plans which are nonqualified, the Service's authority with respect to such governments is nonexistent.

V. CONCLUSIONS

The Department of the Treasury and the Internal Revenue Service lack authority to regulate state and local governments. Actions which purport to require the filing of forms by state and local governments, to tax state and local governments, and to discriminate against employees of state and local governments are invalid. Further, the Service is not acting properly even on the face of the statute as read by the Service. It is itself acting contrary to the law and the Constitution. There simply is no jurisdiction in the Service to take any regulatory actions whatsoever regarding state and local governments.

STATEMENT BY DR. ROBERT L. HOLLISTER, JR., DIRECTOR, STATE OF WASHINGTON, DEPARTMENT OF RETIREMENT SYSTEMS ON BEHALF OF THE STATE OF WASHINGTON

My name is Robert L. Hollister. I am Director for the State of Washington, Department of Retirement Systems. This testimony is given on behalf of the State of Washington.

We appreciate the opportunity to appear in these public hearings concerning S. 1587 which would clarify the absence of regulatory authority on the part of the Internal Revenue Service over state and local governments in respect to their pension plans. I respectfully request permission to file a more detailed statement in the record immediately following these comments.

The State of Washington is particularly concerned with the activities of the Internal Revenue Service in recent years with respect to public pension funds. Acting under authority they apparently feel they have been granted by the Code and ERISA, they have taken a series of actions which appear to us at best capricious and at worst a violation of their authority.

I will not dwell on the legal aspects of their authority as we believe these are adequately addressed in the paper entitled "Why the IRS Lacks Regulatory Authority over State and Local Government Pension Plans." This paper was prepared by Robert W. Doty, General Counsel to the Municipal Finance Officers' Association and is attached to their testimony presented to this Committee.

Instead, we would like to address the practical problems from our viewpoint.

First there is the issue of disclosure. In accordance with our state laws, we believe we are making full and adequate disclosure both as to plan contents and as to the annual financial condition of our plans. Of course, we would be receptive to making any additional disclosures deemed reasonable and necessary.

Second, with respect to our investment portfolios and investment practices, we believe we meet any reasonable test for adequacy and safety to include ERISA.

Third, with respect to the inviolability of our pension funds, our State Supreme Court has so ruled them to be strictly in trust for the benefit of the members.

Fourth is the issue of funding. Our major state plans are funded on an actuarial basis.

Given these four elements just covered, it would seem we should not be subjected to attack, but we still fear we are vulnerable based on past Service actions.

As an example, the town of Hautzdale, Pennsylvania, with a pension plan covering a single employee was fined $3,000 for filing their 5500 report late. The first notice any of us had that the report was to be filed was via a press release by the Service last spring. Hautzdale filed within the time specified by the Service in the press release, but was fined anyway. We are well aware that many public plans including ourselves filed at much later dates but were not penalized; indeed, some plans have totally refused to file up to this time. This incident hardly represents an even application of the Service's authority real or assumed.

As a second example, the Service has taxed the investment earnings of the St. Joseph, Missouri Fireman's Retirement System and the beneficiaries of some public plans in the Southeast. We note that these taxes have been returned and that the Service is "studying" the issue, but they have not clearly renounced their right to tax.

This, to us, is the purpose of S. 1587, to clearly establish that public pension plans are not subject to taxation.

There appear to be two bases for the Service's assumed right to tax.

The first is that the designation of the funds as in trust for the members in some manner suddenly makes them non-public funds. The truth is that whether they are public funds or not, any monies taken from them by Federal taxation must be replaced a dollar for a dollar by State and local taxes. Therefore, such a tax directly or indirectly is a tax on State and local governments.

The significance of such a tax must be noted. In our case, a tax on the earnings of our retirement funds last fiscal year would have amounted to at least $48.5 million. Further, our State Actuary has estimated the two-thirds of our pension benefits will be paid in the long run from the investment earnings. If these earnings are taxed, it will require our employer contributions to be doubled in the long run.

The second basis for taxation relates to whether a plan is qualified or non-qualified. The basis for qualification under Section 401 is designed for private plans, not public. The intent of qualification was to preclude discrimination. Strict application of the current qualification rules produce unusual results when applied to the public sector. As an example, our Law Enforcement Officers' and Firefighters' plan cannot be qualified. One of the requirements is that disability and death benefits must be incidental to service benefits. In this context, incidental means of little consequence. In our police and fire plan, as in similar plans in other jurisdictions, disability and death benefits are of major consequence.

In the private sector such disqualifying conditions may be altered so as to obtain the tax benefits of qualification if the firm so desires. In our case, Our Supreme Court has held that pension benefits, once enacted into law, cannot be withdrawn except as to prospective members.

Further since we have six plans and the Service would logically evaluate them together, if one plan does not qualify, none would qualify.

Thus, despite the fact we make full disclosure, follow proper investment procedures, isolate the funds for the sole benefit of the members and provide actuarial funding, they could all be held non-qualified and subject to taxation.

Finally, if the plans are held to be non-qualified, then the employer's contribution for the employee could be taxed as current income to the employee. By example, the employer's contribution for our police and fire plan is 57.8% of their gross pay. Each member then would have this contribution imputed as part of their gross income for personal tax purposes. This would impose a staggering financial blow.

We believe it is clear that an attempt is being made in some quarters to confuse the tax issue with the question of regulation. We view these as two separate and highly distinct issues. We believe we have amply demonstrated that retirement systems which could clearly meet the objectives of any reasonable regulation could still be vulnerable to taxation. We feel that S. 1587 eliminates this potentially and manifestly unfair possibility and urge its adoption. I am also enclosing a statement on this subject from our Governor, The Honorable Dixy Lee Ray.

OFFICE OF THE GOVERNOR,
Olympia, Wash., March 21, 1978.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Russell Building, Washington, D.C.

DEAR SENATOR BENTSEN: Our state has recently and with considerable legislative trauma succeeded in adopting major pension reform measures. Our current situation and concerns were addressed in Dr. Hollister's presentation to your committee.

I cannot believe that the Congress ever intended that public pension plans should be subject to taxation. Unfortunately, there is a mounting body of evidence that the Internal Revenue Service feels it has such power. Given the grave financial problems faced by most political subdivisions, even the possibility of taxing our pension plans alarms us.

I particularly note the real possibility of some jurisdiction taking actions to technically avoid taxation which could be totally counter productive to the objectives of sound public pension plans.

Therefore, I urge your adoption of S. 1587 which would clarify once and for all the question of taxation of public pension plans.

Sincerely,

DIXY LEE RAY, *Governor.*

Senator BENTSEN. Our next panel will deal with the deferred compensation agreements. Mr. Herman Biegel, Mr. Carroll Savage, Mr. Ralph Ytterberg. If you gentlemen will come forward—and if I have mispronounced a name, I apologize.

STATEMENT OF HERMAN BIEGEL, ESQ., AND CARROLL SAVAGE, ESQ.

Mr. BIEGEL. Thank you, Senator.

My name is Herman C. Biegel. I am a partner in the firm of Lee, Toomey & Kent in Washington, D.C. I am accompanied by Mr. Carroll Savage and I will have him introduce himself.

Mr. SAVAGE. My name is Carroll Savage, Mr. Chairman. I am a partner with the Washington, D.C., firm of Ivins, Phillips & Barker and I appear as a representative of the Rochester Tax Council in lieu of Mr. Kenneth Christrup, chairman of the council, who has filed a written statement.

The council is an organization of companies with strong affiliations throughout the Rochester, N.Y. area, but which manufactures a wide variety of high technology products. It has facilities in all States of the United States.

Senator BENTSEN. You had better get along with your testimony.

Mr. SAVAGE. I was just going to defer to Mr. Biegel for the oral statement in the interest of time, but I did want to state that the members of the council have found that these proposed regulations, even in proposed form, seriously disrupt compensation programs that they have had for many years. Mr. Biegel will address the law and the policy behind our opposition to that.

Mr. BIEGEL. Mr. Chairman, the concept of deferred compensation has been a part of the tax law for many years and has evolved into a well-settled and widely recognized method of compensating employees.

Deferred compensation serves many legitimate corporate purposes. It helps attract and retain valuable employees, not only in the top echelons of management, but in middle management as well. The arrangement is invaluable to small- and medium-sized companies which cannot afford "rich" pension plans or for which qualified, and even nonqualified options are not feasible.

To characterize deferred compensation as a tax loophole or tax shelter is absurd under the present tax structure. The corporate employer is generally in the 48-percent tax bracket; most employees for whom deferred compensation is designed are in the 50-percent bracket on earned income. Accordingly, if deferred compensation were to be taxed currently, the revenue gain derived by taxing the employee would be offset by the revenue loss from the immediate deduction by the employer.

In view of the interplay of the 50-percent maximum tax on earned income with the 48-percent tax on corporate income, it is obvious that tax avoidance is not the objective of deferred compensation arrangements.

Moreover, the proposed Treasury regulation section 1.61–16 would tax currently to the employee amounts of compensation, which, at the employee's election, are deferred to a later taxable year. This position is unwarranted for the following reasons:

(*a*) The proposed regulations are in conflict with the applicable provisions of the Internal Revenue Code as interpreted by the courts for over 30 years and by the Internal Revenue Service for the last 18 years.

(*b*) In view of the long history of judical and administrative acceptance of deferred compensation arrangements, any drastic change in the law should be accomplished only through careful study at the legislative level and by way of legislative action rather than by administrative fiat.

(*c*) If the proposed regulation is promulgated, the administrative problems created by it would be enormous.

Senator BENTSEN. Thank you very much. I will look forward to reading the statement.

STATEMENT OF RALPH YTTERBERG, VICE PRESIDENT, DRESSER INDUSTRIES, INC.

Mr. YTTERBERG. My name is Ralph Ytterberg. I am vice president of industrial relations of Dresser Industries, Inc., which has its headquarters in Dallas, Tex. The purpose of my testimony is to express our concern about a proposed change in the tax laws by the IRS that Dresser believes is contrary to our individual interest as well as being contrary to the national interest in that it eliminates an opportunity for employees to own an ownership interest in their company. Further, we believe it represents action that should be legislative rather than administrative, since it is a reversal of well-established tax rules on a subject having significant policy aspects.

This action is the proposed addition of a new regulation section 1.61–16 which in effect would immediately tax any compensation that an employee has a choice to defer for subsequent payment.

I will briefly try to review our thinking that the proposed change in taxation for the nonqualified deferred compensation program, such as we at Dresser maintain, one, would have an adverse effect on Dresser and its employees, two, would either not serve, or run counter to, the national purpose, and three, is basically erroneous in its concept. Therefore, in our judgment, it should not be permitted to be implemented simply as an administrative procedure without being given serious consideration by the legislature.

Rather than make any formal proposal for amendments, which, by the way, could easily have been included in the recent comprehensive list of suggested new tax law revision now under consideration by the House Ways and Means Committee, the present administration apparently has chosen to cloak this proposed significant reversal of this portion of existing tax law in the guise of an administrative matter.

This, in our opinion, has occurred notwithstanding the evident congressional interest in the topic and the settled state of existing law that is proposed to be overturned.

We, at Dresser, have maintained two alternate deferred compensation plans for many years. The principal plan has been operating about 14 years and it is covered by an IRS ruling that was issued back in 1966.

Under our plans, by proper election before the amount of compensation is finally determined or fully earned or awarded to the participant, he can elect to convert his incentive compensation earnings that would otherwise be paid in cash into account credits for units equivalent to Dresser shares. And because we want to encourage participation in the plans, the stock is made available at a discount from the market value of the stock.

I firmly believe that the existence of these plans and the success and the progress of Dresser are closely related. The plans have helped us in four basic ways, which I will just mention.

First, I believe it has helped us attract and retain real productive employees, good managers, good salespeople.

Second, I think the structure of the plans, the tying of the eventual benefits to stock values, gives the participants a real, proprietary interest in the future of Dresser.

Third, I think the fact of deferral, coupled with the frequent utilization of stock as the form of benefit payment, means that Dresser can conserve its available cash for future growth. During the period from 1964 that we've had these deferred compensation programs, our sales have increased from some $500 million annually to $2.5 billion this last year. Our shareholder equity has gone from $120 million up to over $1 billion. So it is evident that we are experiencing good growth.

Over the same time, our deferred compensation programs have conserved a total of about $30 million in cash that would otherwise have to have been paid out, absent these plans.

And, finally, the way our plans work, the forfeiture provisions that we have included in our plans have helped to dissuade employees who leave Dresser to go to work with competitors from improperly using the confidential information they have acquired while employed with us.

With respect to the cumulative effect of these plans on Dresser, I think it is important to note that we have approximately 375 participants actively in the plans now and another 110 additional former employees, or their beneficiaries, who are currently receiving benefit payments, so obviously they are not designed to restrict it to the top management.

In fact, we have employees with as low a current annual salary as $20,000 who participate in the plan.

Senator BENTSEN. Mr. Ytterberg, I am going to have to ask you to put the rest of your statement in the record. I understand we have one more witness on this panel who would like to comment.

Let me say in passing that I've always favored plans such as that which gives greater stock participation for employees. I did that when I was in business. I know the chairman of this full committee with his strong support of ESOP shares that point of view.

Mr. YTTERBERG. We are also just introducing a stock purchase plan for broader participation in that regard, so we are very much a believer in it.

[The prepared statements of the preceding panel follow:]

STATEMENT OF HERMAN C. BIEGEL, ESQ., LEE, TOOMEY & KENT, WASHINGTON, D.C.

This hearing of the Finance Subcommittee on Private Pension Plans and Employee Fringe Benefits is considering (1) S. 1587, a bill to exempt state and local government pension plans from Federal income tax liability, and (2) the tax treatment of the deferral from income of certain amounts deferred under non-qualified deferred compensation plans.

This statement is being submitted by Herman C. Biegel of Lee, Toomey & Kent, Washington, D.C. The firm of Lee, Toomey & Kent has, for a number of years, specialized in Federal income taxes and in the tax aspects of qualified pension, profit sharing and stock bonus plans, as well as non-qualified plans of deferred compensation. Our clients have included both large and small corporations representing a cross-section of American industry.

We are not taking a position with respect to S. 1587. However, we are deeply concerned with the future treatment of non-qualified deferred compensation plans. In the latter connection, the Treasury Department has issued Proposed Regulations Section 1.61-16, published in the Federal Register on February 3, 1978.

We wish to submit our views on the present treatment of non-qualified deferred compensation plans and register our opposition to the promulgation of Proposed Treasury Regulations Section 1.61-16.

I. PRESENT TREATMENT OF DEFERRED COMPENSATION

Deferred compensation is simply remuneration for services, payment of which is made in a year after the year in which such services are performed. The recipient is not taxed on such amounts until payment is actually received and the employer gets no deduction until that time.

The concept of deferred compensation has been a part of the tax law for many years and has evolved into a well settled and widely recognized method of compensating employees. However, for a long period there was no official guidance from the Internal Revenue Service or the Treasury Department with respect to how deferred compensation was to be treated for tax purposes. Rather, the guidance came from litigated cases interpreting the predecessors to present Sections 61 and 451 of the Code. See generally, *Frank Cowden, Sr.* v. *Commr.*, 289 F.2d 20 (5th Cir. 1961), rev'g. 32 T.C. 853 (1959); *Commr.* v. *Oates*, 207 F.2d 711 (7th Cir. 1953), aff'g. 18 T.C. 570 (1952); *Ray S. Robinson*, 44 T.C. 20 (1965); *Howard Veit*, 8 T.C. 809 (1947) and 8 T.C.M. 919 (1949); *Julian Robertson*, 6 T.C. 1060 (1946). Cf. *Massachusetts Mutual Life Insurance Co.* v. *U.S.*, 288 U.S. 269 (1933); *Old Colony Trust Co.* v. *Commr.*, 279 U.S. 716 (1928).

Section 61 of the Code provides that gross income includes all income from whatever source derived. Section 451 provides that any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer unless other methods of accounting are used. The Regulations under Section 451 also deal with the concept of the constructive receipt of income.

In interpreting the predecessor statutory provisions, the courts uniformly upheld the principle that the unsecured promise of an ordinary business corporation to make payments of compensation to an employee in the future could not be taxed to him until he actually received such amounts. *J. Darsie Lloyd*, 33 B.T.A. 903 (1936), acq. 1950-2 C.B. 3; *Bertha F. Kann*, 130 F.2d 797 (3rd Cir. 1942), aff'g. BTA Memo Dec. 12,152-B (1941). Thus, a cash basis taxpayer does not realize any gross income when he agrees to defer the receipt of such income prior to the time the income actually becomes payable to him. In *Commr.* v. *Oates*, *supra*, the question was whether insurance agents who had renegotiated their contracts with an insurance company so as to defer the receipt of certain renewal commissions otherwise payable to them by the company were liable for income tax only on the commissions they actually received in a tax year rather than on commissions received by the company and accruing to their account during such year. In holding for the taxpayer the Court stated that:

"* * * [T]he realization of income is the taxable event rather than the acquisition of the right to receive it and that realization ordinarily is not deemed to occur until the income is paid * * *"[1]

In another case this principle even has been extended to permit the taxpayer to delay taxation beyond the date to which he had originally deferred the payment of income to a later date by making such an election prior to the date the original deferred payment was due. *Howard Veit*, supra.

After losing a number of cases in this field, the Internal Revenue Service undertook a reevaluation of its position. In 1960, after several years of study, the Service issued Revenue Ruling 60-31, 1960-1 C.B. 174, which accepted the concept of deferred compensation and approved the use of deferred compensation arrangements of various kinds covering both individuals and groups of employees. This basic ruling was followed by a host of other published rulings approving various deferred compensation arrangements. See generally, Rev. Rul. 72-25, 1972-1 C.B. 127; Rev. Rul. 71-419, 1971-2 C.B. 220; Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 68-99, 1968-1 C.B. 193; Rev. Rul. 68-86, 1968-1 C.B. 184; Rev. Rul. 67-449, 1967-2 C.B. 173. In addition, the Service expanded its ruling policy and issued innumerable private rulings on specific plans, programs and contracts involving deferred compensation.

Thus, for over 30 years the courts have uniformly recognized the effectiveness of arrangements deferring the receipt of compensation, and for over 18 years the Internal Revenue Service has concurred in that position. It should be noted that over that period not a single litigated case or legislative provision has given any indication that the treatment of deferred compensation arrangements should be circumscribed.

II. THE TREASURY'S PROPOSED POSITION

The proposed amendment to the Regulations provides that 26 CFR Part 1 is amended by adding a new Section 1.61-16, reading as follows:

"*§ 1.61-16.* Amounts, payments of which are deferred under certain compensation reduction plans or arrangements.

"(a) *In general.* Except as otherwise provided in paragraph (b) of this section, if under a plan or arrangement (other than a plan or arrangement described in section 401(a), 403(a) or (b), or 405(a)) payment of an amount of a taxpayer's basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increases in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer's rights in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment.

"(b) *Exception.* Paragraph (a) of this section shall not apply to an amount payment of which is deferred as described in paragraph (a) under a plan or arrangement in existence on February 3, 1978, if such amount would have been payable, but for the taxpayer's exercise of the option, at any time prior to [date 30 days following publication of this section as a Treasury decision]. For purposes of this paragraph, a plan or arrangement in existence on February 3, 1978, which is significantly amended after such date will be treated as a new plan as of the date of such amendment. Examples of significant amendments would be extension of coverage to an additional class of taxpayers or an increase in the maximum percentage of compensation subject to the taxpayer's option."

The announcement of the proposed change in the Regulations states:

"The new regulation provides that if a taxpayer (whether or not an employee) individually chooses to have payment of some portion of his current compensation or an amount of an increase in compensation deferred and paid in a later year, the amount will nevertheless be treated as received by the taxpayer in

[1] It should be noted that the *Oates* case has been on the books without challenge by the Internal Revenue Service for over 25 years. Only now is the Treasury Department stating that its present acquiescence in the case will be reconsidered. (See the Treasury Department's Notice of Rulemaking quoted at page 7, infra.)

the earlier taxable year. The taxpayer's exercise of the option to defer payment must be under a plan or arrangement other than one described in section 401 (a), 403(a) or (b), or 405(a) of the Internal Revenue Code of 1954 (relating respectively to qualified pension, profit-sharing, and stock bonus plans; taxation of employee annuities; and qualified bond purchase plans)."

In describing the effect of the Proposed Regulations on the Service's present published position, the announcement states:

"If this regulation is published as a Treasury decision, Rev. Rul. 67-449, 1967-2 C.B. 173, Rev. Rul. 68-86, 1968-1 C.B. 184, Rev. Rul. 69-650, 1969-2 C.B. 106, and Rev. Rul. 71-419, 1971-2 C.B. 220 would no longer be applied and present Service acquiescences in the decisions in *James F. Oates*, 18 T.C. 570 (1952) and *Ray S. Robinson* 44, T.C. 20 (1965) would be reconsidered.

"Further, it would be necessary to examine the facts and circumstances of cases similar to those described in several other published revenue rulings (such as Examples (1) and (3) of Rev. Rul. 60-31, 1960-1 C.B. 174, Rev. Rul. 68-99, 1968-1 C.B. 193, and Rev. Rul. 72-25, 1972-1 C.B. 127) to determine whether the deferral of payment of compensation was in fact at the individual option of the taxpayer who earned the compensation.

"On September 7, 1977, the Service announced in IR-1881 that it had suspended the issuance of rulings dealing with the income tax treatment of certain non-qualified deferred compensation plans established by State and local governments and other employers pending completion of a review of this area.

"The plans reviewed permit the employee to individually elect to defer a portion of his or her salary. This proposed amendment represents conclusions reached as a result of this review."

III. OUR POSITION ON THE PROPOSED REGULATIONS

We are opposed to the promulgation of Proposed Treasury Regulations Section 1. 61-16 for the following reasons:

(1) The Treasury Department's approach to deferred compensation arrangements is apparently predicated on the assumption that they are tax loopholes which must be closed by administrative action. We submit that deferred compensation is in no sense of the word a tax loophole.

(2) Deferred compensation serves many legitimate corporate purposes. Its use should therefore not be discouraged or circumscribed.

(3) The Proposed Regulations are in conflict with the applicable provisions of the Internal Revenue Code as interpreted by the courts for over thirty years, and by the Internal Revenue Service for the last 18 years.

(4) In view of the long history of judicial and administrative acceptance of deferred compensation arrangements, any radical change in the law should be accomplished only through careful study at the legislative level and by way of legislative action, rather than by administrative fiat.

(5) If the Proposed Regulation is promulgated, the administrative problems created by it would be enormous.

IV. DISCUSSION OF OUR POSITION

(1) *Deferred compensation is in no sense of the word a "tax loophole."*—The argument that deferred compensation is a tax avoidance device is completely without merit. The vast majority of the employers involved are corporations in the 48 percent marginal tax bracket. Similarly, most of the employees involved are subject to tax at the marginal tax rate of 50 percent on earned income. Accordingly, if deferred compensation is taxable currently, the revenue gain from immediate taxation of the employee would be offset by the revenue loss from immediate deduction by the employer. Moreover, even though there is a deferral of tax until receipt, the employee does not have the use of the money during the period of deferral, and the employer does not get a tax deduction until the time of payment. Thus, the deferred compensation arrangement has none of the attributes (or objections from the Treasury's point of view) of the typical tax shelter device.

It is true that one of the attractive features of deferred compensation to an employee is the anticipation that he might be in a lower tax bracket when deferred compensation payments are ultimately made to him. But there is no guarantee that this will, in fact, be the case. There are numerous instances where just the opposite is true, either because the employee has other income or because he is a widower and thus subject to taxation at single taxpayer rates, or because the tax rates have been increased (e.g., a year in which a surcharge is applicable). Moreover, even in those cases where the tax rates are lower in the year of receipt, the difference in rates is usually small and it has not been demonstrated that it represents a significant method of tax avoidance.

Accordingly, in view of the interplay of the 50 percent maximum tax on earned income and the 48 percent tax on corporate income, it is obvious that tax avoidance is not the objective of deferred compensation arrangements. The real purpose they serve is to provide the employee with a greater degree of financial securiy in his retirement years and narrow the gap in earnings between his active and retirement periods.

(2) *Deferred compensation serves many legitimate corporate purposes.*—Deferred compensaton has been used for many years, wholly apart from tax consequences, as a method of attracting and retaining valuable employees, not only in the top echelons of management, but also in middle management. We submit that these arrangements are not devices limited to a few highly paid employees who are in a financial position to demand them. On the contrary, many companies realize that orderly progression in executive ranks is vital to the success of any enterprise and therefore apply such plans broadly to technical and managerial personnel at many levels.

This is particularly true in the case of small or new companies which cannot afford the fixed annual cost of a pension plan or large current salaries, or where the use of qualified or non-qualified stock options is not visible. More often than not, forfeiture provisions are included to further encourage employees to stay with an employer. Furthermore, under many deferred compensation arrangements the ultimate payout is keyed to the value of the employer's stock. In such case there is an obvious incentive on the part of the employee to increase such value so that the amount he ultimately receives will be that much greater. Deferred compensation can thereby provide the employee with a direct and real stake in the business.

For these reasons the tax laws should encourage the use of deferred compensation arrangements rather than impede their availability to corporate employees.

(3) *The Proposed Regulations are in conflict with the applicable provisions of the Internal Revenue Code as interpreted by the courts for over 30 years, and by the Internal Revenue Service for the last 18 years.*—As pointed out in Part I above, the present treatment of deferred compensation has developed over a substantial period of time, either through court decisions or, ultimately, by publication of Revenue Rulings by the Internal Revenue Service. These judicial interpretations of Sections 61 and 451 of the Code have withstood attack for over 30 years, and even the Service's administrative interpretations of these sections have been consistent with the court decisions. The change in the tax treatment of deferred compensation now proposed by the Treasury flies in the face of long established judicial and administrative precedent.

It is respectfully submitted, therefore, that taxpayers should be entitled to rely on this long established policy announced by the courts and adopted by the Internal Revenue Service, and that no administrative change is warranted at this point in time.

(4) *Any change in existing tax treatment of deferred compensation should be effected by legislation, not by administrative fiat.*—Under Section 7805 of the Code, the Commissioner has the power to prescribe the rules and regulations necessary to enforce the provisions of the Code. This provision, however, has never been construed by the courts as giving the Commissioner the power to deviate so far from the statute as to actually create new legislation. Any such attempt by the Commissioner to adopt a rule totally inconsistent with the statute and its legislative history would be invalid. See, *Manhattan General Equipment Co.* v. *Commr.*, 297 U.S. 129, 134–135 (1936).

As discussed above, the Proposed Regulations are clearly in direct conflict with Sections 61 and 451 of the Code, and all judicial decisions interpreting them or their predecessors. Furthermore, as indicated above, in the 18 years since the issuance of Revenue Ruling 60–31, there have been no changes in the area by way of administrative announcements, court decisions or legislation. It is well settled that where an administrative interpretation of a statute has survived reenactment of the statute, the practice is generally presumed to have been approved by Congress. See, *Helvering* v. *Winmill*, 305 U.S. 79 (1938).

Because of the above, the Proposed Regulations, if finalized, would in all likelihood precipitate lengthy and numerous legal battles, and would create uncertainty as to the validity of these arrangements until the litigation is finally resolved. Consequently, any such change even remotely similar to those contained in the Proposed Regulations should be accomplished, if at all, only through legislation.

Indeed, in the Tax Reform Act of 1969, the House adopted a provision with respect to deferred compensation. (Section 331 of H.R. 13270, 91st Cong., 1st Sess.) However, even this provision did not attempt to tax the employee currently on amounts of compensation deferred to a later year. Instead, it recognized the principle that deferred compensation was taxable only when received. It then provided that, in computing the tax on such deferred compensation in the year of receipt, the applicable rate should be determined by "throwing back" the deferred compensation to the year in which it was earned. The rate of tax that would have been applicable in that year, had the deferred compensation been received in that year, would then be applied to the deferred compensation in the year of receipt. The Treasury Department, however, felt that the provision was overly cumbersome and that the treatment of deferred compensation needed more study. The provision was, therefore, dropped from the bill (See Report of Senate Finance Committee No. 91-552, at pp. 306-307.) Significantly, it was recognized by all concerned, both the Legislative and Administrative Branches, that legislation, rather than administrative fiat, was necessary to change the tax treatment of deferred compensation.

(5) *The administrative problems created by the Proposed Regulations would be enormous.*—In addition to the legal objections to the Proposed Regulations, their implementation would provide numerous administrative problems.

(a) As indicated in the Treasury Department's statement accompanying the Proposed Regulations, "it would be necessary to examine the facts and circumstances of cases similar to those described in several other published Revenue Rulings * * * to determine whether the deferral of payment of compensation was in fact at the individual option of the taxpayer who earned the compensation." What objective standards can be evolved to determine whether the deferment was at the election of the employee or designed for the benefit of the employer? As indicated above, deferred compensation arrangements are frequently initiated by the employer and serve many corporate purposes. Are such arrangements to be viewed with suspicion? Will there be any way the taxpayer, either the employee or the employer, could convince the Service that the deferment was not at the election of the employee? This inquiry would raise serious problems as to the viability of any deferred compensation arrangement.

(b) In the case of a deferred compensation arrangement, would the employee be taxed each year only on the amount deferred with respect to that year or, rather, on the value of the employer's promise to pay under the contract as a whole? In the latter event, it would be necessary to develop a method of valuing the promise to pay in the future, and to take into account the discounted value of such promise as well as the possible contingencies on the payments called for under the contract. (See ¶(c) below.)

(c) What effect would various forfeiture provisions—such as the requirement to perform consulting services, the prohibition of engaging in competitive activities, etc.—have on the treatment of deferred compensation? If such conditions are not to be recognized for current taxability of deferred compensation, then what happens when amounts are actually forfeited which previously had been taken into income? In all fairness, there would have to be developed a set of rules governing the proper treatment of forfeited amounts which previously had been reported by the employee.

(d) One of the deferred compensation arrangements in use by many corporations is the so-called phantom stock plan. Under that plan, the employee is awarded the equivalent of a certain number of shares of the employer. Those awards are credited on the books of the company, but no actual shares are used or delivered to the employee. When dividends are paid on the outstanding stock of the company, a dividend equivalent is credited to the phantom stock on the books of the company. When the employee retires or terminates service with vested rights under the plan, the number of phantom shares standing to his account is valued at the then fair market value of the company's outstanding real stock. And this sum, plus the accumulated dividend equivalents, is paid out to the employee over a period of years.

If such a plan is deemed to be within the scope of the Proposed Regulations, is the employee to be taxed at the time the phantom stock is credited to his account at the then fair market value of the real stock? If so, what happens to the appreciation in the value of the phantom stock; is that to be taxed as it accrues each year (even though it is not received by the employee)? Conversely, if the stock decreases in value from the initial value, when will such depreciation be taken into account, and will it be deductible by the employee as an ordinary loss? Moreover, what tax treatment is to be given to the dividend equivalents credited periodically on the phantom stock? Are they to be taxed currently?

A variation of the phantom stock plan raises even more esoteric problems. Under this version, the employee does not get the full fair market value of the phantom stock at termination of employment. Instead, he receives only the excess (if any) of the value of the phantom stock at termination over the value of such stock at the time of the initial award. How is that employee to be taxed? Is the unrealized appreciation to be taxed annually to him when there is no assurance that the increment of appreciation will survive until retirement? How can this "gleam in the eye" of the corporate employer be converted into taxable income even by legislative action, let alone administrative unilateral action?

(e) There is a potential conflict between the Proposed Regulations under Section 61 and the Proposed Regulations under Section 83 of the Code, dealing with the transfer of restricted property. (Prop. Regs. § 1.83-1) The Section 61 Proposed Regulations provide for immediate taxation whether or not the promise to pay in the future is contingent. Under Section 83, restricted property is not taxed to the recipient (e.g., an employee) until the restrictions lapse, even though the employee actually receives the property immediately. Thus, under Section 83 forfeitability will generally avoid immediate taxation but under the Proposed Regulations applicable to Section 61 it will not.

Furthermore, the Proposed Regulations under Section 83 take the position that an unfunded and unsecured promise to pay deferred compensation is not taxable. (Prop. Regs. § 1.83-3(e)). The Proposed Regulations under Section 61 take the diametrically opposite approach.

V. CONCLUSION

In view of the foregoing, it is respectfully submitted that Congress should preempt the consideration of the future tax status of deferred compensation arrangements. There is too solid a basis and too long a history of recognition by the courts and the Internal Revenue Service of the validity of deferred compensation arrangements to warrant the Treasury Department's proposed change in the ground rules applicable to these arrangements. Only if a study by Congress and its tax staff reveals any deficiency in the current tax treatment of deferred compensation arrangements should any change be made. Moreover, Congress, and not the Treasury, has the authority to set the parameters if warranted between acceptable deferred compensation arrangements.

STATEMENT OF G. KENNETH CHRISTRUP, DIRECTOR OF TAXES, XEROX CORP., ON BEHALF OF THE ROCHESTER TAX COUNCIL

My name is Kenneth Christrup. I am Director of Taxes of Xerox Corporation and I appear before you today as Chairman of The Rochester Tax Council.

The Rochester Tax Council was formed in 1969 as a voluntary organization of companies having strong affiliations with the Rochester, New York area. The Council membership includes: Bausch & Lomb, Inc., Champion Products; Corning Glass Works; Eastman Kodak Co.; The R. T. French Co.; Gannett Co., Inc.; Garlock, Inc., Gleason Works; Schlegel Corp.; Security New York State Corp.; Syborn Corp.; Xerox Corp.

The members of the Council collectively manufacture a wide variety of high technology products. Although these companies have substantial facilities in the Rochester, New York, area, they also have major facilities in all the states in the United States.

Of concern to the Council are the proposed income tax regulations published in the Federal Register of February 3, 1978, under which the Internal Revenue Service would seek to radically change the long-standing tax treatment of amounts of compensation which are voluntarily and irrevocably deferred for payment to employees in later years. Even where the arrangements is entered into before the compensation is earned, so that the employee never obtains a fixed right to it, the proposed regulations would seek to include the deferred amounts in the employee's gross income for the year in which such amounts would have been paid if the employee and employer had not entered into the irrevocable contractual arrangement for deferral.

The Council appears before you today because the Treasury's proposed regulations, even in proposed form, seriously disrupt the compensation programs of members of the council, some of which have been in effect for many years pursuant to long-settled doctrines and well-understood, easily administered and realistic rules developed by the courts and accepted by the Internal Revenue Service and the Treasury. We believe that any change in these rules is a legislative matter. If there are abuses, the Treasury should make them known to the Congress so that they can be dealt with in an orderly authoritative way which is consistent with overall tax reform, with nationally accepted tax policy goals, and with equity to the business community and individual taxpayers.

The proposed regulation is inconsistent with all published administrative and judicial precedent and exceeds the delegated rule-making authority:

Although it is well recognized that gross income includes amounts received as compensation for services, there is a long line of cases which stand for the proposition that a taxpayer does not currently realize compensation income where he has irrevocably agreed to defer its actual receipt at a time before the date such income was actually payable to him. *Howard Veit*, 8 T.C. 809 (1947) and 8 T.C.M. 919 (1949); *Commissioner* v. *Oates*, 207 F. 2d (1953), affg. 18 T.C. 570 (1952); *Ray S. Robinson*, 44 T.C. 20 (1965) The Internal Revenue Service, after initially testing this proposition through numerous court cases, 18 years ago acquiesced in the decisions and published Rev. Rul. 60–31, 1960–1 C.B. 174, which is consistent with the case law, has not been modified or limited in any court decision since, and has basically represented the settled doctrine in this area for almost two decades.

The proposed regulation now seeks to reverse this settled doctrine and to take a radically different approach which is not supported by any existing precedent in the field of income taxation of compensation. Furthermore, the proposed regulation is contrary to all of the judicial and administrative precedent in other areas of the tax law dealing with the time of realization of income, such as the law dealing with deferred payment contracts, casual sales of personal property, and deferred interest government bonds. See *J. D. Amend*, 13 T.C. 178 (1949); *Harold N. Sheldon*, 62 T.C. 96 (1974); *Hineman* v. *Brodrick*, 99 F. Supp. 582 (D. Kan. 1951); Rev. Rul. 58–162, 1952–1 C.B. 234; Rev. Rul. 73–210, 1973–1 C.B. 211, Code sections 454 and 1232. It is well settled that a taxpayer is not bound to arrange his affairs in such manner as will result in the most severe tax impact. *Gregory* v. *Helvering*, 69 F. 2d 809 (2nd Cir. 1934), aff'd. 393 U.S. 465 (1935).

While it is certainly true that the Secretary can interpret the meaning of sections of the Internal Revenue Code by administrative pronouncements, such interpretative rules must be consistent with the Code and must be made before the statutory interpretation is authoritatively settled by the courts. *Brushaber* v. *Union P. R. Co.*, 240 U.S. 1 (1915); *M. E. Blatt Co.* v. *U.S.* 305 U.S. 267 (1938); *Fawcus Machine Co.*, v. *U.S.*, 282 U.S. 375 (1930); and *Bingham's Trust* v. *Commissioner*, 325 U.S. 365 (1944).

The present proposed regulations are in effect legislation by administrative fiat. Furthermore, the proposed rgulation 1.61–16 is not in accord with the express terms of sections 61 and 451 and is contrary to long-standing judicial interpretations of these sections.

It is well settled under section 451 that a cash basis taxpayer is in "receipt" of an item of gross income when he actually receives the element of gross income as cash or the equivalent of cash, or when he constructively receives the element of gross income as cash or the equivalent of cash. Regulation 33, Revenue Act of 1918; Regulation § 1.451; *Old Colony Trust Co.* v. *Comissioner*, 279 U.S. 716 (1928); *Hamilton National Bank of Chattanooga*, 29 BTA 63 (1933); *Ross* v. *Commissioner*, 169 F. 2d 483 (1st Cir. 1948). Until there is actual or constructive receipt of compensation, a cash basis taxpayer does not include such compensation in income.

A fortiori, there is no actual receipt of cash until the compensation is actually paid. Therefore, only two theories are available for finding "receipt" of deferred compensation prior to the actual receipt of the cash: 1) the cash equivalency doctrine, and 2) the constructive receipt doctrine.

Invoking the cash equivalency doctrine (or economic benefit theory as it is also called) requires receipt of property rights which are both unconditional and assignable (*Frank Cowden Sr.*, 289 F. 2d 20 (5th Cir. 1961), reversing 32 T.C. 853 (1959)). Receipt of an unfunded and unsecured promise to pay deferred compensation is not property and thus not income to a cash basis taxpayer. See proposed regulation 1.83–3(e). It is difficult to conceive how the cash equivalency doctrine could support an attempt to tax something which is not property as an item of gross income.

The constructive receipt theory results in "receipt" under section 451 only where the taxpayer has an unconditional right to draw on amounts credited to his account or set apart for him (See, *United States* v. *Christine Oil and Gas Co.*, 269 Fed. 458 (1920) and Reg. § 1.451-2(a)). Such an interpretation of the word "receipt" as used in section 451 is suggested by the legislative history to section 213(a) under the Revenue Act of 1921, the precursor of section 451, as set forth in the Conference Committee Report to the Revenue Act of 1924, H. Rep. 844, 68th Cong., 1st Sess., p. 16, which states that "items of gross income should be considered to be received in the taxable year in which they are unqualifiedly made subject to the demands of the taxpayer."

The proposed regulation seeks to expand the meaning of "receipt" beyond any interpretation of that term to date. It is clearly an interpretation inconsistent with all precedent and contrary to the state Congressional meaning of that term, and therefore beyond the rule-making authority delegated to the Secretary under section 7805. Furthermore, the proposed regulation attempts to stretch the theory of cash receipts to the point where the distinction between the cash receipts and accrual methods of accounting is destroyed.

Nor can the proposed regulation be supported by any application of the assignment of income doctrine, which deals solely with the deflection of income between taxpayers and not with the timing of realization of such income. See *Lucas* v. *Earl*, 281 U.S. 111 (1930); c.f. *United States* v. *Bayse*, 410 U.S. 441 (1973).

It has long been accepted that the language of section 61 was used by Congress to exert "the full measure of its taxing power." *Helvering* v. *Clifford*, 309 U.S. 331, 334 (1939). However, there is weighty authority for the proposition that there is no income until the taxpayer receives something "for his separate use, benefit, and disposal . . ." *Eisner* v. *Macomber*, 252 U.S. 189, 207 (1919); or until there is an instance of "undeniable accessions to wealth, clearly realized, and over which . . . taxpayers have complete dominion." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). The proposed regulation goes far beyond any current theory of when gross income is realized by requiring a taxpayer to include as an item of gross income an unrealized amount which he is not yet entitled to receive and over which he has no dominion or control. Such a theory of gross income is clearly inconsistent with the constitutional requirement that gross income involves an element of realization. Mere appreciation of value, remote possibilities of gain, and naked promises have never constituted realization under section 61.

We believe that, since the proposed regulation goes well beyond any precedent requiring an inclusion in income prior to the year of actual receipt and reverses a longstanding body of judicial and administrative law, it represents an unreasonable use of the delegated authority to issue rules and regulations and is beyond the delegated rulemaking authority. Furthermore, because the proposed regulation attempts to expand the definition of gross income as encompassing amounts over which a taxpayer has no present entitlement, it is certainly inconsistent with any judicially developed theory of gross income defining the parameters of the Congressional mandate.

The proposed regulation would create administrative complexities and uncertainties that render it impractical, unrealistic and unreasonable:

Because the proposed regulation is promulgated as an interpretation of what constitutes income, it is not possible to precisely define the limits of the doctrine as would be the case if Congress were called upon to change the law with respect to a particular type of transaction. The rules as proposed would apply both to fixed compensation and to supplements thereto in the form of bonuses or increases, they would apply to employees and to independent contractors, they would apply to formal plans and individual contracts, they would apply whether or not the employer sets aside or invests any funds pursuant to the agreement or on its own volition, and they would apply whether or not the deferred payments are subject to forfeiture, contingencies, or to upward or downward fluctuation. If the proposed regulation were valid, presumably its principles would apply even beyond the compensation area, to deferred payment sales, accrued interest on U.S. Government "E" Bonds, and any other areas where a cash basis taxpayer may be deemed to have the ability to influence the flow of income by the manner in which he arranges his affairs.

In the compensation area, the proposed regulation would apparently apply to such arrangements as phantom stock plans, where the amount deferred may fluctuate radically over the deferral period. Arbitrarily exposed would also be other types of elective programs resulting in an eventual payment which may be significantly more or less than the amount originally taxed to the employer under the proposed rule. This would necessitate a whole new network of rules and regulations to supplement the basic rule, such as:

(1) Rules for the timing and amount of the employer's deduction;

(2) Rules for the character and timing of the taxation of any income eventually realised over and above that initially taxed;

(3) Rules for the allowability, timing and character of any loss resulting from the eventual receipt of less than the amount initially taxed.

It is evident that the proposed regulation is very much at odds with the purported effort of the present administration and the Congress to bring about simplification of the tax laws.

Other impracticalities of the proposed rule center around the enormous amount of litigation and resultant confusion which would result. Apart from the attacks on its validity, which would drag on for years before being finally settled in all of the many courts which handle tax disputes, there would also be litigation arising out of disputes as to the scope and meaning of the regulation, and such questions as whether the amount to be included in taxable income in the initial taxable year is the face amount or the present value of the amount due in the future, and (if the latter) whether forfeiture provisions and contingencies effectively eliminate any present tax. Even in the absence of forfeitures and contingencies, there are no present rules readily available for determining the proper discount to be applied to a naked, unsecured promise.

The proposed regulation would be unfair and discriminatory in operation:

The proposed regulation would operate unfairly in a number of respects.

The effective date rules discriminate in favor of employees whose employers have maintained formal plans of deferred compensation, and against those who have established practices of arranging deferral through individually designed contractual arrangements, since only the former may continue to defer during the period before the regulations become final. The effective date rules also operate with obvious unfairness to employees who prior to February 3, 1977, have entered into irrevocable arrangements to defer to a later date amounts which were receivable, but for the deferral, on an earlier date which falls more than 30 days after the regulation becomes final.

The regulations also result in severe cash flow hardships for employees at all compensation levels who inevitably would find themselves charged with current income tax on amounts irrevocably deferred to later years. The problems are exacerbated in any cases in which there were misjudgments as to whether a compensation arrangement agreed to with the employer would be deemed to involve an election within the meaning of the regulation. The Internal Revenue Service would be forced to view with suspicion every contractual arrangement providing for future payments for services where the deferral technically appears to qualify under the proposed regulations because it is mandated by the employer, despite the fact that many such contracts are legitimately in the interest of and compatible with the desires of both parties. We foresee that this problem alone illustrates the impracticality of the regulation and renders it unenforcible except with a large measure of inequity.

The proposed regulation is contrary to sound business practices and to the legitimate goals of capital formation, productivity, retirement security and revenue collection:

In many cases the employer has an important stake in tax deferral by employees. This can result not only in increasing working capital, but also helps to stimulate productivity through deferral of compensation as part of incentive programs under which the amounts ultimately paid will depend on the success of the business. This is particularly important in small businesses, where working capital needs may be greatest and stock option type incentives are often unavailable. These programs can be extended to lower and middle echelon employees only by offering a formal election, since mandatory deferral would impose too great a hardship on many employees with heavy current cash needs. For these reasons, it is evident that the proposed rules run counter to sound business practice and to the important current national goals of increasing capital formation and productivity.

The same aspects of the regulation forcing current payment of all compensation to lower and middle level employees runs directly counter to the policies and goals of enhancing savings and retirement security, as reflected in ERISA and related legislation.

The proposal is also unsound from the standpoint of protection of the revenue. Most employers are corporations in a marginal tax bracket of 48 percent. The maximum marginal tax rate on compensation income to employees is 50 percent. Under present law, the employer receives no deduction for deferred compensation until it is paid and the employee realizes income subject to tax. Assuming that under the proposed regulations the employer would be allowed a deduction at the same time as the employee realizes income in the earlier year, the proposal would produce insignificant revenue even if all taxpayers who elect deferral of compensation were in the highest tax bracket. In fact, of course, the contrary is true. Since the most highly compensated taxpayers will be in top brackets in the year to which compensation is deferred as well as the year in which it was originally payable, deferred compensation is attractive as a tax saving device primarily to employees in lower brackets. Thus, it seems likely that the proposed regulation, to the extent that it applies to employees of non-tax exempt employers, would result in a revenue loss.

The proposed regulation represents a departure from the Treasury's undertaking to the Congress in 1969 to develop legislative recommendations for the treatment of deferred compensation:

In the Congressional consideration of the 1969 Tax Reform Act, the House adopted a deferred compensation provision which would have taxed deferred compensation exceeding $10,000 when received, at rates equivalent to those which would have applied when such compensation was earned. The Finance Committee deleted this provision, saying that it was doing so at the Treasury's request and on the understanding that the Treasury would undertake a comprehensive study of the subject and that the Treasury "intends, as part of this study, to develop recommendations dealing with the tax consequences of all deferred compensation arrangements." See Section 331 of the House Bill, pp. 89–91 of H. Rep. 91–413 (Part 1) and pp. 306–307 of S. Rep. 91–552. No such study or legislative recommendations have been submitted to Congress, despite the clear understanding of the tax writing committees of both Houses of Congress, acknowledged by the Treasury, that deferred compensation arrangements are valid for income tax purposes under existing law, changes to which were regarded as a legislative matter.

For the foregoing reasons, the Rochester Tax Council urges that Congress act expeditiously to require the Internal Revenue Service to continue to administer the law consistent with Rev. Rul. 60–31 and to complete a study of the deferred compensation area and present that study to Congress with legislative recommendations.

Statement of Ralph W. Ytterberg, Vice-President, Industrial Relations, Dresser Industries, Inc., Dallas, Tex.

Summary of Testimony

Dresser is deeply concerned about a proposed change in tax laws by the Internal Revenue Service. We believe this change represents action that should be legislative rather than administrative since it constitutes such a clear reversal of well established tax rules on a subject having significant policy aspects. This action is the proposed addition of a new regulation section 1.61–16, which in effect, would immediately tax any compensation that an employee has a choice to defer for subsequent payment.

The last time a serious change in the tax law concerning nonqualified deferred compensation was formally considered was when the Tax Reform Act of 1969 was being formulated. However, the Finance Committee withdrew the proposed amendment when the Treasury Department asked that it be tabled, so the Department could study the subject at greater length and come back with a new recommendation. Rather than include this proposal in the recent list of suggested tax law revisions, the present administration apparently has chosen to cloak their proposed reversal of existing tax law in the guise of an administrative matter.

Dresser has maintained two deferred compensation plans for several years, under which a participant can elect to convert his "incentive compensation" earnings that would otherwise be paid in cash into account credits for units equivalent to shares of Dresser stock. Under the primary plan, the unit or "phantom stock" credits are accumulated—along with credit for additional units derived from "dividend equivalents"—for eventual distribution following retirement.

I firmly believe that the existence of these plans and the success and progress of Dresser are closely related. They assist Dresser in several ways, none of which are primarily motivated by tax considerations. First, these plans have helped to attract and retain productive executives, managers and salesmen. They afford the employee the opportunity to increase the amount of compensation he will eventually receive—both directly, via a "discount," and indirectly through hoped and strived for appreciation in stock value. Second, the structure of these plans gives the participants a proprietary interest in the future of Dresser. This encourages the participants to strive for long-term appreciation in the stock value. Third, the fact of deferral, coupled with the utilization of stock as the form of payment, means that Dresser can conserve cash for growth. During the period since 1964 that Dresser has had deferred compensation programs in effect, Dresser's sales have increased from less than $500 million to over $2½ billion, and shareholder equity from just over $120 million to over $1 billion. Over this same period, the deferred compensation programs have conserved a total of about $30 million from the amount that otherwise would have been paid out in cash.

With respect to these plans, I think it is important that we now have approximately 375 active employee participants and an additional 110 former employees, or their beneficiaries, currently receiving benefit payouts. Obviously, the plans are not designed for, or restricted to, top management but rather are offered to executives, managers and sales people who have the real operating profit responsibility. People with a current annual base salary as low as $20,000 can and sometimes do become participants.

Under present law, deferred compensation is taxed currently only if it falls under either the economic benefit or constructive receipt concepts. The economic benefit theory is applied only where the deferred amount has been set aside for eventual distribution, for example, in a trust or escrow account, not where there is only a contractual right against the employer. The constructive receipt theory is applied only where the employee has a matured right to a definite amount, but chooses not to claim it until some later date. Similarly the employer cannot take the deduction until the employee receives the distribution. Thus, there is no tax avoidance inherent in the present method. At most there may be a deferral of some tax, but the combination of the 50 percent maximum tax rate on compensation and continuing rampant inflation virtually assure that the same rates will be paid whenever the amount is taxed.

I respectfully and strongly urge you to take whatever steps may be appropriate to prevent this important, proposed change from being implemented simply through administrative action.

INTRODUCTION

My name is Ralph W. Ytterberg and I am Vice President—Industrial Relations of Dresser Industries, Inc., which has its headquarters in Dallas, Tex. I appreciate this opportunity to appear before you on behalf of Dresser, which is a diversified supplier of technology, products and services to many industries, including primarily industries involved in the development of energy and natural resources.

PURPOSE OF TESTIMONY

The purpose of my testimony is to express our concern about a proposed change in tax laws by the Internal Revenue Service that Dresser believes is contrary to Dresser's individual interest as well as contrary to the national interest. Further we believe it represents action that should be legislative rather than administrative since it represents such a clear reversal of well established tax rules on a subject having significant policy aspects. This action is the proposed addition of a new regulations section 1.61–16, which in effect, would immediately tax any compensation other than a qualified retirement plan that an employee has a choice to defer for subsequent payment. I intend to review with you our thinking that the proposed change in taxation of nonqualified deferred compensation programs, such as Dresser maintains: (1) would have an adverse effect on Dresser and its employees, (2) either would not serve or run counter to national purposes, and (3) is erroneous in its basic concept. Therefore, it should not be permitted to be implemented simply as an administrative procedure without being given serious consideration by the legislature.

CONGRESSIONAL JURISDICTION

The last time a serious change in the tax law concerning nonqualified deferred compensation was formally considered was when the Tax Reform Act of 1969 was being formulated. The Ways and Means Committee and the Finance Committee were both then advised that under existing law Deferred Compensation was taxable only when paid. The proposal being considered was not to change the time such compensation was taxed, but the applicable tax rates. However, at that time the Finance Committee withdrew the proposed amendment when the Treasury Department asked that it be tabled, so the Department could study the subject at greater length and come back with a new recommendation.

Rather than make any formal proposals for amendments—which by the way could easily have been included in the recent comprehensive list of suggested tax law revisions—the present administration apparently has chosen to cloak their proposed significant reversal of this portion of existing tax law in the guise of an administrative matter. This has occurred notwithstanding evident congressional interest in the topic and the settled state of existing law that is proposed to be overturned.

In addition, Dresser believes that the proposed change would be very adverse to Dresser and would be incorrect and counterproductive as a matter of national policy, and be contrary to basic tax policy. I will attempt to develop these factors in more detail in a moment, so that you can see that this matter is of sufficient importance to warrant a congressional "hold" on the proposed administrative action.

PROPOSAL BAD FOR DRESSER AND EMPLOYEE PARTICIPANTS

Dresser has maintained two alternative deferred compensation plans for several years. The principal plan has operated about 14 years, and is covered by an IRS ruling letter that was issued in 1966. Under these plans, by proper election before the amount of compensation is finally determined, fully earned, or awarded to a participant he can elect to convert such "incentive compensation" earnings that would otherwise be paid in cash into account credits for units equivalent to shares of Dresser stock. Under this plan, the unit or "phantom stock" credits are accumulated—along with credit for additional units derived from "dividend equivalents"—for eventual distribution over a period of time following termination of employment. Under the alternative plan, the deferral of compensation is for a shorter fixed period of three to five years.

Because Dresser wants to encourage participation in these plans, the crediting of units equivalent to stock is made at a "discount" from the market value of the stock.

I firmly believe that the existence of these plans significantly assist Dresser in at least four ways—none of which are primarily motivated by tax considerations.

First, I believe that these plans have helped to attract and retain productive executives, managers and salesmen. They afford the employee the opportunity to increase the amount of compensation he will eventually receive—both directly, via the "discount," and indirectly through hoped and strived for appreciation in stock value. At the same time, they afford the employee the opportunity to build up an amount for his retirement. This is particularly important as the prospective value of pension benefit is constantly being eroded by continued high inflation. It has been my experience that these opportunities have a real attraction for ambitious and productive employees. The fact that an employee who unilaterally terminates will forfeit future benefits from dividend equivalents may also encourage participants not to leave.

Second, the structure of these plans—the tying of evenutal benefits to stock values—gives the participants a proprietary interest in the future of Dresser. This relationship, of course ,encourages the particiapnts to strive for long-term appreciation in the stock value. It is an act of faith and commitment to the future of the company and to the strength of our economy. Obviously, this encouragement will certainly work to Dresser's advantage.

Third, the fact of deferral, coupled with the frequent utilization of stock as the form of benefit payment, means that Dresser can conserve its available cash resources for growth. During the period since 1964 that Dresser has had deferred compensation programs in effect, Dresser's sales have increased from less than \$500 million to over \$2½ billion, and sharehold equity from just over \$120 million to over \$1 billion: thus it is evident we are experiencing good growth. Over this same period, the deferred compensation programs have conserved a total of about

$30 million from the amount that otherwise would have been paid out in cash, absent these plans. This is in a real sense a capital investment on the part of our employees and a capital formation vehicle for the company. At the present time, by virtue of other factors primarily of a tax nature, individuals' incentives for such investment have been increasingly chilled and the consequent lessening of industry's ability to marshall capital has serious omens for the continued strength of our economy.

Finally, the forfeiture provisions in the plans have helped to dissuade employees who leave Dresser to go to work with competitors from improperly or unfairly using confidential information that they acquired while employed at Dresser. While actual enforcement of this provision has been minimal, its existence undoubtedly has had a salutary effect on the actions of former participants in general.

With respect to the cumulative affect of these plans on Dresser, I think it is important to note that we now have approximately 375 active employee participants and an additional 110 former employees, or their beneficiaries, currently receiving benefit payouts. Obviously, the plans are not designed for, or restricted to, top management but rather are offered to executives, managers and salespeople who have the real operating profit responsibility. People with a current annual base salary as low as $20,000, and with grade classifications as low as "Exempt six" in a scale of grades from one through 23 can and sometimes do become participants.

At this point I will reiterate that our plans have been very helpful to Dresser and to our employees—primarily for the non-tax reasons outlined above. However, the proposed change in the tax law would render the plans unworkable in practice by requiring an immediate tax payment regarding amounts deferred. Thus, non-tax benefits would be denied by tax law changes that are unnecessary and incorrect in concept, as I shall now discuss.

PROPOSAL BAD IN CONCEPT

The taxation of deferred compensation has been quite clear and consistent for many years, particularly so since the issuance of Revenue Ruling 60-31 in 1960. In general, such compensation is not taxed until the employee receives it or has the right to receive it. The proposed change provides that if the employee could have made arrangements for payment at an earlier date, he will be taxable then, regardless of when he is actually paid or has a right to be paid under his actual contract.

That this represents a clear reversal of existing law is confirmed by the collateral revocation of existing Revenue Rulings and acquiescences by the IRS, as well as the "grandfather clause" in the proposed regulation covering deferrals under pre-existing plans.

In examining the proposed change, it is clear that the result cannot be supported by any previously accepted tax theory, and none is offered in the release accompanying the proposal. It is clearly inconsistent with the normal, cash basis method of recognizing income when it is received.

One possible exception would be the economic benefit theory, under which a person is found to have received something other than cash which has a definite economic value to him, and is taxed upon receipt of such item. However, the only "thing" received at deferral under our plans is Dresser's unsecured promise to make certain future payments which promise is conditional and not a vested right to receive benefits because of the forfeiture provisions. Such limited rights consistently have been held not to support taxation under this theory.

The only other possible theory is the constructive receipt theory, under which a person who could have received income as of a certain date simply "turns his back" on the income until a later date, is held to be taxable on the first date. However, this clearly does not apply where the taxpayer has no right to receive the item at any time prior to its actual receipt, after the right was earned or matured. Indeed, if this theory were to apply in this case, it would just as logically apply to a host of commercial transactions such as loans, leases, etc.

Not only does the proposed change lack any theoretical legal support, it also would be very difficult to understand and apply to specific situations. In Dresser's case, would there be "an amount deferred," as is required by the proposed change, where the original amount is converted or exchanged for something totally different in form and value? If so, what is the "amount deferred"? The original amount otherwise payable in cash, the market value of shares equivalent to the initial account credit, or a discounted guess as to the eventual benefit to be received.

I am convinced that the proposed law change would introduce a provision that is inherently bad in concept. As a part of my testimony, I should like to submit as Appendix A the technical protest letter to the IRS that was recently filed by Dresser. This attachment will more fully express our technical objections to the proposed change.

PRESENT LAW IS PROPER

Under present law, deferred compensation is taxed currently only if it falls under either the economic benefit or constructive receipt concepts mentioned earlier. The economic benefit theory is applied only where the deferred amount has been set aside for eventual distribution, for example, in a trust or escrow account. It is not applied where there is only a contractual right against the employer. The constructive receipt theory is applied only where the employee has a matured right to a definite amount, but chooses not to claim it until some later date.

Coordinated with this timing of income is the timing of the deduction for the employer. The employer cannot take the deduction until the employee receives the distribution, unless one of the above theories applies.

Thus, there is not tax avoidance inherent in the present method. At most there may be a deferral of some tax, but the combination of the 50% maximum tax rate on compensation and continuing, rampant inflation virtually assure that the same rates will be paid whenever the amount is taxed.

For these reasons, Dresser feels that current law furthers our interests and reflects good national tax policy in that it does not permit clear tax avoidance yet it does not thwart programs that afford the significant non-tax advantages to both employers and employees as set forth above.

CONCLUSION

In concluding, I would like to repeat that Dresser strongly feels that we are dealing here with a bad idea that is in danger of being adopted without sufficient, objective consideration of it by those who are really responsible for making such a decision on a matter which should be beyond IRS authority. It is definitely an arbitrary approach to a supposed but in our opinion misunderstood and exaggregated "problem" of tax avoidance. If the proposed change were to be adopted, we believe, it will significantly impede Dresser's ability to attract and encourage the types of executives, managers and salesmen that we need to achieve our objective of becoming a more competitive and successful force in world-wide energy development programs. We attribute great significance in our past growth and success to the dedication and leadership of our fine managers, executives and salesmen, and we attribute great significance in the motivation of these employees to the provisions of our deferred compensation plans.

I respectfully and strongly urge you to take whatever steps may be appropriate to prevent this important, proposed change from being implemented simply through administrative action.

Thank you.

APPENDIX A

DRESSER INDUSTRIES, INC.,
Dallas, Tex., March 6, 1978.

Re proposed regulations section 1.61-16, nonqualified deferred compensation.

COMMISSIONER OF INTERNAL REVENUE,
Internal Revenue Service,
Washington, D.C.
(Attention of CC:LR:T—LR-194-77)

DEAR SIR: A proposed addition to the income tax regulations, section 1.61-16, announced in the Federal Register of February 3, 1978, provides that if "an amount of * * * compensation (under a nonqualified plan or arrangement) * * * is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year."

We wish to protest the proposed regulation and the collateral revocation of rulings and acquiescences which was announced in the same notice.

We presently maintain two nonqualified deferred compensation plans. Both are for upper and middle management personnel, and are in the nature of phantom stock plans. The principal one, established in 1966 pursuant to an IRS ruling, provides for deferred payments over various periods after termination of employment; the other, for payments in the third, fourth, and fifth year following the deferral. Under each plan, the employee may elect whether a portion of his "incentive compensation" earnings for the current year should be paid to him in the following year, or alternatively, should be credited to his account in units corresponding to shares of Dresser stock, for later distribution as provided in the plan. This election must be exercised before the amount of such earnings is finally determined, awarded, or fully earned.

Because Dresser wishes to encourage eligible employees to accept incentive compensation paid through the deferred stock unit accounts, so as to have a proprietary interest in Dresser's future, an employee making that election is credited with a substantially greater present account value in such units than the amount of cash that would have been paid to him if he had elected to receive a current payment. Phantom dividends are paid or added to deferred stock accounts in additional stock units. Distributions from such accounts are in actual shares or in cash based on the number of such units multiplied by the current market value of Dresser stock. Under the long-term plan, an employee may elect prior to termination between certain alternatives as to the duration of the payout period. Under both plans, accounts are subject to forfeiture for certain misconduct, and any employee who terminates voluntarily prior to retirement is denied any further benefits for phantom dividends.

Dresser has approximately 375 presently active employee participants in these plans, and about 110 additional former employees who are currently receiving benefits. The interests of these employees, as well as the interests of Dresser, would be severely affected by the proposed regulation. If the regulation is adopted and upheld, no employee would be able as a practical matter to elect a deferment, and the plans, as they exist today, would have to be abandoned. We think there is no alternative which would so well serve the interests of Dresser or its employees, and we cannot see how any alternative would better serve the interests of the Government since Dresser does not receive a tax deduction for such amounts until they are actually paid and taxed to the employee.

Our benefits from the plans include: (a) attracting and holding productive employees, (b) further encouragement to employees for excellent performance and resulting increases in stock values, (c) conservation of capital through deferral of compensation and utilization of stock instead of cash for many benefit payments, and (d) restraint of improper actions by former employees through operation of forfeiture provisions.

We submit that apart from the interest of Dresser and its employees, the proposed regulation is badly conceived and should be rejected. There are several reasons for this conclusion, as follows:

(1) The proposed regulation is against all legal precedent.

This point seems to be recognized in noting for revocation nine contrary rulings and acquiescences. There are of course many other contrary decisions, going back much earlier than those cited in the notice. See, e.g., *Adolph Zukor*, 33 B.T.A. 324 (1935), and *Howard Veit*, 8 T.C. 809 (1947). For other contrary decisions with respect to other forms of income, see *Kay Kimbell*, 41 B.T.A. 940 (1940), *J. D. Amend*, 13 T.C. 178, acq. 1950-1 C.B. 1, and *Rev. Rul. 73-210*, 1973-1 C.B. 211. For a summarization of the legal precedent as of 1960, see *Rev. Rul. 60-31*, 1960-1 C.B. 174. The cases and rulings cited in the notice, most of which are post-1960, show that *Rev. Rul. 60-31* has been confirmed by recent developments. Further confirmation appears in an example in the regulations under section 1348, adopted in December 1976, at section 1.1348-3(b)(4), Ex. (2), where a description of a plan of elective deferral is followed by the statement—

"Since the salary which E elects to defer is includible in his gross income only in the taxable year in which actually received by him, * * *"

(2) The proposed regulation is without support in any acceptable theory of what may be regarded as gross income.

Over the many years that the tax treatment of deferred compensation has been developed, only two theories have previously been advanced as a possible basis for imposing a current tax—the economic benefit theory, and the constructive receipt theory. See *Rev. Rul. 60-13*, supra. The economic benefit theory is plainly inconsistent with the cash method of accounting normally used by employees.

As sought to be applied to deferred compensation in *Shuster* v. *Helvering*, 121 F. 2d 643 (CA-2, 1951), it was stigmatized by Judge L. Hand as "absurd" and "so fantastic as to deserve no discussion." 121 F. 2d at 645. Moreover, invoking the economic benefit theory would require taxing deferred compensation in general, without reference to the taxpayer's individual option.

The constructive receipt theory, while universally accepted as a basis for taxing items to which it applies, clearly does not apply where the taxpayer has no right to receive the item, either during the taxable year or at any other time prior to receipt after the right was earned or matured. See Regs. 1.451-2(a). If the proposed rule were based on constructive receipt (or economic benefit), it would logically extend to sales of property, leases, loans, and other commercial transactions as well as to compensation.

Thus, the proposed regulation cannot claim the sanction of either of these theories. Instead, it would simply declare that an individual will be treated as having income in a particular year because he could have made a contract under which he would have had income in that year—even though he actually made and his earnings accrued under a different contract. This declaration would deny effect to private contracts and impute income without claiming the sanction of any theory. We do not believe that the concept of gross income has nearly so elastic a meaning.

(3) The proposed regulation is not within the departmental power, under section 7805(a), to prescribe "needful rules and regulations for the enforcement of this title."

It may be admitted that the regulatory power is extensive. The validity of a regulation has often been upheld where it reflected a uniform and long-continued administrative practice left undisturbed by the Congress, or a contemporaneous construction of a statute, or an exercise of a specific delegation to make rules in a prescribed area. See *U.S.* v. *Correll*, 389 U.S. 299 (1967); *Bingell* v. *Johnson*, 394 U.S. 741 (1969); *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90 (1939). But the general regulatory power held under section 7805 is not a power to legislate. See *Koshland* v. *Helvering*, 298 U.S. 441 (1936). As stated in *M. E. Blatt* v. *U.S.*, 305 U.S. 217 at 279 (1938)—"Treasury regulations can add nothing to income as defined by Congress."

And as stated at greater length in *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129 at 134–135 (1936)— "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. (Case citations omitted.) And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable."

We submit that it is not reasonable, and not in harmony with a tax on income, to assert the tax against items which, as in the case of deferred benefits under the Dresser plans, are not matured, and which continue to be subject to contingencies and indeterminate in amount.

(4) The proposed regulation will be extremely difficult of administration except in simple cases.

The first difficulty will be in determining whether the proposed regulation applies. This difficulty is obvious in the case of an individual deferred compensation contract which has no option in the contract, and where the written record will not indicate what current payment alternative, if any, would have been available to the employee in the negotiation of the contract. In such a case the fact of deferral is not necessarily indicative of an employee option, since the employer often has more reasons to desire deferral than does the employee. For example, the employer always benefits from having the intervening use of the funds, and usually benefits from the incentive effect of deferred vesting and forfeiture conditions, while the tax benefit of deferral to the employee will often be limited or even eliminated by the 50 percent maximum rate on earned income.

In the case of a plan applicable to a class of employees which expressly grants an individual option to each participant, is the regulation intended to apply if the future reward is substantially different in kind, amount, or conditions of payment, from what might have been received currently? In that case the employee's choice is more between two different payments than it is between two different times of payment, or in the terminology of the proposed regulation, it is not that "an amount is deferred" by the employee's choice, but that one amount is waived in favor of a different amount.

A relevant example is provided by the Dresser long-term plan, under which the employee chooses between (i) receiving after retirement the then value of one share of Dresser stock, supplemented by the then value of the reinvested dividends, and (ii) the alternative of receiving currently a payment equal to 75 percent of the present value of one share. Under this plan the deferred payment is usually expected to be much greater than the alternative current payment, but it certainly could be less, and the relationship between one and the other is quite unpredictable. For this and similar situations the proposed regulation is completely devoid of any standards for deciding on its applicability.

A second difficulty will be in determining the amount on which the employee is taxable and where the regulation does apply. Is it the amount he would have received if he had made the other choice, or the amount he expects to receive in the future under his actual choice? If the latter, is there a discount for deferral, for the risks of forfeiture, or for noncollectibility? With particular reference to the Dresser plan, how is the present value of the right to receive a share of stock twenty years in the future determined, even where the stock is widely traded and the company well established?

The obvious third difficulty is the one facing the unfortunate taxpayer who is confronted with the necessity of financing the payment of the resulting tax, many years in advance of his receipt of the income on which the tax is based.

In conclusion, we submit that for the reasons stated the proposed regulation would be a serious mistake from the standpoint of tax law and policy.

In addition, we would repeat that Dresser and its employees who participate in the Dresser plans consider that we have vital interests at stake: Dresser, our interest in maintaining programs of incentive compensation, on terms that are both advantageous to the company and compatible with our employees' financial requirements; and our employees, their interest in continuing to have the opportunity to participate in these programs—primarily for non-tax reasons. We think that the protection of these interests would be sound public policy as a contirbution to economic growth and stability.

Very truly yours,

VIRGIL D. LANG,
Employee Matters Counsel.

Senator BENTSEN. I understand Mr. Gerald Sherman has a statement.

STATEMENT OF GERALD H. SHERMAN, COUNSEL, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

Mr. SHERMAN. Yes, Mr. Chairman. My name is Gerald Sherman. I am a member of the Washington law firm of Silverstein & Mullens and I am here today as counsel for the Association of Advanced Life Underwriting which, with its affiliated organization, the National Association of Life Underwriters, represents approximately 130,000 life insurance sales agents in the United States.

I submitted a detailed statement for the record and will consequently try to be extremely brief.

The members of the organization I represent sell life insurance and annuity products to employers to assist those employers in securing their obligations to pay deferred compensation. As a consequence, our members are vitally interested in this subject.

They are significantly involved in helping business, primarily small business, in developing compensation plans by which those businesses can acquire and maintain effective executive level personnel.

Our written comments dwell, in some detail, on some of the drawbacks of these regulations. As an initial matter, to repeat what other witnesses have said, these regulations constitute a usurpation of what should really be a congressional function, their conclusion is bound not only the long case and administrative history that Mr. Biegel referred to, but also is predicated on the fact that the matter was before Congress in 1969 when the Treasury recommended an adjustment of deferred compensation. At that time the Senate Finance Committee withdrew the adjustment from the 1969 Tax Reform Act.

So the Congress has looked at this and has rejected a regulatory solution.

Senator BENTSEN. Thank you very much, Mr. Sherman. Unfortunately, our time has expired.

Mr. SHERMAN. Thank you, Mr. Chairman.

Senator BENTSEN. We have, unfortunately, the problem of having a great deal more witnesses than we can handle and we have tried to accommodate as many as we can.

We will take all of your statements for the record.

I am somewhat sympathetic with your comments having spent a long time in that industry, having a substantial amount of experience with deferred compensation.

Mr. SHERMAN. Thank you, sir.

[The prepared statement of Mr. Sherman follows:]

STATEMENT OF GERALD H. SHERMAN, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING (AALU)

My name is Gerald H. Sherman. I am a member of the Washington, D.C., law firm of Silverstein and Mullens and am Counsel to the Association for Advanced Life Underwriting (AALU). AALU is a national association of approximately 1,000 members who specialize in one or more fields of advanced life underwriting. Collectively, they are responsible for annual sales of life insurance in excess of $2 billion, mostly in circumstances involving intricate factual situations and often dealing with complex business planning. AALU is affiliated with the National Association of Life Underwriters (NALU), the largest life insurance industry field force organization in the United States. NALU has a membership of approximately 130,000 life insurance agents.

We appreciate the opoprtunity to testify before this Subcommittee on a subject that we feel is of major importance. The taxation of non-qualified deferred compensation has been a settled matter since 1960 when the Internal Revenue Service issued applicable guidelines.[1] Unfortunately, the law has again become uncertain due to the promulgation by the Internal Revenue Service of proposed regulations that would purport to change the existing rules regarding the treatment of deferred compensation.[2]

Two reasons can be suggested why the Internal Revenue Service and Treasury Department may feel that the established treatment of deferred compensation is no longer appropriate:

(1) That the present treatment engenders a substantial revenue cost to the government and that the proposed regulations will end this revenue loss.

(2) That it is inequitable for taxpayers, to be able to elect to defer the taxation of income.

In analyzing these two position, it should be kept in mind that deferred compensation agreements are commonly used in both the public and private sector. In the private sector, the deferred compensation agreements are commonly utilized by limited numbers of employees. In the public sector, the use of deferred compensation appears to be more wide-spread and is generally utilized by second wage earners in a family, e.g., a working wife of a family whose main support is derived from the husband's income. Although we do not currently have precise revenue estimates, it is probable that the greatest revenue loss results in the public sector because of the fact that the employer is not postponing its tax deduction. I will elaborate on this further in the course of the testimony.

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[1] See Rev. Rul. 60-31, 1960-1 C.B. 174.
[2] Prop. Treas. Reg. § 1.61-16.

I. PROPOSED TREASURY DEPARTMENT REGULATIONS ON DEFERRED COMPENSATION

AALU submits that the proposed regulations on deferred compensation are contrary to established law, are discriminatory against small business, will engender unnecessary litigation and are not justifiable in view of the problems they will create.

A. The Proposed Regulations are Contrary to Established Law

The thrust of the proposed regulations is to tax an individual on compensation that he or she presumably could have received even though the funds in question are still held by the employer and may still be subject to a risk of forfeiture. Before 1960, the Internal Revenue Service maintained a position roughly similar to that it currently proposes to adopt. During that period, the Internal Revenue Service examined individual situations on a case-by-case basis and determined whether the payment was constructively received based on the particular facts involved. This approach of ad hoc determinations resulted in extensive litigation on the question of when payment was received, since there was often a genuine factual and legal difference with regard to the appropriate result. The litigation produced uneven and inconsistent rules from jurisdiction to jurisdiction. Different courts analyzed the problem differently. The vast majority of courts, however, held in favor of the taxpayer and generally declined to apply the doctrine of constructive receipt in situations where the employee had not, in fact, received the income, but had made an election to defer the receipt of that income.

The position suggested in the proposed regulations is directly contrary to the bulk of the existing decisions and as a result, would probably be held by most courts to be an improper position for the Internal Revenue Service to take by regulations.[3]

In addition to the substantial questions which are raised in the cases, we wish to point out one aspect of the proposed regulations that is particularly unsupportable. They assume that the employee, in effect, received the income and reinvested it with the employer. The proposed regulations go on, however, to state that the compensation is currently taxed even if the amounts are forfeitable while held by the employer. Realistically, however, an employee who could have received funds would never have reinvested those funds with the employer if there was any significant risk that the funds would be lost. Many agreements, for example, provide that if the employee does not continue to work for the employer for an established period of years, then the payments will not be made. It would be absurd to suggest that the employee effectively received those funds in an earlier year and reinvested them with the employer, thereby creating a substantial likelihood that the funds would be lost.

We would like to further point out that, over and above the established case law in this field, the Internal Revenue Service is attempting to do by regulations what Congress specifically declined to do statutorally in 1969. In enacting the 1969 Tax Reform Act,[4] substantial consideration was given by Congress to the proper tax treatment of compensation payments. To this end, § 83 of the Internal Revenue Code, regarding the treatment of restricted property and other funded arrangements, was adopted and the maximum tax provisions on earned income were added to the Code.[5] As part of the same reform consideration the House Ways and Means Committee proposed a rule, which was eventually adopted by the House of Representatives, dealing with unfunded, nonqualified deferred compensation.[6] This proposal would have included the amount of the payment in income at the time it is actually received (in contrast to the Treasury's proposed regulations) but would tax it at a rate (determined through a special computation) which would have been applicable had the income been received at the time it was earned. This proposal was, however, deleted by the Senate in its consideration of this bill.[7]

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[3] See, e.g., *Amend* v. *Comm'r,* 13 T.C. 178 (1949), acq. 1950–1 C.B. 1; *Hall* v. *Comm'r,* 15 T.C. 195 (1950), aff'd per curiam, 194 F.2d 538 (9th Cir. 1952); *Veit* v. *Comm'r,* 8 T.C.M. 919 (1949); *Veit* v. *Comm'r,* 8 T.C. 809 (1947), acq. 1947–2 C.B. 4; *Drysdale* v. *Comm'r,* 277 F.2d 413 (6th Cir. 1960); *Casale* v. *Comm'r,* 247 F.2d 470 (2d Cir. 1957); *U.S.* v. *Christine Oil & Gas Co.*, 247 F.2d 440 (2d Cir. 1957); *Comm'r* v. *Olmstead, Inc. Life Agency,* 304 F.2d 16 (8th Cir. 1960); *Comm'r* v. *Oates,* 207 F.2d 711 (7th Cir. 1953), acq. 1960–1 C.B. 5; *Centre* v. *Comm'r,* 55 T.C. 16 (1970).

[4] P.L. 91–172.

[5] See §§ 383 and 1348 of the Internal Revenue Code.

[6] It appeared as section 331 of the House version of H.R. 13270 and would have been reflected as new § 1354 of the Internal Revenue Code of 1954.

[7] See S. Rep. No. 91–552, 91st Cong., 1st Sess. 306 (1969).

We submit that the rejection by Congress of any attempt in 1969 to legislate in this field, especially in view of the long-standing position taken by the Internal Revenue Service in Rev. Rul. 60-31, was tantamount to approval of the existing rules on unfunded deferred compensation and that the Internal Revenue Services' current suggestion that new rules should be adopted is clearly in violation of the Congressional intent as expressed in 1969. We further submit that if the proposed regulations are adopted in their current form, they will create serious inconsistencies with the tax treatment of other deferred compensation. For example, under § 83 of the Internal Revenue Code as adopted in 1969, an individual who receives property that is subject to a substantial risk of forfeiture will generally not be taxed until such time as the restrictions lapse.[8] However, under the proposed Treasury Department regulations, if an employer were to make an unfunded promise to pay the same property to an employee with the same restriction, and the employee had the right to receive that property, the employee would nevertheless be taxed in the year he could have received it, notwithstanding the forfeitability of the amounts. Consequently, the employee who defers the receipt of restricted property would be taxed sooner than an employee who actually receives restricted property.

The present proposal by the Internal Revenue Service and Treasury Department can accurately be described as involving over-reaching by those agencies in the proper interpretation and application of the Internal Revenue laws. The Internal Revenue Service and the Treasury Department, in proposing these regulations, are ignoring established case law, sound economic reality and existing precedent as approved by Congress and are proposing rules that produce difficult, uncertain and in some cases, contradictory results.

B. Proposed Regulations Discriminate Against Small Business

At best, the proposed regulations create substantial uncertainty as to when an individual is taxed on compensation that is not currently paid.

This situation poses a problem of immense importance for small businesses where the principal employees who may utilize deferred compensation arrangements are frequently also owners of the business. Consequently, any arrangement for the payment of compensation at a future date for such an emloyee will automatically be highly suspect by the Revenue Service. The Service will doubtless contend that a stockholder-employee is always in a position to receive currently, compensation that is deferred. Larger corporations, however, with more diversified ownership, will be better able to contend that the employee had no choice as to when the payment would be made.

The net effect of the proposed regulations in their application then, will be patent discrimination against small business. Instead of curing an inequity in the tax laws, these proposed regulations would, in fact, create a different, more eggregious inequity by, in effect, limiting deferred compensation arrangements to employees of large corporations and eliminating them for stockholder-employees of small corporations.

C. Proposed Regulations Create Uncertainty and Will Lead To Litigation

There can be little doubt that, if finalized, the proposed regulations will create substantial uncertainty regarding when an employee is taxed on compensation that is to be paid at a future date. The proper year in which the compensation is includible in income will depend on a factual determination that may be very difficult to make. Almost regardless of what the results will be, it is a desirable goal that the tax laws provide certainty in their application so that taxpayers will know in advance the proper tax treatment of a particular item.

The uncertainty inherent in the proposed regulations is further aggravated by numerous technical difficulties. Just to highlight a few of the major technical difficulties:

1. The regulations offer no guidelines in determining whether the employee could have received the funds or not. As a consequence, taxpayers will not know, except in the most obvious situations, whether the regulations are applicable to their situation.

2. The regulations make no attempt to establish the amount that would be includible in income. For example, if an employee has a contractual agreement that promises to pay $100 to him on retirement, is the employee currently taxable on $100 or is the $100 discounted? If the $100 is not discounted, then an

[8] See § 83(a) of the Internal Revenue Code.

absurd result is produced because clearly no employee would have received $100 and given it back to the employer interest-free for a substantial period of time. If the amount is to be discounted then no guidelines have been suggested regarding how that discounting is to be determined.

3. The transition rules established under the proposed regulations create enormous uncertainty. These rules basically state that for existing arrangements, the treatment of amounts that otherwise would have been receivable before 30 days after the regulations are finalized will continue to be governed by the existing rules. However, the transition rule does not clarify when amounts otherwise would have been receivable. For example, if an employee has an arrangement with an employer under which the employer promises to pay him $100 a month for the rest of his life beginning at retirement, would the amount that is payable have otherwise been payable in a lump-sum when the agreement was entered into or would the amounts have otherwise been payable in addition to the employee's regular weekly paycheck?

4. The regulations do not consider the question of when the employer is entitled to a deduction. If the employer is on a cash basis the regulations may produce the unsupportable result that the employee must take the compensation into income in a year before the employer is entitled to a deduction.

5. The proposed regulations are inconsistent with section 83, as noted above. Under section 83 an employee may receive restricted property and postpone taxation. Under the proposed regulations, if the employee does not receive the restricted property but it is promised to him, he may be taxed currently, notwithstanding the existence of the same restriction.

The uncertainty created by these regulations will undoubtedly lead to litigation. The pre-1960 experience virtually guarantees that result. In general, the pre-1960 results were favorable to the taxpayer but each court applied its own interpretation in establishing rules in this area.

In returning to the pre-1960 status, the Revenue Service is, in fact, returning to a position that it wisely abandoned as unworkable 18 years ago. Promoting rules that do not produce certain results and create litigation is not in anyone's best interest. Substantial dollars are wasted by both taxpayers and the government in arguing (in court or elsewhere) over the appropriate rules of taxation. As a consequence, there is an enormous indirect and often hidden cost to these proposals.

D. The Revenue Impact of the Proposed Regulations Will Not Justify the Result

Unfortunately, we have been unable to obtain any revenue estimates on these proposals. However, it would appear that the proposal has been an insubstantial revenue impact as applied to the private sector. A private employer, under the current rules, is not entitled to deduct the payments in question until such time as those payments are actually made.[9] Consequently, the employer will be entitled to a deduction at the same time the employee has income. Since corporations are taxable at rates up to 48% and employees are taxable up to 50% on compensation,[10] the rates of deduction and taxation are roughly equal.

If the employee's tax rate declines between the time he or she otherwise might have received the payment and the time of actual receipt, there may be revenue loss but we believe this loss due to rate differential should not be substantial. Further, if the employee was entitled to the funds in an earlier year, it is unlikely that he would agree to a deferral unless the amount were increased to compensate him for his lost use of the funds. If this is in fact done, then the increase in the amount of the compensation for the period of deferral will be reflected in the revenue collected from the employee, i.e., the employee will tend to be in a higher tax bracket.

The only substantial revenue loss that is apparent from the current treatment of deferred compensation under Rev. Rul. 60-31 occurs in the public employee situation. Thus, only the employee is a taxable entity. The governmental employer does not enjoy a tax deduction in any event. Therefore, deferral in the receipt of the income results in a genuine revenue loss. Notwithstanding this fact, it is difficult to imagine that the adverse results that would be created by the adoption of these regulations (uncertainty, litigation, discrimination against small companies) could possibly justify the revenue gains that might possibly occur with

[9] See §§ 162 and 404(a)(5) of the Internal Revenue Code.
[10] See § 1348 of the Internal Revenue Code.

respect to public sector employers. Any revenue gain would, of course, be substantially offset by the direct cost incurred by the government in monitoring such a factual intensive program for the taxation of compensation and by the taxpayers' indirect cost in pursuing the same task.

II. ALTERNATIVE SOLUTIONS FOR CONSIDERATION

If, in fact, there is an abuse here that needs correction, what types of solutions should be considered? Certainly the proposal suggested by the Internal Revenue Service and the Treasury Department is entirely improper and should be flatly rejected. We further submit that the long established position maintained through Rev. Rul. 60-31 provides fair and appropriate treatment.

We would strongly recommend that the proposed regulations be legislatively overruled or that the Treasury Department be instructed to withdraw those regulations. Bills have already been introduced to produce this result with regard to the situation of public employees.[11] Legislation would, of course, only be necessary if the Treasury Department and the Internal Revenue Service will not withdraw the proposed regulations.

We have heard it suggested that there are situations in which the employee has control over the investment by the employer of amounts equal to the compensation that has been deferred and that in such a situation the deferred amount should be subjected to immediate taxation. We question, however, whether any special administrative or legislative remedy need be applied here since the rules of § 83 seem to provide an appropriate mode of taxation. There is really no need for a second set of rules setting forth the quantum of employee asset control that would trigger the inclusion of amounts in the employee's income. Section 83 is adequate to the task.

Another approach, the one that found its way through the House of Representatives in 1969, should be rejected as it was by the Senate before the Tax Reform Act of 1969 was passed. That approach, which would tax compensation as received, but at the rates that would have been applicable at the time the compensation was earned, suffers from virtually all of the technical difficulties inherent in the Treasury's current proposal. We see no merit in returning to that line of analysis.

The special distinction between deferred compensation arrangements in the private and public sectors leads to a further thought with respect to the public sector. Since, as we have stated, the government employer does not have the benefit of an income tax deduction, any deferral of an employee's income results in a direct deferral of the taxability of that income and the revenue raised with respect thereto. In this regard, the situation of government employees is identical to the situation of employees of tax exempt § 501(c)(3) organizations. For such an employee, the amount of income that may be deferred can, in general, not exceed 20 percent of his income over the years for which service has been performed.[12] We would, therefore, suggest that the use of this so-called 403(b) annuity approach be considered as applicable to public sector employees generally. However, it can have no applicability to employees in the private sector where there are totally different revenue considerations and little chance of substantial revenue leakage.

Thank you for permitting us to present our views.

Senator BENTSEN. Our next panel will represent the public sector. We will have Mr. L. G. Skip Smith, legal counsel, State of Texas Deferred Compensation Plans, and if the rest of the audience will identify themselves.

Mr. KRASICKY. My name is Eugene Krasicky. I am first assistant attorney general of Michigan.

Mr. BOSZ. I am Henry Bosz, secretary of personnel for the State of Maryland, chairman of our State Board of Trustees or Deferred Compensation.

[11] See S. 2627 introduced by Senator Gravel and H.R. 10746 introduced by Congressman Waggonner.
[12] § 403(b)(2).

Mr. ARCENEAUX. I am Delton Arceneaux, and I am former chairman of the Louisiana Deferred Compensation Commission for the State of Louisiana.

Mr. MARSHALL. I am James F. Marshall, executive director of the Assembly of Governmental Employees.

Senator BENTSEN. The great response we have had shows the intense interest in this subject, and we will be pleased to hear your leadoff witness.

STATEMENT OF L. G. SKIP SMITH, LEGAL COUNSEL, STATE OF TEXAS DEFERRED COMPENSATION PLANS

Mr. SMITH. My name is Skip Smith. I represent Hon. Bob Bullock, comptroller of public accounts, and the administrator of the State of Texas Deferred Compensation Plans.

Senator BENTSEN. Mr. Smith, I have been trying to get as many witnesses here as the State of Florida has.

Mr. SMITH. I appreciate your efforts, Senator.

A deferred compensation plan is simply a forced savings plan with a tax advantage if the employee follows the cash method of accounting for income. The advantage is that income tax is not due on the amounts deferred until retirement, because that is when the employee has a right to receive that portion of his or her income.

In the past, the courts and the IRS have held that employees in plans such as ours were entitled to this tax break under section 451 (a) of the code. Last month, the IRS proposed a Treasury regulation under section 61 of the code that would make this tax break unavailable to anyone on a predetermined fixed salary.

The IRS is saying that the agreement to defer should be considered a sham for income tax purposes if the employee is given the choice of whether or not to defer part of a fixed salary. I find it extremely difficult to consider an employee in receipt of money that the employee was never able to obtain, regardless of whether the decision to defer was voluntary or involuntary.

It is one thing to consider a taxpayer in constructive receipt of salary he has already earned and could receive but for his decision not to. However, that principle by which you are not allowed to turn your back on income to which you are entitled does not apply if the decision to defer is made before the salary is ever earned, because, under those circumstances, the employee is never entitled to the income until the employer fulfills his promise to pay at retirement.

So why did IRS propose this regulation?

After listening to Mr. Halperin's testimony, I conclude that Treasury thinks there is an abuse problem and a Federal revenue loss problem.

As to abuse, I do not see how Treasury perceives abuse only in the public sector. I see no difference between an employee exercising an option to defer granted to him by statute as opposed to one granted by company policy or as a result of arm's-length negotiations. Personally, I find no abuse in either sector. The fact that some employees can defer more than others is not an abuse; it is usually simply a consequence of earning more money.

As to Federal revenue loss, I have yet to see statistics that show the amount of net Federal revenue loss. By net, I mean the difference between what the Treasury would have received if the amount deferred were taxed at the time of deferral and the amount that the Treasury does receive at the time that benefits are paid to the employee, at which time the amount subject to tax, of course, is much larger due to investment increases during the interim.

Of course, you would have to figure in loss of the use of the money to the Federal Government in the interim and the lower bracket at payout time that would exist in many, but not all, cases.

I would like to see statistics taking all of those factors into consideration.

For whatever reasons the IRS might have, the recent action shows no legitimate policy goals that I can perceive. Perhaps the strangest twist of all is the fact that IRS's proposal to eliminate this tax advantage runs counter to the present administration's goal of allowing all taxpayers the same tax breaks regardless of their income.

Our studies show that 70 to 80 percent of the participants earn less than $20,000 a year. According to a recent survey prepared by the Treasury Department, that is precisely what 84 percent of the taxpayers in this country presently earn, so this is a majority rather than a minority tax break IRS proposes to abolish and if the proposed regulation is interpreted by IRS not to apply to highly paid corporate executives' deferred compensation arrangements, the irony will be bitter indeed.

There are, at present, five bills with a total of 53 sponsors introduced in the House, and one bill with 17 sponsors in the Senate, which would effectively kill IRS's proposed regulation to preserve deferred compensation plans for the future.

I urge this committee to support this legislation and thereby eliminate this ill-conceived threat to our employees' retirement plan. I feel that the thousands of employees who have entered deferred compensation plans with the good-faith belief that they were legal and fully approved by IRS deserve your most careful consideration. It's my opinion the plans are lawful and should not be interfered with.

Senator BENTSEN. Thank you, Mr. Smith. Tell my good and able friend Bob Bullock we are sorry he couldn't be here. You spoke succinctly and well.

STATEMENT OF DELTON ARCENEAUX, FORMER CHAIRMAN, STATE OF LOUISIANA DEFERRED COMPENSATION COMMISSION

Mr. ARCENEAUX. Mr. Chairman, I would just like to say one word. I am Delton Arceneaux from the State of Louisiana, and I wish to concur with the comments of Mr. Skip Smith from the State of Texas.

We have had a deferred compensation plan implemented for 1 year in our State and, to date, we have some 3,000 employee participants averaging approximately $950.

Our plan administrator is directed to make each and every State employee knowledgeable of the plan and afford he or she an opportunity to participate. We want to continue this plan in our State. I am sure there are 20 or plus States that have plans that would like to continue theirs and some 15 or so States who have plans waiting to be implemented when they know what direction to go, as well as many municipal and county segments.

I wish to thank you, Mr. Chairman and members of your committee, for allowing me to deliver my comments today and ask that you support our endeavor. Thank you.

STATEMENT OF HENRY BOSZ, DIRECTOR OF PERSONNEL, STATE OF MARYLAND

Mr. Bosz. Mr. Chairman, I am Henry Bosz from the State of Maryland. Just as Maryland was one of the Original Thirteen Colonies, it was one of the original States, early States, into deferred compensation. We spent 2 years studying deferred compensation. I think it was something very significant.

It was a cooperative effort between labor and management. The American Federation of State, County, and Muncipal Employees, the Maryland Classified Employees Association, the two largest, participated in the actual development of the program and today sit on the board, a five-member board.

We feel that, in no way, is our program discriminatory. We are very proud of the fact that we've got 16,000 employees out of a work force of 55,000 that are participating.

The average amount, predicated on the end of the year figures, represents $1,354 per employee. We strongly urge you to not allow deferred compensation to be taken away from the public employee.

If you have no objection, Mr. Chairman, may I leave for the record a copy of the letter that we have sent to IRS Commissioner Kurtz indicating our desire to appear administratively before the Internal Revenue Service.

Senator Bentsen. Fine, Mr. Bosz.

[The material referred to follows:]

Department of Personnel,
Baltimore, Md., February 28, 1978.

Mr. Jerome Kurtz,
Commissioner, Internal Revenue Service,
Washington, D.C.

Dear Mr. Kurtz: It has come to the attention of this office that the Internal Revenue Service has filed with the Federal Registry, a Proposed Internal Revenue Service Regulation (4830-10) which threatens to seriously impact one of the most important programs ever developed for over 200,000 Maryland State, City, County and other Public Employees.

This Proposed Regulation threatens to reverse, in general, over twenty years' of precedent I.R.S. Revenue Rulings and Procedures regarding the tax status of Non-qualified Deferred Compensation Plans as provided by law for many different individual taxpayers, but worse yet, proposes to specifically reverse and withdraw the Private Letter Ruling granted the State of Maryland on June 26, 1975, by your office, which approved the implementation of the Maryland Public Employee Deferred Compensation Program—a benefit specifically established and approved for our 50,000-plus State Employees.

BACKGROUND

The Maryland Program, as conceived by a special Task Force and authorized by House Bill 246 of the Maryland General Assembly on April 30, 1974, had one singular objective: To provide our Maryland State Public Employees with the same type of Incentive Savings Programs and Benefits as those long enjoyed by millions of comparable employees in Private Industry through the use of Profit Sharing, Thrift Plans, Stock Purchase Plans, as well as similar benefits made available to over five million employees of Educational, Eleemosynary, Charitable, and other nonprofit organizations and institutions under 403(b) plans.

The obvious socioeconomic intent of all of these plans—as established and approved by continued precedent of the U.S. Congress and specifically by the State of Maryland with this Program—is to hopefully encourage all working Americans to individually and voluntarily supplement their basic Public or Private Retirement Plans and Social Security by providing for their own future financial security, free of the ever increasing reliance by the Aged upon Federal, State, City and other Tax Funded social service and welfare programs.

One need only to analyze the startling revelations of Mr. Joseph Califano's, the Secretary for Health, Education and Welfare, recent testimony to the U.S. Congress in which he revealed that in excess of one-third of our $500 billion Federal budget was now directed in some form to specific Tax Funded benefits to the Aged: Even more threatening is that with the aging of our demographic population factors combined with the ever increasing threat of continued inflation in a progressive economy, these tax burdens will continue to escalate. Such results obviously must be curtailed, and this objective should become a major concern of the U.S. Congress, as well as Tax Policy as determined by your Service, the Department of Treasury, and the Executive Branch of our National Government.

It should be noted that the above mentioned payments to the Aged do not include any of the additional Social Service payments, subsidies and other benefits paid by our fifty states and cities and counties, directly to the same and other recipients.

Obviously, any plan which can be established to help curtail this catastrophic trend is one which will not only benefit the proposed Public Employee participants themselves, but also their employers (the Cities, Counties and States); the taxpayers throughout the United States who hopefully will not have to support these individuals with such imposing tax burdens as we currently and will continue to require.

Prior to the implementation of our Maryland Program for State Employees, several specific considerations and safeguards were built into our proposed Plan and administrative systems. Many of these were designed to make certain that the Plan represented maximum benefits to our Maryland State Employees at minimum cost, and that the Plan was established and administered consistent with the best interests of the State of Maryland, its Public Employees and Taxpayers, per se.

However, two specific objectives were paramount in these considerations:

First, the Plan had to be non-discriminatory, both in technical and operational terms.

Our requirements were that the benefits had to be available, affordable, beneficial, and understandable to every Maryland Public Employee regardless of their income classification. It was our specific and determined intention that this Plan would not be a program which was designed for and used for the exclusive benefit of the highly paid individual.

To achieve this objective, our Plan was designed not only to insure both technical and practical nondiscriminatory factors, but even more importantly our entire system was established to make certain that every employee had the individual opportunity to personally review, understand and evaluate the benefits of this Program relating to his personal needs and objectives. Obviously, this required the substantial investment of time, man-hours, and money by the State of Maryland, our Agencies, and the Administrators and Underwriters of our Program.

The tremendous success of our Program with specific respect to this nondiscriminatory activity is documented by recent statistics developed by our Maryland State Public Employee Board of Trustees revealing the statistical participation analysis of our 54,000-plus eligible State Employees.

As of January 11, 1978, over 32,000 of our employees have personally attended orientation meetings to review the benefits of this Plan. As a result of these efforts, over 13,396, or 41 percent, of those attending meetings have enrolled in the Plan. Without even completing our comprehensive introductory efforts, this represents almost a 25 percent participation of total eligibel employees.

The degree of participation by salary level is shown below:

	Percent
$5.000 to $15.000	70
$15.000 to $25.000	25
$25,000 and over	5

This broad level of participation, particularly among the lower the middle income levels, represents to our knowledge, the most successful Plan in the United States in achieving an overall employee participation.

We feel that this success serves genuine local and national public interest by helping to encourage our Public Employees on an individual voluntary basis, to personally provide for their own future needs, hopefully free of Federal, State and City Welfare in the future.

Second. The second objective of our Plan was that it was to be absolutely legal, established and administered in total compliance with all applicable regulatory jurisdictions—especially the Internal Revenue Service.

To this end, we retained the finest technicians in this field to design our Plan, to secure appropriate regulatory approvals, and to administer our Plan in compliance with these requirements.

The Maryland Plan was designed consistent with specific intent of the Internal Revenue Service Code, Sections 451–1(a) and 451–2(a), and Sub-Sections 1.446–1(c)(1)(i) regarding the technical issue of Construction Receipt of income. In addition, our Plan was designed in reliance on all known Internal Revenue Service Rulings and Procedures dictating the terms, restrictions and requirements for such Plans as interpreted for over twenty years by the Internal Revenue Service (most notably Ruling 69–650 and Ruling 60–31), and supported by several Judicial decisions upholding these opinions.

After numerous conferences, communications and amendments, our Proposed Maryland Plan was approved by your office, signed by Mr. Billy Hargett, Acting Chief, Individual Income Tax Branch, and in June 1975 we began implementation of this benefit for our employees.

SUMMARY

Today, this Plan is a most important cornerstone of our entire State Employee Benefit System. In addition, many of our Cities, Counties, and other Political Sub-Divisions either already have or are currently in the process of establishing similar benefit plans for the benefit of their employees.

As a result of these efforts, tens of thousands of Maryland Public Employees are currently depending upon these Plans as an integral part of their future financial security—and hopefully additional tens of thousands will continue to participate in the years to come. Obviously, the long-range economic benefits, both to the employee-participants themselves, the State, and the Nation can only result in a substantially reduced overall tax expenditure through the utilization of this voluntary system to encourage and secure the individual's responsibility for his own needs.

In addition, it must be noted that these plans are not "tax loopholes." At the time the employee receives the actual income, he will obviously have to pay his then fair-share of Federal Taxes.

Equally important, our State, our Cities, and our Counties are depending on these plans and benefits as a means to attract and keep high-level personnel in public service in competition with the comparable benefits currently available to Private Industry and other types of non-profit employers who have had such opportunities. To achieve this end, we have expended tens of thousands of man-hours and dollars which are threatened to be wiped out by your proposed action.

Our Plans were established consistent with all legal requirements and implemented in good faith and reliance upon the integrity of your service, the Department of Treasury and the Federal Government.

It seems inconceivable that the Internal Revenue Service could issue this Proposed Regulation without ever making any attempt to seek input from those Cities, Counties and States so seriously impacted by these proposed actions. The mere issuance of your Proposed Regulations creates major problems for the day-to-day operations of our Plan on an on-going basis by the "uncertainty" of their ultimate future.

It is again inconceivable that the intent of the Internal Revenue Service Code, Section 451, is unclear as applied to these Plans, since over twenty years' of repeated Revenue Rulings, Procedures and Judicial Decisions have consistently provided clear and unequivocal interpretation that our Plan is legal. In addition, these specific types of Public Employee Deferred Compensation Plans have been reviewed repeatedly by your office since 1972, and have received, we understand, in excess of 100 special such Private Letter Approvals—from over five different Acting and Permanent Branch Chiefs of the Service.

How there could then be question as to intent or interpretation is beyond our most extreme tolerance and understanding.

If, however, this issue is still unclear or if, more likely, Internal Revenue Service wants to change the law—then we respectfully request that such action be taken through the proper Constitutional Authority—the United States Congress.

We are asking our Maryland Congressional Delegation to use every influence of their offices to seek this end result through either administrative procedure or, if necessary, legislative action.

We urge you to reconsider these Proposed Regulations and to issue as soon as possible clarifying modifications so as to go forward without the current cloud of uncertainty and to further establish such necessary procedures as deemed proper by your office to insure the continuation and extension of these plans providing equal opportunity, under the law, to millions of hard-working, middle-class American Public Employees.

Such a result not only provides equity, under the law, but represents sound tax policy for the long-range public interest to help curtail what is unquestionably one of the most threatening, and potentially destructive, trends in our Nation's economic future.

This memorandum will serve as our initial comments and request for further input into any decision-making process which will in any way affect our Plan. In the interim, it is the intent of our State, to pursue every available opportunity to insure the continuation of not only our Maryland State Plan, but equal plans for every Public Employee in the State of Maryland.

We sincerely request your earliest possible response and action to this important matter.

Sincerely yours,

HENRY G. BOSZ,
Secretary of Personnel.

STATEMENT OF EUGENE KRASICKY, FIRST ASSISTANT ATTORNEY GENERAL OF THE STATE OF MICHIGAN

Mr. KRASICKY. Mr. Chairman, my name is Eugene Krasicky. I am here on behalf of the Civil Service Commission of Michigan.

We have had a deferred compensation program for 3 years. It was approved by the Internal Revenue Service. Three years later, because there are new people there, IRS intends to take it away from us.

Mr. Halperin, today, tells us there is some doubt as to whether the law allows this. We strongly disagree that there is any doubt. The court cases that they contested on deferred compensation they lost and then acquiesced in them. Congress has acted on the Internal Revenue Code many times since; it has not changed it.

We welcome IRS's suggestion today that this is really a policy matter that Congress should consider. We strongly object to administrators in the executive branch changing the law. This is the responsibility of the elected representatives in the legislative branch.

Now it has been suggested that this is a program for the rich to evade taxes. Our experience is that the average Michigan deferred compensation program is only $1,100 a year. Seventy percent of our members earn less than $20,000.

Senator BENTSEN. I understood Mr. Smith was saying the same thing under the Texas plan.

Mr. KRASICKY. So our experience is like theirs.

Mr. BOSZ. May I add, Mr. Chairman, the Maryland plan has the same percentage, 70 percent.

Mr. KRASICKY. I would conclude by saying that we have a nondiscriminatory program. It is a fair program, it is a program that is understood by our members, and it is going to help us look out for our old age because our retirement system plan is inadequate.

We have 12,000 retired State employees that are drawing less than $240 a month. Under Federal standards, this is poverty.

So we want to save our own money for our old age. We are going to pay taxes on it. The day is coming when we are going to pay taxes on it. And if there should be any change in this, Congress should make the change, not the Internal Revenue Service.

Thank you.

Senator BENTSEN. I am very sympathetic to that kind of comment. In this country, you know, our savings rate is substantially below that of the European countries and the Japanese and certainly one of the social objectives, it seems to me, is to provide for retirement and to encourage people to do so.

So I certainly sympathetic with your suggestion.

STATEMENT OF JAMES F. MARSHALL, EXECUTIVE DIRECTOR, ASSEMBLY OF GOVERNMENTAL EMPLOYEES

Mr. MARSHALL. My name, Mr. Chairman, is James F. Marshall, executive director of the Assembly of Governmental Employees and I greatly appreciate the opportunity to testify before this committee today.

The Assembly of Governmental Employees, for your information, is a federation of independent public employee associations across the country. We currently represent several hundred thousand State and local employees in 35 States and are very concerned about both issues before the committee today.

I was in hopes of testifying earlier on Senator Stone's bill—S. 1587. I want to briefly comment on this issue. I have made sure that the clerk has our written statement on both issues—S. 1587 and S. 2627.

The important thing that we want you to know is that our several hundred thousand public employees have established a policy in support of the Stone bill because of a very simple reason. We feel that when the Congress, in its wisdom, established ERISA it said that a task force should study public sector pensions and deal with them separately, and we feel that that's what should happen.

We are very concerned about many of the public pension problems that exist around this country. The task force has come out with its report, I understand, and we are going to be very anxious to be involved in the legislation, but we do not feel that IRS should be in a position at this point to involve itself in ERISA reporting requirements of public pension plans, nor do we want to see public pension plans in jeopardy for taxation.

We will have a different posture when the Erlenborn-Dent report is finalized and legislation is established.

Now, in the area of deferred compensation, we have been involved for 6 years in that issue and have been instrumental in assisting many of the States across the country in incorporating deferred compensation programs for their public employees. What these gentlemen say is very true on the average public employee. In my written statement, I point out that, from the fact sheets we have been able to gather, the average participant in public sector deferred compensation programs around this country earn less than $15,000 annually and they defer somewhere between $50 and $100 a month.

I only want to make two points, because I know time is very short. The first point is one of principle. If the principle of deferred compensation is valid for the corporation executive, if it is valid for the professional athlete, if it is valid for the self-employed and valid for educational employees then the principle ought to be valid for the public employee truck driver in Austin, Tex., and the State trooper in Columbus, Ohio.

Senator BENTSEN. I do not see how anyone could argue that point.

Mr. MARSHALL. OK. That is good; because that is a very strong point. Public employees are more in jeopardy than anyone else of losing this program if the Treasury ruling is activated and that is why we are very concerned.

I would like to make another, final statement, and that has to do with the kind of employees that we are talking about. I know that from recent publicity that the average citizen probably thinks that a public employee retires at 125 percent of his income because of some of the extreme examples that have been publicized lately. I know that is not true, and I know you know that is not true.

As a matter of fact, the average public employee does not very often retire at the full retirement package that is offered.

Still, in most jurisdictions across this country, the annual turnover rate of public employees is in excess of 20 percent a year. That means that a fifth of that labor force is in and out of public employment and does not have time to establish a good vested roll in that pension plan and, in fact, in most pension plans, he or she is only able to get out his or her contributions without even receiving interest on the money.

Another element that should be noted, is that the average public employee is still over 40 years of age. A lot of people come into public service in the higher years of their work life and they do not have the time, in most pension systems, to develop a full pension program.

So what do they do? They say, "I want to help myself." This is the perfect tool for them to do that, and it should be encouraged, rather than discouraged.

I want to say, on behalf of the Assembly of Governmental Employees that we strongly urge committee support for S. 2627 and any similar legislation developed because it is a very valid program and greatly needed for the public employee.

Senator BENTSEN. Do you think there should be a limitation, percentagewise, on compensation, to try to avoid any abuses?

Mr. MARSHALL. I have no trouble with a limitation. I would anticipate that that would be something that the sponsors of the bill would deal with. We are not in support of the abuses, and if there is a way to adjust the limitation to correct those abuses, certainly we would be anxious to talk with the sponsors and anybody else on this issue.

Senator BENTSEN. I have heard of some examples in the private sector of virtually the total deferral of compensation, that type of thing.

I have taken off my glasses because I did not want to see the clock go past 12.

Mr. MARSHALL. You notice we talked very fast.

Senator BENTSEN. Thank you very much.
Mr. MARSHALL. Thank you, Mr. Chairman.
[The prepared statements of the preceding panel follow:]

STATEMENT OF L. G. SKIP SMITH, LEGAL COUNSEL, STATE OF TEXAS DEFERRED COMPENSATION PLAN

Mr. Chairman and distinguished committee members, the purpose of my presentation is to discuss a recent move by IRS which threatens the existence of all deferred compensation retirement plans.

Under these plans all employees have the right to defer receipt of a certain portion of their salary until retirement: the employee agrees to give up all present rights to a certain part of each paycheck before it is earned; the employer gives the employee an unsecured promise to pay that same amount, plus or minus any gain or loss through investment, at the time the employee terminates his or her employment.

So a deferred compensation plan is simply a forced savings plan with a tax advantage if the employee follows the cash method of accounting for income: the advantage is that income tax is not due on the amounts deferred until retirement, because that is when the employee has a right to receive that portion of his or her income.

In the past the courts and the IRS have held that employees in plans such as ours were entitled to this tax break under Section 451(a) of the Code.

Last month the IRS proposed a Treasury regulation under Section 61 of the Code that would make this tax break unavailable to anyone on a predetermined, fixed salary.

I find it extremely difficult to consider an employee in receipt of money that the employee was never able to obtain, regardless of whether the decision to defer was voluntary or involuntary.

It is one thing to consider a taxpayer in constructive receipt of salary he has already earned and could receive but for his decision not to; however, that principle, by which you are not allowed to turn your back on income to which you are entitled, does not apply if the decision to defer is made before the salary is ever earned, because under those circumstances the employee is never entitled to the income until the employer fulfills his promise to pay at retirement.

So why did IRS propose this regulation?

I suppose there is a possibility they are confused. A spokesman from Treasury is quoted in the February 2 edition of the Wall Street Journal as saying, "This regulation poses the question: Have you got the cash?" The unanimous reply of all participating employees would be, of course, "No, and we can't get the cash until we retire."

Another possibility is that IRS feels that all employees should report their income when it is earned, regardless of when it is received. Unless the Congress decides to repeal the cash method of accounting for income, however, that notion has no support.

It has been suggested that IRS is tired of the administrative burden of being required to issue advance rulings on each contemplated plan and have therefore proposed the regulation so that all the plans either will be eliminated or given a permanent berth in the Code by Congress, along with the existing qualified plans.

For whatever reasons the IRS might have, their recent action serves no legitimate policy goal that I can perceive. Deferred compensation plans cause no greater drain on the national treasury than do qualified plans. Therefore their elimination because of loss of federal revenue would be unjustified and discriminatory.

Perhaps the strangest twist of all is the fact that IRS's proposal to eliminate this tax advantage runs counter to the present administration's goal of allowing all taxpayers the same tax breaks, regardless of their income. Our studies show that 70–80% of the participants earn less than $20,000 a year. According to a recent survey prepared by the Treasury Department, that is precisely what 84% of all taxpayers in this country presently earn. So this is a majority rather than a minority tax break IRS proposes to abolish. And if the proposed regulation is interpreted by IRS not to apply to highly paid corporate executives' deferred compensation arrangements, the irony will be bitter indeed.

There are at present five bills with a total of 53 sponsors introduced in the House and one bill with 15 sponsors in the Senate which would effectively kill IRS's proposed regulation and preserve deferred compensation plans for the future.

I urge this Committee to support this legislation and thereby eliminate this ill-conceived threat to our employees' retirement plans. I feel that the thousands of employees who have entered deferred compensation plans with the good-faith belief they were legal and fully approved by IRS deserve your most careful consideration.

STATEMENT OF EUGENE KRASICKY, FIRST ASSISTANT ATTORNEY GENERAL OF THE STATE OF MICHIGAN

Honorable Senators and staff, my name is Eugene Krasicky. I am the First Assistant Attorney General for the State of Michigan. The Michigan Civil Service Commission has requested that I appear today to express the opposition of the State of Michigan to proposed regulation of the Internal Revenue Service which adversely impact important State of Michigan employees' deferred compensation benefits and to voice support for Senate Bill 2627, which would permit the continuance of such deferred compensation programs.

SUMMARY OF PRINCIPAL POINTS INCLUDED IN THE STATEMENT

1. The State of Michigan fully supports Senate Bill 2627 and opposes the actions of the Internal Revenue Service to revoke the tax-exempt status of employee deferred compensation to the State Deferred Compensation Program.
2. The State of Michigan Deferred Compensation Program is non-discriminatory and has in excess of 9,500 participants, most of whom earn between ten and twenty thousand dollars and have a median contribution to the program of $41.52 bi-weekly.
3. The action of the Internal Revenue Service to revoke its approval of the tax-exempt status of employee deferred compensation to the State of Michigan Deferred Compensation Program discriminates against public employees in favor of employees in the private sector and employees of school systems and of certain tax-exempt organizations.
4. The action of the Internal Revenue Service to revoke its approval of the tax-exempt status of employee deferred compensation to the State of Michigan Deferred Compensation Program is contrary to previously issued rulings and tax court decisions regarding income receipt and taxation.
5. The action of the Internal Revenue Service to revoke its approval of the tax-exempt status of employee deferred compensation to the State of Michigan Deferred Compensation Program adversely impacts the State's ability to attract and retain highly qualified employees and jeopardizes the financial security of thousands of state employees.

Michigan's deferred compensation plan was instituted following the imprimatur of the Internal Revenue Service in July of 1975. Under the plan, all state employees are provided the opportunity to defer portions of their income in order to establish a retirement program. Most employees contemplate applying such funds as a supplement to their state pension and social security benefits so as to allow them to enjoy their post working days without serious diminution in their standard of living. In essence, these employees are willing to sacrifice a little now so that they will not have to sacrifice greatly later.

It should also be pointed out that the State of Michigan Employee Retirement Plan, like that of so many other state and public bodies, is wholly inadequate in meeting the needs of retired employees. Recent statistics show that approximately 12,500 retired state employees are receiving an average monthly benefit of $236.83. Of these, approximately 20% receive less than $100.00 per month. Thus, state employees who lack either the foresight or financial ability to provide a supplementary source of retirement funds face a poverty level existence. The state's deferred compensation program provides the opportunity and the ability to assure that state employees are not forced to seek public assistance or further employment when they retire.

Michigan's deferred compensation plan is similiar to plans already in existence or soon to be implemented in 37 other states. The make-up of its participants clearly shows that it was not designed as a tax shelter for the well paid. Instead, Michigan's plan is comprised of a broad spectrum of state employees totalling over 9,500 participants. The median deferral of compensation of these employees into the plan is $41.52 per two-week pay period. Approximately 90% of these employees earn between ten and twenty-five thousand dollars annually, with 40.7% earning between ten and fifteen thousand dollars, 31% earning between fifteen and twenty thousand dollars, and 17% earning between twenty and twenty-five thousand dollars. Only about 9% of the participants earn in excess of twenty-five thousand dollars.

The proposed action of the Internal Revenue Service would, in one sweeping regulation, destroy the expectations and dreams of thousands of state employees. It would place such employees at an unequitable disadvantage compared to employees in the private sector who are eligible for such income deferral plans as profit sharing, stock options, and bonus programs. It would further place such employees at a disadvantage when compared to public school employees and employees of certain tax-exempt organizations whose deductions for annuities are specifically exempted from taxation under section 403(b) of the Internal Revenue Code. An interesting point to note is that Michigan public school employees enjoy a higher state pension on the average than do state employees. Public school employees receive an average $318.46 per month, while Detroit public school employees receive an average $411.53 per month. That means that the school employees receive $1,000.00 to $2,000.00 more per annum.

Michigan's deferred compensation plan was expressly approved by the Internal Revenue Service in a letter dated July 16, 1975. Therein, the Service recognized that consistent with the cash receipts and disbursement method of accounting and income reporting, a state employee electing to defer a portion of his or her income to a later date would be able to defer inclusion of such sums in his or her gross income until the money was actually paid or otherwise made available to the employee. The IRS would now take the position that such funds are includable in the gross income of state employees at the time the funds are deferred, despite the fact that such employees do not have possession of the money, exercise no dominion over the investment of the funds, and cannot reach such funds until retirement or death of the employee. The proposed action of the Internal Revenue Service, reversing its earlier determination regarding the taxability of deferred income, amounts to an arbitrary and capricious shift in policy, a policy, I submit, which may be made only by the people's elected representatives. We submit that such action is illegal in that it is contrary to such tax court decisions as In Re Oats, 18 Tax Court 570 (1952) and In Re Robinson, 44 Tax Court 20 (1965), as well as a lengthy list of revenue rulings and acquiescences. In revenue rulings 60–31; 67–449; 68–86; 68–79; and 69–650, the Service recognized that income is only constructively received and is taxable when funds are credited to the employee's account, set apart for him, or otherwise made available so that the employee may obtain them at any time. Income is not, under the traditional view, received if the taxpayer's control of it is subject to stringent limitations and restrictions. Under the State of Michigan's deferred compensation program, employees are required to designate the amounts of deferment in advance of any payment. Such funds are retained by the state and are at all times state funds subject to all statutory and constitutional limitations. The employee has no access to such funds and can only receive them on the happening of certain agreed upon contingencies, i.e. death, retirement, separation, and disability, and unforeseen catastrophe. Thus, the state's deferred compensation program is consistent with the long established Service interpretation regarding income receipt and taxation.

It is significant that the Internal Revenue Code has been amended many times since these decisions and service rulings. In particular, section 451, dealing with the taxable year of income inclusion, was amended in 1965 by P.L. 89–97, in 1969 by P.L. 91–172, and as late as 1976 by P.L. 90–455. The failure of Congress to take action contrary to the historical interpretation regarding income deferment is seen as evidence of Congressional approval. Accordingly, any deviation from this traditional approach must come from Congress and cannot be effected by administrative fiat.

Almost 10,000 employees of the State of Michigan have relied upon the 1975 action of the Internal Revenue Service, have denied themselves so as to provide for their old age without fear or anxiety of becoming a burden on society. The Internal Revenue Service, without the authorization of Congress, seek to deny them the benefits to which they are entitled under law. I would urge the Congress to act to prevent this unjust result. On behalf of the State of Michigan, the public good is served by the retention of qualified employees in the public service. The program of deferred compensation helps accomplish the worthy purpose of attracting and retaining dedicated public servants.

STATEMENT OF JAMES F. MARSHALL, EXECUTIVE DIRECTOR, ASSEMBLY OF GOVERNMENTAL EMPLOYEES

Mr. Chairman and members, I appreciate this opportunty to appear on behalf of state and local public employees on a matter of grave concern to all of us. For over 25 years, the Assembly of Governmental Employees has been a federation of independent public employee organizations representing state and local employees throughout the United States. Some of our affiliate organizations have been representing public employees for more than 50 years. We have 46 affiliate organizations located in 35 states, including 34 state employee organizations.

Our organization has been seriously concerned with federal policy decisions for needed reform in public sector pension plans. We recognize the need for federal pension reform legislation and support the extension of such legislation to the public sector through development of an act similar to ERISA, adapted, however, to meet the needs of public employees. We support S. 1587 as necessary and urgently needed legislation to stabilize the situation pending the development of federal legislation dealing with public pension plans. We look forward to the report of ERISA Public Pension Task Force Study wihch is expected to be available this month. We anticipate that this comprehensive report will provide a factual basis for the early development of legislation dealing with public sector retirement systems in an orderly and logical manner. We hope to work with other interested groups in the development and passage of appropriate legislation.

IRS agents in several jurisdictions have made inquiries into qualifications of various public plans based on both pre-ERISA and post-ERISA taxing and reporting authority. However, because difficult questions have been raised on the application of the law, IRS has imposed a temporary moratorium on any further examination into public plan tax status. Reporting requirements, however, will remain in effect.

Prior to 1972, most public sector plan administrators believed their pension system to be automatically exempt from federal taxation. This belief was founded on the principle of sovereign immunity, a general exemption contained in Internal Revenue Code Section 115, and the lack of any attempts by IRS to impose liability.

In 1972, however, IRS ruled that public employee pension trusts must meet Code requirements (Sects. 401(a), 501(a)) in order to qualify for favorable tax treatment (Rev. Rul. 72–14). The ruling did not raise the question of taxability of state and local governments, but rather sought to establish the principle that the trusts were separate from the governmental unit and therefore taxable. In addition, the ruling affected the tax liability for employees and certain beneficiaries.

Theoretically if a trust does not qualify it could: (a) Be taxed on investment income; (b) Subject the employee to income tax on employer contributions made after vesting; (c) Subject the employee to income tax on his own contribution interest; (d) Result in unfavorable lump-sum distribution taxation.

The primary stumbling block to public pension qualification under pre-ERISA law is the prohibition on discriminatory benefits. Typically, state systems provide more favorable vesting and benefit schedules to elected officials and members of the judiciary.

In 1974, when Congress passed the pension reform act (ERISA), the public sector noted with interest Title III which established a task force to study public pension systems and make recommendations for legislation. The rest of the law was believed inapplicable due to specific exemptions or clear congressional intent. Title I, relating to Department of Labor regulations, exempts governmental plans in Subtitle A. Section 4(b)(1) as defined in Section 3(32). A similar provision exempts public plans from termination insurance in Title IV, Subtitle B, Section 4021(b)(2).

Title II, which amends the Internal Revenue Code, sets new participation. vesting and funding standards for private plans. Governmental plans are specifically exempt (IRC Secs. 410(c),(1)(A); 411(e)(1)(A); 412(h)(3)). Having thus made the new standards inapplicable to governmental plans, this law goes on to state that *public plans must meet the pre-ERISA standards of IRC Secs. 401 (a) (3), (4), and (7)*, thereby codifying the decision of Rev. Rul. 72–14.

Despite this reaffirmation of authority, IRS until recently had not actively pursued enforcement, and then only in an inconsistent fashion. In Florida, agents decided to tax plan participants but not the thrust, while in Missouri a trust is being taxed but not the participants. The moratorium was imposed on these issues as well as broader policy questions.

Title II of ERISA also imposes requirements on plan administrators to file an annual registration and annual report wtih IRS. Public plans are clearly ex-exempt from registration, but IRS believes they must file annual reports under authority of IRC Sec. 6058(a). Unlike Sec. 6057 for annual registrations, Sec. 6058(a) contains no specific exemption from reporting for state and local plans. It is plausible that this omission was legislative oversight considering the general intent to exclude governmental plans documented in House Conference Report 93–1280.

Moreover, Sec. 6058(a) provides that the information required in the annual report shall be prescribed by regulation. IRS to date has not issued any such regulation specifically directed at the public sector, nor has there been any opportunity for comment. Rather, the reporting requirement was announced and modified through press releases.

Although the report by IRS is very limited in its scope, it remains disturbing. Not only has no formal input into the content been sought from the public sector, but it also asks for basic "foot-in-the-door" information upon which IRS may act should it lift the current taxing moratorium.

Senator Stone of Florida has introduced S. 1587 which seeks to exempt state and local plans from taxaation and reporting requirements. Congressman Cunningham of Washington has a similar bill pending in the House (H.R. 9118). Both measures are gaining additional co-sponsors and support as their purpose becomes more widely known.

The thrust of these bills is not in opposition to public sector pension reform or to reasonable reporting and disclosure requirements. Rather, they seek to hold in abeyance any legislation or administrative action prior to the outcome of the ERISA public task force study. This position is based on the history of nonenforcement by IRS, the potentially devastating impact on trust fund financial stability, the adverse affect on employee tax liability, and the presence of serious questions of constitutionality. Once the pension task force report is available, effecttive legislation can then be drafted appropriate to the public sector pension plans.

Mr. Chairman, it is estimated that there are over 6,500 public plans presently in operation in the United States. Objective evaluation of the management of these pension funds indicates that they go fom excellent to very bad. However, at this time they have one thing in common. They all face uncertainties as to their tax status and the tax status of the beneficiaries, and they face uncertainties as to their responsibilities under federal law. In the absence of clear direction from Congress they may be faced at any time with extremely adverse decisions by the Internal Revenue Service impacting upon the functioning of these important plans.

In 1974, Congress recognized the complexities and difficulties inherent in federal regulation of public sector plans by creating a task force which shortly will produce the most comprehensive and detailed study of public sector plans that has ever been undertaken. The Internal Revenue Service, in declaring a "temporary" moratorium, has recognized the problems inherent in their proposed actions.

We believe that early and affirmative action on Senator Stone's bill will clarify the present situation to the benefit of beneficiaries of all of these plans and will provide a needed basis for further action by Congress. The facts which will be available from the task force report will enable Congress to establish clearly the responsibilties of those who administer these plans as well as the rights of the beneficiencies of these plans. We urge adoption of the Stone bill.

Senator BENTSEN. The subcommittee is recessed, subject to call of the chair.

[Thereupon, at 12:05 the subcommittee recessed to reconvene at the call of the Chair.]

[By direction of the chairman the following communications were made a part of the record:]

NATIONAL GOVERNORS' ASSOCIATION,
March 27, 1978.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR MIKE: The National Governors' Association supports the statements made on March 15 by the state witness before the Subcommittee on Private Pension Plans. We support favorable consideration by the Committee on both S. 1587 and S. 2627.

We believe it is discriminatory to deny public employees benefits that are available by law to private individuals. We commend the committee for holding hearings to explain our deep concern over recent IRS actions which we believe were taken without congressional authorization. Favorable congressional action on S. 1587 and S. 2627 would be appreciated.

Most sincerely,

JAMES L. MARTIN,
Staff Director, Committee on Executive Management.

CITY OF LOS ANGELES, CALIF.
April 14, 1978.

Hon. LLOYD BENTSEN,
Chairman, Senate Subcommittee on Private Pension Plans and Employee Fringe Benefits, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I would request that this letter be made a part of the record in order to show the city's strong support for the early enactment of S. 1587.

It is extremely important that this legislation be enacted as soon as possible in order to clarify the apparent misunderstanding as to the intent of Congress to exempt state and local government retirement systems from Federal taxation and control.

During its regular meeting of April 7th the Los Angeles City Council voted to support S. 1587 and to urge its early enactment. In addition, it recommended that IRS withdraw its proposed regulations which would subject local government pension plans to filing annual reports.

Sincerely,

JAMES F. SEELEY.

STATEMENT OF WILLIAM J. JOSEPH, DIRECTOR, NEW JERSEY DIVISION OF PENSIONS

I am William Joseph, the Director of Pensions of the State of New Jersey. Our division in the Treasury Department administers public employee benefit programs, including nine pension plans involving 325,000 employees of the State and everyone of its 1,700 political subdivisions, a health benefits program covering 900,000 employees and dependents, and similar benefit plans pertaining to pen-adjustments, prescription drug, dental expense, and Social Security.

I support the provisions of S-1587 and urge its enactment.

INTRODUCTION

For some time there has been a hazy relationship between state and local governments and agencies of the Federal Government in the area of employee benefits. There have been revenue rules and regulations which initially appear to be blanket exemptions, relieving state and local governments from any reporting to Internal Revenue. However, revenue ruling 65–130 IRB 1965–19, and 18, stipulate that information returns such as 1099s are required to be filed by state systems qualified under 401a of the Code. Thus, the ruling appears to distinguish public systems which are and which are not qualified. Yet, most systems have been acting as if they were qualified for three decades.

We note that state and local governmental systems have periodically been held to be qualified. (I.T. 4102, 1952–2 Cum. Bull. 1973; Miller vs. Commissioner, 144, F. 2d 387 (4 cir. 1944)). As there are few published rulings, it has been held by most of us that State and municipal plans which are separately funded do qualify under the Code. However, if a revenue agent finds some technical defect, he might hold that the plan isn't qualified and then the rules regarding nonqualified plans would apply. The result would be to tax current income to employees on any contributions in which they had nonforfeitable rights at the time of contribution. What about the taxability of the income of the fund? If it is a trust fund, managed by trustees subject to the control of State or local governments, it would appear that it is a political instrumentality and might be considered exempt as such is appropriate to the income of any instrumentality derived from a governmental function (IRC of 1954 Section 115(a)).

Up till now the test of qualification was in the matter of what any particular IRS district office or even of what any revenue agent might consider. There is always the possibility of a lack of uniformity from one community to another. Is it not better to avoid these hit and miss decisions in favor of a blanket statute making all Federal, State and municipal plans qualified if they are funded by a separate trust or insurance contract and providing coverage and a uniform benefit formula for a recognized department of the government? Such a proposal was introduced in Congress as early as 1964 (HR 10 256, 88th Congress, 2d Session).

QUALIFICATION

In 1974 Congress appeared ready to clarify the taxability of state and local systems requiring qualification under Section 401. It was suggested at that time that governmental plans wouldn't necessarily be required to meet the new standards proposed but rather those of the existing legislation.

Let us look at the intent of Section 401 and the regulations pertaining thereto in terms of public systems. We all know that the effort is to make the plan available to employees generally and not merely to a few, high-paid officers. The tax advantage is to encourage industry to establish plans, deducting the expenses involving the funding of these systems. However, public employers do not pay taxes. On what basis could anyone argue that the public systems were the target of 401 treatment? There is no mention of public plans in the entire previous history of this part of the Code. There is no indication that public plans are not eligible for qualification or that they are required to meet qualification. Certainly, when this issue surfaced in the past the lack of interpretation is demonstrated by inconsistent IRS rulings. Revenue ruling 72–14 said that in a public plan the beneficiaries were not entitled to favorable treatment unless the system met the requirements for qualification. This was reiterated by the national office in Washington and ignored by most directors of IRS.

Perhaps the best demonstration that public plans were never involved with 401 is the number of studies which Congress has ordered, including the pension task force. Even Congress recognizes that there is a problem and that before legislation to include public plans under 401 or under ERISA, it would be proper to know a little more about these programs. IRS occasionally doesn't share this concern. If the public plans of state and local governments are subject to qualification, then the treatment afforded to these public employees is discriminatory, because the Congress has never deemed federal retirement systems to require qualification. Does anyone seriously believe that the courts could support a finding that state employees must pay the tax on their entire allowance while permitting federal employees an exemption on their contributions even though the latter group are members of systems which are not qualified. Let us examine the concern that congressional committees have expressed and the reasons which they have, therefore, indicated require congressional action, whether it be in the sector of taxation or in comparable ERISA standards.

They are worried about the financing of the systems. Is the plan actuarially sound or is there a constitutional guarantee that benefits will be provided as promised? When plans are integrated with Social Security, there is a problem in computing final average salary. Yet, it is Congress itself which appears to have come to the conclusion that all plans should be integrated, all perhaps except Federal plans. Prior service must be awarded on an equitable basis for all members. Is that the treatment afforded under the multitude of Federal plans? We regret that we have to note the differential treatment beween Federal and oher public systems. We do so only because they are the only other plans in the public sector.

Also, if these requirements are proper for state and local governments, Congress must appreciate that sooner or later they will be deemed proper for all public systems.

Over the years some public systems have applied to IRS to determine if they do qualify under Section 401a and they have received letters making that stipulation. Yet, very few have reported every change to IRS to determine if qualification has continued. We have no doubt that many of the changes have not been reported. What is involved is legislation enacted by a sovereign state to meet the needs of its public employees. Yet, here a federal agency would review this change and determine that the plan is or is not qualified and, therefore, whether the income of the trust and the taxable status of the payments received by the beneficiaries are to be altered as a result of this federal oversight of state enactments. The employee is going to have to pay the tax on the employer's contribution to the plan to the extent that his benefits are vested. The employee is also going to pay the tax on the value of the employer's contribution on his behalf for life insurance. It may be a gift tax which the survivor will have to pay on the contributions made to his or her pension by the employer.

This is what qualification means: a loss of state sovereignty to a federal agency which is operated by individuals who are not elected by the public, who may not be quartered in the state and whose judgment is patently different from that of the elected officers who voted the change.

PROPOSED QUALIFICATION CHANGES

Let us examine the problem of qualification in terms of recent proposals made by the Federal Treasury which would affect employee benefits.

There's a suggestion which would reduce the $30,000 limit on employer provided group term life insurance to $25,000. This is a revenue matter and would not have much of an effect on public systems where the provision for group life is normally very modest in terms of the face value of coverage or the total of coverage expressed as a multiplier of the annual compensation. For one thing, salaries are comparatively low in government and secondly, many systems are contributory in nature.

The second proposal is that tax exempt group life, health, accident, and disability plans do not discriminate in favor of officers or higher-paid employees. Again, we don't believe this would be of any material consideration in state and local governments any more than it would be in the case of Federal plans of the same nature.

A third proposal would repeal the tax preference for prepaid local insurance just enacted in 1976. Since the states, as employers, have no tax to pay, the only burden might fall upon the beneficiaries and we presume that public employees would pay their fair share of the tax burden, which presumably would be applied uniformly.

The fourth proposal is to decrease the maximum annual limit on defined benefit plans without consideration of annual cost of living increases. This would decrease the maximum from $84,525 to $60,000. We don't think state and local government would have much concern here any more than Federal pension plans.

A fifth proposal would reduce the maximum annual limit on defined contribution plans, currently $28,175 to $15,000 without any cost of living considerations. Most state and local systems, like their Federal counterparts, are fixed benefit plans while money purchase plans are found primarily for faculty members at public institutions, similar to the plans available to faculty members of private institutions of higher education. We see no reason why such limits would be as suitable for those in public schools any more than they would be for those in private ones.

A sixth proposal would reduce the overall limit for employees who are covered by both fixed and money purchase plans from 140 percent to 100 percent of a single plan limit. Again, we don't think that this would disturb too many public plans, although it is bound to have a much greater effect, as is the case of all the other proposals, in private plans.

The seventh proposal would prohibit a plan from excluding employees whose entire wages are covered by Social Security. We know of no such public plan. If anything, public plans normally provide for maximum participation with fixed, limited waiting periods.

An eighth proposal would extend the $7,500 limit for self-employed persons to 10 percent shareholders in a private plan. This has no effect upon public systems.

A ninth proposal would repeal the $5,000 statutory death benefit exclusion on employer-paid death benefits. If the Congress deemed this to be proper, then it would have the same effect upon all plans, public or private.

Finally, the tenth proposal would tax ⅔ of the Social Security benefits for retired persons with substantial other income. Such other income would be $15,000 or $25,000 per single person and $20,000 or $30,000 for married persons. We can assure the Congress that there would be very few individuals in public plans who would be thus affected.

All in all, what we have been attempting to demonstrate is that for purposes of more adequate tax revenue considerations or considerations of meeting certain standards which Congress may want to impose upon public as well as private plans, most state or local governmental systems have little to fear except as a Federal restraint upon the determination by state and local governments of the benefits that they should provide for their employees. Certainly if Congress feels that state and local governments would benefit from such standards, then it is generally alone in that consideration, because most state and local governments apparently do not share that concern.

What we are therefore left with is the exercise of power by Federal agencies which undoubtedly would violate the constitutional basis of our Federal system of government. Sooner or later, we appear to reach this bottom line in Federal-state relations.

ERISA

In the private sector, the significant problem was hardly in the amount of the benefit because that is subject to negotiation between labor and management. The true horror stories involved employers and unions who promised benefits and never provided the funds. They then went out of business and the pension anticipation of the employees were not realized. Governments have not gone out of business lately. In New Jersey no employee has ever suffered a loss in benefits in the entire history of public employee pensions. If benefits have been altered they have usually been liberalized; but if they were cut back, such changes applied only to new employees while guaranteeing the benefits which had been promised to those hired before the change. We are confident that this has been true in all other states. Certainly, if state and local governments are required to meet federal standards which cost significant sums, the benefits will no be realized because Congress has yet to indicate that it is prepared to assume the debt.

In our mind the worse tragedy of ERISA was the termination of the plans, which were all qualified, but which could not support the price of ERISA standards. The employers and the unions, who had met their obligations in a proper way, are now paying for those who did not. This is the kind of penalty that would be imposed on New Jersey and many other states if we had to pay monies to the Federal Government in order to insure benefit guarantees for those communities who had promised much but appropriated little. This means that we are going to have to cut back on what we now do in meeting our obligations, which weakens our structure and our standards. They are generally higher than those considered by the Congress. It means that benefit liberalization which should be adopted will have to be set aside in favor of rescuing plans in other states. We will be paying for the guarantee of benefits which may be more liberal than those which we provide although our benefits are funded.

Let us briefly examine some of the standards by which the House Education and Labor Subcommittee has measured its findings among state and local government plans and which has led it to endorse a study of its pension task force on public systems.

The first matter involves the absence of a single Federal agency to enforce laws thus preventing the development of a unified national policy on pensions. From the perspective of Washington, everything must be uniform; everything must be departmentalized. The over 70 Federal pension plans do not disturb the subcommittee even though this is an area with which Congress does have the right to act rather than the rather dubious area of imposing its will upon state and local governments.

In the absence of such uniform regulations, the subcommittee believes that the benefit structure of the plans have not been effectively communicated, that there is an inadequate safeguarding of plan assets and insufficient protection of rights under public systems. Is the structure of state and local government systems materially different than those of Federal programs? Are the booklets issued by the Federal Civil Service Retirement System extraordinarily different than those used by state and local governments? Have the assets of any funded plan been so misused that the benefits which have been promised have not been awarded? If an individual is aggrieved, he normally seeks a hearing and if that is unsuccessful, he will sue. Have the State courts been derelict in their concern for the rights of employees in state and local governments? Is a Federal agency required to overcome this lack of proper State Judicial Review? This is what the subcommittee is saying but have they really established this case? The report of the task force indicates that there are serious deficiencies to the extent that information is not reported and disclosed to members, leading to forfeitures and loss of earned benefits. Is this a repetition of the horror stories that led to ERISA? If these terrible things have been happening, how is it that the employees, public officials, and the taxpayers have not arisen to remedy these problems? Do we need a Federal bureaucracy to impose its will on what it believes are deficiencies, what it believes is unwarranted, what it believes is inadequate?

One significant finding is that most of the plans do not meet the ERISA minimum vesting requirements. How many plans in private industry did before ERISA? Obviously very few among defined contribution systems. Actually, what was adopted under ERISA was essentially the service requirement for vesting established by the Federal Government for its largest system. What was good for Congress patently was good for those in other plans. However, Congress doesn't provide the wherewithal required to meet the cost of such liberalization. For those private plans where the employer still finds the tax exemption more significant than the cost of a liberalization in this area, the new minimum applies in lieu of terminating the plan. However, in state and local governments the philosophy is that of an earlier generation where plans were established for the purpose of retaining employees in jobs normally paying comparatively smaller salaries than those in industry. This philosophy is only changing recently and if it is slow, it is because it takes money, a good deal of money, to decrease a vesting requirement from 20 to 15 years, to 10 or 5 years. State and local governments with their funded systems are not prepared to promise benefits which only the Federal Government can guarantee by the printing of paper money.

Another finding of the task force was that most systems do no provide a realistic assessment of pension costs due to a lack of actuarial valuations and standards. Among the several thousands of state and local governmental plans there is no doubt that a majority can be counted, each delimited to one or only a handful of employees, which are not established on a sound basis. This in contrast to the pension plans of the Federal Government where millions of people are enrolled. Yet Congress would impose such a burden upon state and local governments even when the employees, who are members of these pension plans, are lobbying for benefits in State Legislatures everyday and have not been so exorcised over the issue of the requirements for vesting that appears to excite so many of the federal planners on the task force. While Congress has received much in the way of actuarial information concerning the Federal retirement system, and while many proposals have been considered, happily we note that no plan has been advanced which would delimit benefits for any individual, but unfortunately no plan has been advanced to meet the actuarial cost implications of any liberalization or even of the present benefits.

The task force finds that pension costs will be going up because many plans are funded on a pay-as-you-go basis. This is regrettable but when you have one or two people covered by a plan, a small community is likely to think of providing the cost through direct appropriations each year rather than by any other more advanced means. Prepayment of the pension debt affects not only next year's budget but the budgets for many years in the future and most small communities are not prepared to increase their obligation so significantly as reserve funding would require. In this regard most of these communities follow the practice of the Federal Government.

The task force recommends that there should be uniform actuarial standards so that everybody will know what the future needs of the system are and how they can be met. We support this view completely, but we believe that under our Constitution the Federal Government has no right to impose standards, which itself refuses to adopt, upon state and local governments which must make their own financing arrangement based on their own needs and financial posture. State Legislatures are increasingly apprehensive about imposing standards upon local governments where this restricts the ability of local government to meet its budgetary requirements. We view this recommendation as contradictory of what the general mood is in the Congress and throughout the country in the matter of Federal funds. We are especially denoting the attitude about Federal aid to our older and decaying urban centers; Congress has come to appreciate that the monies cannot continue to be so tied that local officials have no opportunity for rational decisions in meeting the actual needs of their communities rather than the needs that Congress had considered.

Finally, the task force recommends a uniform standard of fiduciary conduct. This is an extraordinary consideration. After all, pension costs are usually expressed as a percentage of salary. There must be something terrible that the pension task force has uncovered in the area of the way state and local governments operate and particularly in the area of the payment of salaries because salaries constitute a very large part of any state or local government budget. If salaries are misappropriated and improperly paid, then, of course, it follows that pension costs, 5 to 10 or even 30 percent of salary, may likewise be misappropriated. Has the task force made such a finding and have they reported these misadventures to the proper state and local government officials?

CONCLUSION

In this discussion we have not entered into the issue of advantages and disadvantages of qualification. There are pros and cons on that matter. Our concern is with a much broader aspect of Federal-state relationships and specifically the ability of state and local governments to care for their own employees just like the Federal Government cares for its employees. It is the public who is the employer in each case. It is the public who elects its representatives to the Congress and to the legislatures. The public relies on the wisdom of both. Is the wisdom of the Congress greater than the wisdom of the legislature in the particular state? More importantly, is the wisdom of the federal bureaucracy superior to that of the elected representatives of the public? All of the members in Congress, regardless of party, always support the Jeffersonian or Lincolnian philosophy that the best government, governs less and that the best resides closest to the people. Yet, in every enactment and every regulation democracy is slowly being whittled away in favor of a Federal Government which is remote from the states, the cities, the public and whose powers to govern are evidently limited, by its own incapacities to attack the problems which confront us, often inhibited by a bureaucracy which cannot be controlled and which also cannot deal with every aspect of life in modern America.

New Jersey's public employee retirement systems were established as early as 1919 and 1920. There were studies on the actuarial funding of pension liabilities in 1917. New Jersey has placed all of its major systems on such a basis since their inception. We believe New Jersey's record is better than that of the Federal Government and this is true of many states. We appreciate that there are states and many municipalities where such is not the case, but that is the problem of those states and those municipalities—not New Jersey. Why should we give up some part of our democracy and the ability to govern ourselves?

This is not a matter of extraordinary need. Can anyone in Congress claim that the overwhelming majority of public employees in state and local governments desire federal intervention on their behalf? Has Congress received groups of employees clamoring for federal standards in the area of taxes or for purposes of ERISA? Where has this call for federal action come from? We can assure the Congress that from our position in every state it appears that it is a normal extension of the staff who where concerned with the problems in private plans. That's rational and understandable but now they are dealing with another element. Public plans do not demand qualification in order to avoid a tax on our income. We have no tax to pay. We have systems that are decades old and have been found proper to meet our needs in each community and in each state. Federal standards will only mean that all of our plans will have to be altered, often at prohibitive cost to the public. There is no unlimited source of revenues. Increasingly state and local governments depend on federal tax revenues. If the changes are required, they will cost significant sums. Where is this money coming from?

If federal qualifications were prescribed and if state and local systems did not qualify, who would be the losers? First, there would be the public who would have to make increased contributions to the retirement system because the interest income of the trust would be subject to tax. The second would be the employees who would have to pay increased taxes on the employer's contribution and the pension disbursements they receive. The third would be their survivors who would have to pay taxes on their incomes including incidental life insurance or similar death benefits. We could go on but essentially who are the losers—the public, the employees, their survivors. Is this what Congress wants—to punish the taxpayer and the beneficiaries of these pension plans?

We therefore support the legislation which would determine state and local government systems qualified so that adverse tax consequences will not be imposed upon trusts and therefore upon the beneficiaries. Are state and local systems the usual nonqualified plans? Those are generally designed to provide retirement benefits which are tailormade for a few top executives and private employers are prepared to make this available even at a less favorable tax treatment. Are the overwhelming majority of state and local government plans designed for this purpose? If so, then they share the same nonqualification with Federal plans. Again, there are employers who are willing to contribute to a fund without being able to deduct the contribution from their taxable income. What taxable income do state and local governments have to pay?

LAW OFFICES,
SUTHERLAND, ASBILL & BRENNAN,
Washington, D.C., April 10, 1978.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BENTSEN: Your Subcommittee on Private Pension Plans and Employee Fringe Benefits held hearings on March 15, 1978 on proposed regulations issued by the Treasury Department (Prop. Reg. § 1.61–16) to limit the use of so-called "nonqualified" deferred compensation arrangements. We respectfully request that this letter, which is submitted on behalf of J. M. Huber Corp., be included in the printed record of the Subcommittee's hearings.

J. M. Huber Corp. ("Huber") was organized in 1883 as a manufacturer of printing inks and pigments. Today, Huber is a diversified company that produces and markets a variety of products. For valid business reasons, Huber has entered into deferred compensation agreements with certain of its employees. The purposes of such agreements are to assure that selected key employees remain with Huber and do not act in any way which is contrary to Huber's interest either before or after retirement as, for example, by disclosing technical "know-how" acquired during the course of employment.

When Huber chooses to extend to a particular employee an offer to enter into a deferred compensation arrangement, the employee is given an option, at the time of a periodic salary discussion, to receive an increase in base salary for the forthcoming year or to defer receipt of such compensation until his retirement or other severance from service.[1] The amount of the increase in base salary is itself proposed by Huber and is not fixed by any statute or contract. Those employees who are offered deferred compensation agreements receive such offers, and must accept them, prior to the commencement of the year in which the services for which compensation is deferred are performed. Once an employee executes a deferred compensation agreement, the agreement is irrevocable and applies to all future years. Thus, if an employee foregoes an increase of $4,000 in base salary in one year, he must forego a like amount of current compensation in each subsequent year of employment.

Once an employee to whom an offer to defer a portion of future compensation is made accepts that offer, a written agreement is sent to him for execution. Among other things, the agreement provides that the amounts payable thereunder may not be assigned or commuted, nor the right to them encumbered. Also, the agreement contains substantial risks of forfeiture. Specifically, the agreement provides that Huber shall be relieved of all obligations under the agreement

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[1] The amount covered by a deferred compensation agreement is twice the amount of the salary increase that the employee foregoes by reason of his decision to enter into the arrangement. The doubling of the increase in base salary for purposes of the deferred compensation arrangement takes into account the fact that the reduced base salary received by the employee will lessen (1) the contributions made on his behalf to Huber's qualified profit sharing and retirement plan, (2) the amount of group life insurance purchased on his behalf, and (3) the amount of any bonus payable during employment, all of which are determined by reference to base salary.

if the employee is discharged for cause, and of all further obligations beyond the date when either (a) the employee competes with Huber or enters the employ of a company competing with Huber, or (b) the employee does "anything adverse to the best interest" of Huber.

The amount covered by a particular employee's deferred compensation agreement is credited to a bookkeeping account by Huber and a like credit is made for each year of service until retirement. The bookkeeping account is not funded by insurance or otherwise. It does appear as a liability on Huber's financial statements. Beginning the last day of January following retirement (or other termination of employment), the employee receives a monthly pension for five years. The monthly amount is determined by prorating the credit balance in the account over a 60 month period. For Federal income tax purposes, deductions are claimed by Huber only as, and to the extent that, retirement benefits are in fact paid and included by the retired employee in his gross income. See section 404(a)(5) of the United States Code.

On February 8, 1966, the Internal Revenue Service (IRS) issued a favorable ruling with respect to a deferred compensation agreement entered into in 1963 between Huber and one of its employees. The agreement there involved was substantially identical in substance to those since used by Huber for its other employees. In the 1966 ruling, the IRS held that payments received by the employee would be taxable to him only in the year he actually received such payments, and that the amounts of those payments would be deductible by Huber only when actually paid to the employee. Since 1966, Huber and those of its employees who have executed deferred compensation agreements have relied upon this letter ruling, as well as published Revenue Rulings issued by the IRS for the guidance of taxpayers generally, as properly prescribing the Federal income tax consequences of such arrangements. Moreover, we know of no case which has held that a deferred compensation agreement of the type utilized by Huber (i.e., one where an irrevocable agreement to defer is made prior to rendering of the services for which the compensation is to be paid, and is subject to substantial risks of forfeiture) will not be given effect for Federal income tax purposes.

The regulations proposed by the Treasury and the IRS provide by their terms that deferred compensation agreements will no longer be given effect for Federal income tax purposes where deferral results from the voluntary action of the individual taxpayer in entering into a deferred compensation agreement. Although it is uncertain whether the proposed regulations do apply, and/or were intended to apply, in situations such as Huber's where compensation is not fixed by statute or written contract,[2] Huber nevertheless believes that the proposed regulations are invalid as a matter of law. The reasons for Huber's position that the proposed regulations are invalid as a matter of law are set forth fully in its April 4, 1978 submission to the Internal Revenue Service, copies of which are available to the Subcommittee upon request.

We understand that some have suggested that the Congress should intervene in the current controversy and either postpone the application of the proposed regulations for some period of time or provide statutory rules governing the extent to which agreements to defer compensation will be given effect for Federal income tax purposes. Huber respectfully submits that, if any such legislation is enacted, it should mandate the continued application of present law in cases such as Huber's. As explained previously, the compensation paid by Huber is not fixed by contract or statute, deferral occurs only where an irrevocable agreement to defer compensation which is executed prior to the rendition of the services for which the compensation is to be paid, and Huber's obligations are at all times subject to substantial risks of forfeiture.

There are no compelling considerations of tax policy which would warrant the enactment of legislation which provides that arrangements such as Huber's will not continue to be given effect for Federal income tax purposes. Unlike so-called "qualified" plans, an employer such as Huber receives no current deduction or other tax benefit from entering into a nonqualified deferred compensation agreement.

Any deduction to which it is entitled is, under present law, to be taken only when and to the extent that payments are made to the individual and included by him in his income. For the same reason, there is no significant Federal revenue

[2] This uncertainty arises by reason of the Treasury's testimony to this Subcommittee on March 15, 1978 in which Mr. Halperin suggested that the regulations were directed at situations where compensation (a portion of which is deferred) is fixed by contract or statute, a circumstance not present in Huber's case.

loss involved. If employees are taxed prior to the time when they receive income, employers would necessarily be able to deduct a like amount in the earlier year as well. Thus, the revenue gain resulting from accelerating the time when an employee is taxed will be largely offset by the employer's deduction. Finally, as pointed out previously, nonqualified deferred compensation arrangements such as that utilized by Huber have business purposes for the employers that are independent of any tax benefits the employee may hope for at the time he enters into such an agreement.

If, however, legislation is enacted that modifies the doctrine of constructive receipt to impose a premature tax in cases such as Huber's, it is essential that those who made irrevocable elections in the past to defer compensation that may be earned in the future not be subjected to the changed rules on a retroactive basis. The proposed regulations do not provide such relief and instead would tax all future deferrals, including those made pursuant to prior irrevocable agreements. No sound policy considerations requires either the Congress or the IRS to tax currently income that is deferred by reason of an irrevocable election which the employee cannot now recant merely because the law has been changed and applied to him on a retroactive basis.

For all of the foregoing reasons, Huber respectfully submits that the proposed regulations are invalid as a matter of law, and that any modification of present law must occur only by legislative action. Huber also respectfully submits that, if legislative action is taken, nonqualified deferred compensation arrangements such as those used by it should not be disturbed. In any event, employees such as Huber's employees, who have made irrevocable elections in the past to defer future compensation should not now be adversely affected by a retroactive change in the tax rules clearly applicable at the time such agreements were executed.

Respectfully submitted.

DONALD V. MOOREHEAD.

NATIONAL ASSOCIATION OF COUNTIES,
Washington, D.C., March 30, 1978.

HON. LLOYD BENTSEN,
Chairman, Senate Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BENTSEN: On behalf of the National Association of Counties I want to extend our sincere appreciation for the opportunity to appear before your Subcommittee on March 15, 1978 in support of S. 1587 and S. 2627. Enclosed for your information and the record is a copy of the resolution adopted by the NACo Board of Directors endorsing legislation to require the Internal Revenue Service to maintain its current practice with respect to deferred compensation plans.

If the Treasury Department has data which clearly illustrates abuses in the program, then NACo would certainly be willing to work with the I.R.S. and contends that such plans are voluntary salary reduction schemes through which highly paid public employees avoid taxation. In fact over 70 percent of employees participating in most state plans earn less than $20,000 a year. The same applies to most counties, for example, Hennepin County, Minnesota has a plan with 10 percent of all county employees participating (519 active employees), 50 percent earn less than $16,000 a year and the rest earn more; the average contribution per year is approximately $2,548.00. Attached for your information are other examples of salary deductions and wage levels of a number of other counties that have deferred compensation plans.

The National Association of Counties believes that this action by the I.R.S. is without legal basis, contrary to their previous administrative position that has been relied upon by states, counties and cities across the nation through Private Letter Rulings and may disrupt negotiated contracts with employee unions. These plans encourage voluntary savings and increased security for the nation's retirees, at no cost to local governments or to the local property taxpayer.

Mr. Chairman, in view of the wide interest and concern about this matter, the National Association of Counties respectfully urge your support as co-sponsor of S. 2627 and also request that your Subcommittee call for a postponement of the proposed ruling issued by Treasury on February 3, 1978 until the Congress has had an opportunity to study this matter more thoroughly.

Again thanks for the opportunity to present our views, we stand ready and willing to work with you and members of the Subcommittee toward a fair and reasonable legislative solution.

Please call me at NACo if I can provide you with additional data.

Sincerely,

ANN M. SIMPSON,
Legislative Representative.

Enclosures.

RESOLUTION ON DEFERRED COMPENSATION PROGRAMS

Whereas, With the approval of the Internal Revenue Service in over 30 states and hundreds of thousands of counties, cities and towns since before 1970 to establish a deferred compensation program to encourage and permit employees to plan for and provide for their retirement; and

Whereas, Such programs have been established for a number of years and several other jurisdictions have submitted plans for Private Letter Rulings by I.R.S. are still pending; and

Whereas, Programs of this type meet socially desirable objectives, and enable public employers with a minimum of expense to assist their employees in their long term financial planning; and

Whereas, these deferred compensation plans for public employees would be rendered ineffective under the proposed Internal Revenue rules published in the Federal Register of February 3, 1978; and

Whereas, legislation has been introduced in both the House and Senate to require the I.R.S. to maintain its current practice with respect to deferred compensation plans, the bills are H.R. 10746 by Representative Waggonner (D-La.), H.R. 10893 introduced by Representative Pickle (D-Texas) and Senator Gravel (D-Alaska) introduced S. 2627; and Now, therefore, be it

Resolved, That the Board of Directors of the National Association of Counties oppose the proposed regulations and submit comments to the Internal Revenue Service with supporting data, and also support legislative efforts by urging the House Ways and Means Committee and the Senate Finance Committee to hold hearings as soon as possible with the objective of enacting legislation, or provide other administrative relief which will allow the continuance of plans approved through Private Letter Rulings.

Adopted by the Board of Directors, March 14, 1978.

ORANGE COUNTY, FLA.,
Orlando, Fla., March 20, 1978.

NATIONAL ASSOCIATION OF COUNTIES,
New York Avenue, N.W.,
Washington, D.C.

(Attention: ANN SIMPSON).

GENTLEMEN: We have written to our Senators (Chiles and Stone) and our Representatives (Frey and Kelly) protesting the proposed changes in IRS regulations affecting Deferred Compensation.

We instituted a Deferred Compensation Plan for Orange County employees some six months ago and it has already proven to be a very popular program. Statistics are:

Number of employees involved to date: 241.
Average deduction per payroll: $89.
Average salary: $13,000 per annum.

I hope these statistics will dissuade IRS that the program is simply for upper level salaried employees. We have found that the program is particularly popular among middle management employees and with employees where both the husband and wife have incomes.

These are wage earners most impacted by increased taxes and social security deductions and Deferred Compensation is virtually the only means available for them to plan for their retirement. We hope that Congress will see fit to approve H.R. 10746.

Sincerely,

JAMES L. HARRIS,
County Administrator.

COUNTY OF SAN BERNARDINO,
March 23, 1978.

Hon. SHIRLEY PETTIS,
Longworth House Office Building, Washington, D.C.

DEAR MRS. PETTIS: It has recently come to our attention that the Internal Revenue Service has issued proposed regulation (LR-194-77) which would cancel deferred compensation plans for employees of state and local government. The purpose of this letter is to ask your support of legislation which would override the proposed regulation.

We are deeply concerned by the IRS proposal. Three years ago, San Bernardino County adopted a deferred compensation plan for our employees which was reviewed by the IRS and, following receipt of a determination letter, was implemented in good faith. Approximately 300 employees are members of our plan which is open to all regardless of position or salary level.

The plan encourages voluntary savings and increased security for our retired employees, at no cost to local government or to the local property taxpayer. Our plan is consistent with traditional Federal policy which has established tax deferred savings plans (Keogh, IRA, etc.) for millions of American citizens. The IRS proposal would be highly discriminatory by singling out local government employees and denying them the same privileges afforded most other American workers.

The proposed IRS ruling would, in our opinion, be very poor public policy. Deferred compensation serves a useful social purpose by encouraging our employees to be financially self-sufficient in their retirement and not dependent upon governmental assistance for their support.

We respectfully urge your support of H.R. 10746 (also H.R. 10893 and H.R. 11174) which would provide for Congressional approval of state and local deferred compensation plans.

Sincerely,

ROBERT O. TOWNSEND,
Chairman, Board of Supervisors.

NACO FACT SHEET: LEGISLATION,
NATIONAL ASSOCIATION OF COUNTIES,
Washington, D.C., February 15, 1978.

DEFERRED COMPENSATION PLAN FACT SHEET

I. State of Arizona, County of Maricopa.
II. Authorizing State or Local Statute: Arizona Revised Statutes Sec. 11-251.
III. List Counties That Have Deferred Compensation Plans.
IV. Participation (i.e., number of County Employees in Plans): 365.
V. Salary Ranges of the Participants:

[Percentage of participants currently enrolled]

$5,000 to 15,000	47
$15,000 to 25,000	63
$25,000 and Over	17

VI. Average Contribution Per Year: $2,171.
VII. Support the Waggonner Bill:
Yes[1]
VIII. Will submit Written Comments on the Proposed Regulations:
Yes

Please return ASAP to:
Ms. Ann M. Simpson, Legislative Representative
National Association of Counties
1735 New York Avenue, N.W.
Washington, D.C. 20006
202-785-9577

[1] Support conditioned upon amendment to the Waggonner Bill to provide protection to all states and counties.

NACO FACT SHEET: LEGISLATION,
NATIONAL ASSOCIATION OF COUNTIES,
Washington, D.C., February 15, 1978.

DEFERRED COMPENSATION PLAN FACT SHEET

I. State: Oregon.
II. Authorizing State or Local Statute: ORS 294.0^4.
III. List of Counties That Have Deferred Compensation Plans: Lane County.
IV. Participation (i.e. number of County Employees in Plans) : 30.
V. Salary Ranges of the Participants:

[Percentage of participants currently enrolled]

$5,000 to 15,000	63.3
$15,000 to 25,000	23.3
$25,000 and Over	13.3

VI. Average Contribution Per Year: $3,792.
VII. Support the Waggonner Bill—we would be extremely supportive of an immediate effort to put pressure on IRS, via Congress, to withdraw proposed regulations:
Yes.
VIII. Will Submit Comments on the Proposed Regulations:
Yes.
Please return ASAP to:
Ms. Ann M. Simpson, Legislative Representative
National Association of Counties
1735 New York Avenue, N.W.
Washington, D.C. 20006
202-785-9577

Washington, D.C., April 4, 1978.

MEMORANDUM BY COVINGTON & BURLING

Re: Proposed Treasury regulations section 1.61-16, relating to the income tax treatment of nonqualified deferred compensation.

INTRODUCTION

We are submitting this memorandum on behalf of a number of employers that provide nonqualified deferred compensation to their employees. These employers provide deferred compensation pursuant to a wide variety of unfunded arrangements. The arrangements include both separately negotiated contracts between employers and individual employees and more broadly based deferred compensation plans that apply to groups of employees.

Deferred compensation arrangements typically play a very significant role in the employer's total compensation and benefits program. In addition, such deferred compensation arrangements ordinarily become an important part of the financial, retirement and estate plans of the participating employees. The arrangements have been carefully designed to satisfy the well-established and well-understood rules regarding the income tax treatment of deferred compensation, so that each participating employee could be assured that the deferred compensation would not be included in gross income prior to the time when the deferred compensation is actually received.

Proposed regulations section 1.61-16 would radically alter the established income tax rules governing nonqualified deferred compensation and the cash receipts and disbursements method of accounting upon which those rules are based. The Treasury Department, it is submitted, lacks the authority to make such a fundamental change in the law. In view of the far-reaching and disruptive effect that the proposed regulations would have (i) existing deferred compensation arrangements, (ii) upon the compensation and benefit programs and the financial, retirement, and estate plans of which those arrangements are an integral part, and (iii) perhaps most significantly, upon the long-established cash receipts and disbursements method of accounting, it would be highly inappropriate for such a fundamental change in the law to be made without Congressional approval.

This memorandum will demonstrate that Congress has approved the established rules regarding the income tax treatment of nonqualified deferred compensation and that any change in those rules must be made by Congress, not unilaterally by the Treasury Department. In this connection, the memorandum will conclude that the proposed regulations appear to represent a breach of the Treasury Department's commitment in 1969 that it would recommend to Congress any changes in the income tax treatment of deferred compensation. In addition, the memorandum will demonstrate that the proposed regulations would change a fundamental principle underlying the cash receipts and disbursements method of accounting and that any such change in the cash receipts and disbursements method may be made only by Congress. The memorandum concludes by making a number of comments regarding the application of the proposed regulations.

I. The Proposed Regulations Conflict With the Congressionally Approved Treatment of Deferred Compensation

A. THE CASH RECEIPTS AND DISBURSEMENTS METHOD OF ACCOUNTING

constructively receives that item. See Treas. Regs. § 1.451-1(a). A cash basis taxpayer using the cash receipts and disbursements method of accounting is not charged with the receipt of an item of gross income until the taxpayer actually or constructively receives that item. See Treas. Regs. § 1.451-1(a). A cash basis taxpayer is thus not required to include compensation in gross income until the compensation is actually or constructively received.

For the great majority of individual taxpayers—particularly those who are employees and who have no other trade or business—and for the Internal Revenue Service as well, the cash receipts and disbursements method of accounting is an extremely convenient and practical method of reporting income for tax purposes. That is because the cash receipts and disbursements method ordinarily makes it clear when an item is received or disbursed. In most cases it is easy to identify the year in which an item has been actually received or disbursed; sophisticated accounting judgment is not ordinarily required. In addition, under the cash receipts and disbursements method, a taxpayer generally incurs additional income tax liability for the year in which an item of gross income is actually received; the taxpayer's receipt of that item obviously facilitates payment of the additional tax.

However, under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back on income and thereby select the year for which the income will be reported. Under the constructive receipt doctrine a taxpayer will ordinarily be deemed to have received an item of income if the taxpayer has (a) a right to receive that item and (b) the exercise of that right is not subject to substantial limitations. See Treas. Regs. § 1.451-2(a); Treas. Regs. 45, Art. 53 (1921); H. Rep. No. 844, 68th Cong., 1st Sess. 16 (1924).

In addition, under certain conditions, a taxpayer is required to treat the receipt of non-cash benefits as income. The integrity of the income tax system would obviously be jeopardized if only cash receipts were taken into account. Under the cash receipts and disbursements method, a taxpayer is required to report any item of income that is received in cash or in the form of a "cash equivalent". See W. P: Henritze, 41 B.T.A. 505 (1940); Treas. Regs. §§ 1.61-2(d), 1.446-1(a)(3) and 1.446-1(c)(1)(i); Treas. Regs. 45, Art. 33 (1921); cf. Code §§ 83 and 402(b).

The application of the constructive receipt and cash equivalent doctrines to deferred compensation has not always been well settled. The law developed as the result of controversies between taxpayers and the Internal Revenue Service and resulting judicial decisions. However, the decided cases eventually indicated that:

1. An unsecured promise to make a future payment, not represented by a note, was not an item of gross income under the cash receipts and disbursements method. See *Jackson* v. *Smietanka*, 272 F. 970 (7th Cir. 1921); *E. F. Cremin*, 5 B.T.A. 1164 (1927), acq. VI-I Cum. Bull. 2 (1927); *C. Florian Zittel*, 12 B.T.A. 675, 677 (1928); and

2. Neither the constructive receipt doctrine nor the cash equivalent doctrine would be applied to a taxpayer merely because the taxpayer agreed with the payor in advance to receive compensation on a deferred rather than current basis, as long as the agreement was made before the taxpayer had obtained an unqualified and unconditional right to the income. See *James F. Oates*, 18 T. C. 570 (1952), aff'd, 207 F.2d 77 (7th Cir. 1953), acq. (and prior nonacq. with-

drawn) 1960-1 Cum. Bull. 5; *Howard Veit*, 8 T.C. 809 (1947), acq. 1947-2 Cum. Bull. 4; cf. *Kay Kimbell*, 41 B.T.A. 940 (1940), acq. and nonacq. 1940-2 Cum Bull. 5, 12; *J.D. Amend*, 13 T.C. 178 (1949), acq. 1950-1 Cum Bull. 1; *James Gould Cozzens*, 19 T.C. 663 (1953); *Howard Veit*, 8 T.C.M. (CCH) 919 (1949).

REVENUE RULING 60-31

In 1960, after years of deliberation, the Internal Revenue Service published Revenue Ruling 60-31 which set forth a broad policy statement regarding the application of the constructive receipt and cash equivalent doctrines to nonqualified deferred compensation arrangements. See 1960-1 Cum Bull. 174. At the same time the Service withdrew its prior nonacquiescence and acquiesced in the decision in *James F. Oates, supra*. See 1960-1 Cum. Bull. 5.

Revenue Ruling 60-31 set forth a number of general observations regarding the constructive receipt and cash equivalent doctrines and then provide five examples of their application to deferred compensation arrangements. The general observations confirmed that:

1. "A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method." 1960-1 Cum Bull. at 177; and
2. ". . . [T]he statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment." *Id.* at 178.

Together wtih the foregoing observations, the five examples set forth in the ruling made it clear that the constructive receipt and cash equivalent doctrines would not be applied to a deferred compensation arrangement between an employee and by an employer even though the employee might have obtained an agreement from the employer to make an immediate cash payment following the provision of services.

Thus in the first example, involving a typical deferred compensation contract with an individual employee, entered into before any services were rendered, the deferred payments were ruled to be includible in the employee's gross income only in the year in which they were actually received.

In the third example, relating to an author who had already written a book, the author and a publisher simultaneously entered into two agreements. The first agreement provided for semiannual royalties to be paid to the author; a second "supplemental" agreement limited the amount to be paid in any year and provided for the deferred payment of any excess royalties. The royalties were ruled to be includible in the author's gross income only in the taxable years in which they were actually received.

The Service's acquiescence in *James F. Oates, supra*, which was announced simultaneously with Revenue Ruling 60-31, confirmed that the policy set forth in Revenue Ruling 60-31 applied to a plan under which an employee is expressly given an opportunity, prior to the time his right to compensation accrues, to elect the year or years in which he receives that compensation. Oates, a general agent of an insurance company, was entitled by contract to receive certain renewal commissions following his retirement. Shortly before Oates' retirement, the insurance company gave each general agent the right to elect either (a) to continue to be covered by the prior payment schedule (which resulted in decreasing payments as policies were discontinued) or (b) to receive a reduced annual amount which would be paid at a level rate over a longer period of time. Both the Tax Court and the Court of Appeals held that Oates, who had elected the second alternative, could not be charged with receipt of amounts in excess of those amounts that were actually paid in accordance with the deferred payment schedule that he had elected.

C. Subsequent Internal Revenue Service Rulings

Subsequent published I.R.S. rulings continued to confirm that the constructive receipt and cash equivalent doctrines would not be applied merely because an employee was permitted to elect, before the compensation was earned, to receive the compensation on either a current or deferred basis.

Thus in Revenue Ruling 67-449, 1967-2 Cum. Bull. 173, the Service considered a plan under which awards of supplemental compensation were payable in equal cash installments in each of four years. The first installment was ordinarily payable on or before April 15th of the year in which the award was made; the three subsequent installments were ordinarily payable on the January 10th of the three succeeding years. However, if the employee made an election by the December 15th of the year preceding the scheduled payment date, payment was deferred until retirement. The plan also permitted an employee to designate, prior to retirement, the time when the deferred payments would be made following his retirement. Each installment was forfeitable unless the employee "earned out" the installment by continuing in the employ of the employer or, if employment was terminated for any reason other than death, by refraining from competition with the employer and by remaining available to provide consulting services. The Service concluded that in view of the plan's substantial forfeiture provisions, any compensation deferred thereunder would be includible in gross income only in the year in which it was actually received (unless otherwise made available at an earlier date).

In Revenue Ruling 68-86, 1968-1 Cum Bull. 184, an employee had an agreement with his employer under which he was to receive a base salary plus an annual bonus to be established by the employer's board of directors. The employee was given the right to elect, prior to January 1 of each year, to have all or any part of any bonus for that year distributed in restricted stock rather than in cash. The Service concluded that if the employee elected to receive the restricted stock in lieu of cash, the employee would be charged with income when the restrictions on the stock lapsed or, if earlier, when the stock was sold in an arm's length transaction. The employee was thus not charged with the receipt of the cash bonus that he had previously elected not to receive.

Finally, in Revenue Ruling 69-650, 1969-2 Cum Bull. 106, the Service considered an employment contract which provided that the employee could elect, prior to December 31st of any year, to have payment of either five or ten percent of his salary for the following year deferred until his employment terminated. The Service concluded that the deferred portion of the employee's salary was not includible in gross income in the year earned, but was includible in the year actually received (or, if earlier, in the year otherwise made available to him).

Thus by 1969 it was well recognized by both the courts and the Internal Revenue Service that an employee would not be charged with the receipt of income prior to the time that the employee actually received it merely because the employee had been allowed to elect, before the income had been earned, to receive the compensation either currently or on a deferred basis. During the period from 1969 through 1974 the established income tax treatment of deferred compensation was reconsidered by both Congress and the Treasury Department. As will be seen below, the existing law was deliberately left unchanged.

D. THE TAX REFORM ACT OF 1969

In 1969, during Congressional consideration of the Tax Reform Act of 1969, the House of Representatives approved an amendment to the Internal Revenue Code that would have altered the income tax treatment of deferred compensation. Under the House bill, deferred compensation would have continued to be includible in the income of a cash basis taxpayer only when received, but would have been subject to a minimum tax at that time. The minimum tax was designed to subject the compensation to the rate of tax that would have applied if the compensation had been received when it was deemed to have been earned. See § 331, H.R. 13270, 91st Cong., 1st Sess., 115 Cong. Rec. 21802 (1969).

The report of the House Ways and Means Committee reveals that the House was fully aware of the established rules regarding deferred compensation: "Under present law, the Internal Revenue Service has allowed substantial tax benefits to be obtained with respect to certain types of deferred compensation arrangements for key employees. These arrangements are not required to meet the qualifications prescribed in the tax law for qualified pension and profit-sharing plans, and they are often available only to highly paid employees. *Generally, under these arrangements, employees are permitted to defer the receipt (and taxation) of part of their current compensation until retirement*, when they presumably will be in lower income tax brackets.

"The following example is typical of these arrangements: The employer and the employee enter into a 5-year employment contract which provides for a specified amount of current compensation and an additional specified amount of nonforfeitable deferred compensation. The deferred compensation is credited to a reserve account on the company books. It is accumulated and paid in equal annual installments in the first 10 years after the employee's retirement.

"Prior to 1960 it was not clear whether the Internal Revenue Service would hold that tax deferral was available in the case of deferred compensation ar-

rangements of this type. In 1960, however, the Service issued a comprehensive ruling (Revenue Ruling 60-31) which described in detail various types of ar-
rangements of this type. In 1960, however, the Service issued a comprehensive
it considered that tax deferral was available. In general, the basis for the ruling was that the employee did not have the right to receive the compensation immediately, and the doctrine of construction receipt therefore did not apply to treat the employee as currently receiving the additional compensation.". H. Rep. No. 91-414 (Pt. 1), 91st Cong., 1st Sess. 89-90 (1969) (emphasis supplied).

During subsequent hearings before the Senate Finance Committee, the Treasury Department recommended that the Committee delete the deferred compensation provision from the bill: "From a conceptual standpoint, this provision modifies in certain respects both the cash method of accounting and the annual accounting period. The annual accounting concept underlies our entire tax system. While the cash method of accounting may not lead to perfect results in some cases, the imperfections extend to many areas other than deferred compensation. *We believe that with further study of this problem in the context of tax treatment of all deferred compensation, including amounts paid under both qualified pension and profit sharing plans and nonqualified plans, a better solution in principle can be developed.*

"In addition, there are a number of problems in the practical operation of this provision which the Treasury Department has not solved satisfactorily. For example, we have been unable to date to develop a satisfactory definition of the term 'deferred compensation.' Further, while the bill authorizes Treasury regulations to determine the year in which deferred compensation is deemed to have been 'earned,' we are concerned about the difficulty of developing satisfactory and workable tests for this purpose.

"*Deferred compensation is only one aspect of the over-all employee benefits problem.* Under present law the form of business organization materially affects the tax treatment of the contributions to retirement funds. Thus many partnerships have been induced to convert into essentially artificial corporations. Recent court decisions invalidating regulations defining 'professional corporations,' as well as the present incongruity in the treatment of deferred compensation plans of 'small business (Subchapter S) corporations' (treated in the bill), make it *essential that the Treasury Department develop comprehensive recommendations dealing with the tax consequences of all deferred compensation arrangements.*

"*We have undertaken a comprehensive study of both qualified and nonqualified plans. Our study will be completed and will result in recommendations to the Congress without extended delay.* For these reasons, and because of the basic difficulties in these provisions of the bill, the Administration recommends that this provision be deleted from the present bill." S. Fin. Comm. Hearings on H.R. 13270 (Pt. 1), 91st Cong., 1st Sess. 585-87 (Sept. 4-5, 1969) (emphasis supplied.)

The Finance Committee adopted the Treasury's recommendation: "The Treasury Department recommended that this provision be deleted from the bill. The Treasury indicated that further analysis was necessary to determine whether the proposed solution was consistent with the cash basis of accounting and whether alternative solutions were available. The Treasury also indicated there are a number of problems in the practical operation of the provision which it believed had not been solved satisfactorily. Among these are the scope of the term 'deferred compensation,' and the determination of the year in which deferred compensation is deemed to have been earned. *The Treasury Department has undertaken a comprehensive study of both qualified and nonqualified employee benefit plans, and it intends, as part of this study, to develop recommendations dealing with the tax consequences of all deferred compensation arrangements.*

"The committee agrees with the concern of the House in this regard, but believes that the administrative difficulties associated with the House provision make further study desirable. *The committee has, therefore, deleted this provision from the bill pending further study by the Treasury Department.*" S. Rep. No. 91-552, 91st Cong., 1st Sess. 307 (1969) (emphasis supplied).

The conferees agreed to the Senate amendment, and the Tax Reform Act of 1969 did not include the House provision regarding deferred compensation. See H. Rep. No. 91-782, 91st Cong., 1st Sess. 305 (1969).

Thus in 1969 Congress expressly considered and declined to adopt a provision that would have altered the established income tax treatment of deferred compensation. Significantly, Congress made its decision of the basis of the Treasury Department's representation that it had "undertaken a comprehensive study of both qualified and nonqualified plans" and that the study would "result in recommendations to the Congress without extended delay."

E. THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

The Treasury Department followed through on the commitment that it made to Congress in 1969. The Treasury Department continued its comprehensive study of deferred compensation, and on December 13, 1971, the Treasury submitted to Congress a draft bill entitled "Individual Retirement Benefits Act of 1971". See Tax Proposals Affecting Private Pension Plans: Hearings Before the House Comm. on Ways and Means, 92d Cong. 2d Sess. 6–34 (1972). On April 17, 1973, the Treasury submitted a revised and expanded version of the 1971 bill, entitled "Retirement Benefits Tax Act". See H. Comm. on Ways and Means. Material Relating to Administration Proposal Entitled the "Retirement Benefits Tax Act.", 93d Cong., 1st Sess. (1973).

While the Treasury Department's proposals provided for far-reaching changes in the income tax treatment of qualified plans, they recommended no changes in the established income tax treatment of nonqualified deferred compensation. It is apparent that, after completing its review of deferred compensation, the Treasury did not consider it necessary to recommend a change in the established income tax rules regarding nonqualified deferred compensation. Moreover, on June 21, 1971 and September 20, 1971—just before the Treasury submitted its initial draft bill to Congress—the Internal Revenue Service published two announcements which confirmed that the Treasury would continue to apply the established income tax rules to nonqualified deferred compensation arrangements.

In Revenue Procedure 71–19, 1971–1 Cum. Bull. 689 (published on June 21, 1971), the Service announced that it would issue advance rulings concerning the application of the constructive receipt doctrine to an unfunded deferred compensation plan only if the plan satisfied the following requirements: ".01 If the plan provides for an election to defer payment of compensation, such election must be made before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions.

".02 If any elections, other than the initial election referred to in .01 above, may be made by an employee subsequent to the beginning of the service period the plan must set forth substantial forfeiture provisions that must remain in effect throughout the entire period of the deferral.".

Paragraphs .01 and .02 of the procedure clearly correspond to the rules that had been recognized in Revenue Ruling 69–650, supra, and Revenue Ruling 67–449 supra, respectively. The guidelines set forth in the Revenue Procedure thus confirmed that the Service would continue to apply established law to nonqualified deferred compensation plans. See also Rev. Rul. 72–25, 1972–1 Cum. Bull. 127.

In Revenue Ruling 71–419, 1971–2 Cum. Bull. 220 (published on September 20, 1971), the Service considered an unfunded deferred compensation plan that permitted each director of a corporation to elect, on or before December 31st of any year, to defer all or part of the director's annual fees for the succeeding calendar years. Amounts deferred under the plan together with accumulated interest were ordinarily distributed in ten annual installments after the participant ceased to serve as a director. An election to defer fees continued from year to year unless the director terminated the election. The Service concluded that a director reporting income on the cash receipts and disbursements method would not be required to include the deferred amounts in income until they were actually paid (unless they were otherwise made available at an earlier date).

Thus by early 1973 the Treasury had completed its study of the income tax treatment of deferred compensation and had not considered it necessary to recommend a change in the treatment of nonqualified plans.

Subsequent events made it clear that Congress concurred with the Treasury's judgment. In 1973 and 1974 Congress completed its own comprehensive review of qualified and nonqualified deferred compensation plans. The efforts of Congress culminated on September 2, 1974, with the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA included amendments to the Internal Revenue Code that made substantial changes in the income tax treatment of both qualified plans themselves and distributions from qualified plans. Concurring with the Treasury Department's judgment, Congress made no change whatever in the income tax treatment of nonqualified plans.

Congress thoroughly considered the impact of ERISA upon unfunded nonqualified plans. Subject to limited exceptions, section 262 of the Senate bill would have prohibited an employer from maintaining a nonqualified plan. See § 262, H.R. 2, 93d Cong., 2d Sess., 120 Cong. Rec. 4984 (1974). The Senate provision was not included in the final bill. However, ERISA did include a number of provisions that specifically recognized that nonqualified deferred compensation plans would continue to be maintained by employers. Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA specifically exempted from the Act's principal substantive requirements any plan that was unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. The conference report cited a "phantom stock" or "shadow stock" plan that was established solely for the officers of a corporation as an example of a plan that would be covered by the statutory exemption. See H. Rep. No. 93-1280, 93d Cong., 2d Sess. 296 (1974).

In addition, ERISA provided a general exemption for unfunded "excess benefit plans"—plans that were maintained solely for the purpose of providing benefits in excess of those permitted under qualified plans by Code section 415. See ERISA §§ 3(36) & 4(b)(5).

Unfunded deferred compensation plans and excess benefit plans commonly give each participating employee an election with regard to the time that he receives the deferred compensation. As explained earlier, the Internal Revenue Service has publicly recognized that unfunded deferred compensation plans frequently offer each eligible employee the opportunity to elect to receive compensation on either a current or deferred basis. Furthermore, both traditional deferred compensation plans and excess benefit plans ordinarily offer each participant the opportunity to designate a payment option (*e.g.*, a lump sum payment, an installment payout over a fixed period, a life annuity or a joint and survivor annuity). Obviously, some methods of payment provide for a more extended period of deferral than do others. A participant who elects a life annuity in lieu of a lump sum payment is clearly electing to defer the receipt of compensation.

Thus, in approving the continued use of unfunded deferred compensation plans and excess benefit plans, Congress implicitly approved of both the continued provision of employee elections under those plans and the continued validity of the income tax rules that had been applied to the plans in the past. Indeed, if the established rules did not continue to be applicable, and plan participants were charged with the receipt of income before they actually received payments under the plan, many of the plans that Congress had specifically exempted from ERISA would no longer be viable. As a practical matter, plan participants could not tolerate an arrangement under which they were required to pay tax on income that they had not actually received and might never receive.

Moreover, in section 2006 of ERISA, Congress specifically addressed the income tax consequences of elective arrangements involving qualified plans and other funded plans receiving preferred tax treatment. Congress' exclusion of unfunded, nonqualified plans from section 2006 provides further evidence that Congress intended that the established income tax rules would continue to apply to them. See H. Rep. No. 93-1280, 93d Cong., 2d Sess. 345 & 355-56 (1974); H. Rep. No. 93-807, 93d Cong., 2d Sess. 38-39 (1974).

In view of—

(a) The Legislative histories of the Tax Reform Act of 1969 and ERISA;

(b) The studies of deferred compensation plans that were undertaken by the Treasury and by Congress;

(c) The publication of Revenue Rulings 67-449, 69-650, and 71-419 and Revenue Procedure 71-19;

(d) The explicit statutory approval given by ERISA to unfunded deferred compensation plans and excess benefit plans; and

(e) The exclusion of unfunded, nonqualified plans from section 2006 of ERISA,

there can be no doubt that Congress was aware of the established income tax rules governing nonqualified deferred compensation plans and did not intend to change them. See also Code § 1348(b)(1)(A), as amended by § 302(a), Public Law 94-455 (Tax Reform Act of 1976); S. Rep. No. 94-938, 94th Cong., 2d Sess. 114-16 (1976); S. Rep. No. 94-1236, 94th Cong., 2d Sess. 428 (1976).

The legislative histories of the Tax Reform Act of 1969 and ERISA thus reveal that during the period between 1969 and 1974 the Treasury Department and Congress studied the subject of deferred compensation and, after completing their studies, proposed no changes in the established rules regarding the income tax treatment of nonqualified deferred compensation. Certainly if either the

Treasury or Congress had considered it desirable to propose a change in the established rules, it had ample opportunity to do so.

F. CONCLUSION

It is well settled (a) that where Treasury interpretations are long continued without substantial change, applying to unamended or substantially reenacted statutes, the Treasury's interpretations are deemed to have been approved by Congress and have the force of law; and (b) that Treasury regulations which are inconsistent with the statute and its legislative history are invalid. See *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 283–86 (1966); *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938); *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 134–35 (1936).

It is submitted that in view of the actions taken by the Treasury Department and Congress between 1969 and 1974, if the proposed regulations are adopted in final form, they will not be valid. In addition, the regulations would represent a breach of the Treasury Department's commitment in 1969 that it would recommend to Congress any changes in the income tax treatment of deferred compensation—a commitment that Congress explicitly relied upon when it adopted the Tax Reform Act of 1969 and implicitly relied upon when it adopted ERISA.

II. The Proposed Reguations Conflict With the Cash Receipts and Disbursements Method of Accounting

As explained earlier, the established rules governing the income tax treatment of nonqualified deferred compensation represent merely one application of the cash receipts and disbursements method of accounting. See Rev. Rul. 60–31, *supra*. The proposed regulations would substantially change the application of the cash receipts and disbursements method to deferred compensation without giving any recognition to the effect of that change upon the treatment of other types of transactions.

It is submitted that the proposed regulations would effect a substantial revision in the cash receipts and disbursements method and that such a fundamental revision should not be made without Congressional approval and without giving full consideration to the consequences of that revision.

Revenue Ruling 60–31, supra, was explicitly based on the generally applicable principles that had been developed under the cash receipts and disbursements method of accounting. After observing that a "mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method", the Ruling relied first on *United States* v. *Christine Oil & Gas Co.*, 269 F. 458 (W.D. La. 1920) which involved, not the payment of salary, but the sale of oil leases. Likewise, after stating that "the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment", the Ruling referred initially to *J.D. Amend*, 13 T.C. 178 (1949). acq. 1950–1 Cum. Bull. 1, which involved the sale of wheat.

The taxpayer in *Christine Oil & Gas Co.*, *supra*, was held to be taxable only with respect to the cash that it actually received from the sale of oil leases, and not with respect to deferred payments that it had not received. The Court relied principally upon the Court of Appeals' decision in *Edwards* v. *Keith*, 231 F. 110 (2d Cir. 1916), cert, denied, 243 U.S. 638 (1917), involving the income tax treatment of deferred commissions to be paid to a life insurance agent: "In the case of *Edward* v. *Keith* . . . the Court of Appeals for the Second Circuit said:

"'But no instructions of the Treasury Department can enlarge the scope of this statute, so as to impose the income tax upon unpaid charges for services rendered and which, for aught anyone can tell, may never be paid.'

"What is there said of unpaid services applies with equal force to unpaid purchase money." 269 F. at 459.

In *J.D. Amend*, *supra*, the Tax Court considered a farmer's sale of wheat in one year pursuant to an agreement that called for payment in the following year. Although the purchaser was able and willing to pay cash at the time of the sale, the Court rejected the Commissioner's effort to apply the constructive receipt doctrine:

"Our conclusion . . . is that the contracts were bona fide arm's-length transactions and petitioner did not have the right to demand the money for his wheat until in January of the year following its sale. This being true, we do not think the doctrine of constructive receipt applies.

See *Howard Veit*, first point decided, 8 T.C. 809. 13 T.C. at 185.

Howard Veit, supra, acq. 1947-2 Cum. Bull. 4, the case cited by the Tax Court, involved a 1939 agreement between an employer and an employee calling for a cash payment in 1941 of a share of the employer's 1940 profits. In November of 1940 the agreement was amended to defer the payment until 1942. The Tax Court held that the constructive receipt doctrine was inapplicable and that the employee could not be charged with receipt of his share of 1940 profits in 1941. Notably, in its decision in *Veit*, the Tax Court relied exclusively on the Board of Tax Appeals' decision in *Kay Kimbell*, 41 B.T.A. 940 (1940), acq. and nonacq. 1940-2 Cum. Bull. 5, 12, which involved the application of the constructive receipt doctrine to the sale of oil leases.

The reliance upon *Christine Oil & Gas Co.* and *J.D. Amend* in Revenue Ruling 60-31, the reliance upon *Edwards* in *Christine Oil & Gas Co.*, the reliance upon *Howard Veit* in *J.D. Amend*, and the reliance upon *Kay Kimbell* in *Howard Veit* graphically illustrate the fact that the application of the constructive receipt doctrine to deferred compensation is inextricably intertwined with the application of the doctrine in other contexts. It is simply not possible for Treasury regulations to alter the application of the constructive receipt doctrine to deferred compensation without affecting its application to other types of transactions. See also *Ray S. Robinson*, 44 T.C. 20 (1965) (relying on *Kay Kimbell, supra*, and *J.D. Amend, supra*), acq. 1976-2 Cum. Bull. 2; *Commissioner* v. *Oates*, 207 F.2d 711 (7th Cir. 1953) (relying on *Massachusetts Mutual Life Insurance Co.* v. *United States*, 288 U.S. 269 (1933)), affirming 18 T.C. 570 (1952) (relying on *Kay Kimbell, supra, Howard Veit, supra*, and *J.D. Amend, supra*); *Ernest K. Gann*, 31 T.C. 211 (1958) (relying on *James F. Oates, supra, Kay Kimbell, supra*, and *Howard Veit, supra*), acq. 1960-1 Cum Bull. 4; *Margaret L. Carpenter*, 34 T.C. 408 (1960) (relying on *Howard Veit, supra*), acq. 1960-2 Cum. Bull. 4. It is too late in the day for the Treasury to attempt to accord special treatment to deferred compensation arrangements. The established law governing the cash receipts and disbursements method is too well developed and too interdependent to permit the Treasury's approach.

Analogous applications of the cash receipts and disbursements method can be readily appreciated. For example, if a cash basis taxpayer wishes to sell his house, and a prospective purchaser makes a cash offer to the taxpayer, the taxpayer is free to decline the cash offer and to agree to accept payment either in the following year or, if he so chooses, on an installment basis. The taxpayer is free to sell or not to sell the house, and he will not be charged with constructive receipt of a cash offer that he does not accept. Cf. Rev. Rul. 68-482, 1968-2 Cum. Bull. 186.

Revenue Ruling 73-210, 1973-1 Cum. Bull. 211, described the following practice of a farmer's cooperative: Once a member delivered cotton to the cooperative the member was entitled to an advance payment with respect to the cotton. However, the cooperative's by-laws gave each member an election to defer the advance payment. On October 1, a cash basis taxpayer entered into a deferred payment agreement with the cooperative. The agreement provided that advance payments for cotton delivered thereafter would be deferred until the following January 5th. The Ruling set forth the following conclusion: "In the instant case, at the time the deferred payment contract was entered into, the taxpayer had not yet delivered cotton covered by such contract and therefore did not have an unqualified right to receive payment therefor. . . .

"Accordingly, it is held that the proceeds from the sale of the cotton delivered after the date the deferred payment contract was entered into are includable in the taxpayer's gross income for the taxable year in which payment is received." 1973-1 Cum. Bull. 212.

Under existing law, an employee is likewise able to agree with his employer—before consenting to work for the following year—that he will work during that year for a combination of a reduced current salary and deferred compensation, rather than solely for a current salary. See Rev. Rul. 69-650, *supra;* Rev. Rul. 71-419, *supra.*

A well-established fundamental principle—applicable both to deferred compensation arrangements and to other transactions—explains each of the foregoing examples. If a taxpayer has the opportunity to enter into one transaction or another, the transaction that he actually enters into, not the transaction that he might have entered into, determines the income tax consequences under the cash receipts and disbursements method. This principle has been fundamental to the cash receipts and disbursements method for many years. It has had widespread application; it has not previously been modified by the courts or the Treasury; and it has survived Congressional reenactment of the statute. In the absence of a statutory directive to the contrary, it should continue to be applied consistently to all transactions that are subject to the cash receipts and disbursements method.

As the Supreme Court observed in another context: "This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not. *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289, 293 (1934); *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. 'To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.' *Founders General Corp.* v. *Hoey*, 300 U.S. 268, 275 (1937); *Television Industries, Inc.* v. *Commissioner*, 284 F.2d 322, 325 (CA2 1960); *Interlochen Co.* v. *Commissioner*, 232 F.2d 873, 877 (CA4 1956). See *Gray* v. *Powell*, 314 U.S. 402, 414 (1941).". *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

The Treasury's proposed regulations would create the same kind of "burden and uncertainty" that the Supreme Court has considered objectionable. The income tax system must be based on the transactions that taxpayers actually enter into, not on the basis of speculation.

In calling for a departure from this fundamental principle, the proposed regulations purport to take an action that only Congress can take. It is submitted, therefore, that if they are adopted in final form, the proposed regulations will not be valid. See *Fribourg Navigation Co.* v. *United States*, *supra*; *Helvering* v. *Winmill*, *supra; Manhattan General Equipment Co.* v. *Commissioner*, *supra;* cf. *Central Illinois Public Service Co.* v. *United States*, 46 U.S.L.W. 4163 (1978).

COVINGTON & BURLING.

BURLINGTON INDUSTRIES, INC.,
Greensboro, N.C., March 31, 1978.

Hon. LLOYD BENTSEN,
U.S. Senate, Chairman of Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BENTSEN: Proposed Treasury Regulations Section 1.61-16 was published in the Federal Register on February 3, 1978, and the public was extended the opportunity to make written comments. The Proposed Regulation relates to taxation of those amounts the payment of which is deferred under compensation reduction plans or deferred compensation arrangements.

We are writing to express our opposition to the promulgation of the Proposed Regulation.

Burlington Industries, Inc. is vitally interested, as are all businesses, in attracting and retaining in its employment persons of outstanding ability, competence and potential. In its continuing effort to meet this objective, the Company established an incentive compensation plan, the adoption of which was approved by its more than 30,000 stockholders on February 4, 1971. Under the terms of this plan benefits are payable five years after they are awarded in an amount to be determined on the basis of dividends on and increase in the book value of the Company's common stock during the five-year period. At the time benefits under the plan are awarded, the employee may elect to receive payment at the end of the 5-year period or to defer payment to some later date.

As we interpret the Proposed Regulation, an employee who participates in the above-described plan would be taxed on benefits at the end of the five-year period whether or not he had elected to defer them. The Proposed Regulation would thus effectively remove the employee's option to defer payment of the benefits—a result which, we respectfully submit, benefits neither the Treasury, the employee nor the employer.

The Proposed Regulation provides no benefit to the Treasury since no increase in, nor acceleration of, revenues will result. Deferred compensation plans involve no element of tax avoidance. The Company will deduct such benefits, and the employee-recipient will report them as income in the year paid. The resulting gain or loss in revenue to the Treasury is represented by the difference in the employee's tax rate and the 48 percent rate at which the Company is taxed.

Generally, a decision by an employee to defer the payment of benefits under the plan described above is made as a part, and in furtherance of, his retirement planning—that is, he is seeking to provide greater financial security for his retirement years. The Proposed Regulation removes a tool previously available to him for use in accomplishing that objective.

The employer also loses on adoption of this Proposed Regulation since he no longer has available to him this proven means of attracting and retaining highly qualified employees. By basing the benefits of our plan on dividends and increase in book value of the Company's stock, we are also able to use the plan to provide additional incentive, making it an especially valuable arrangement.

Benefits under this Company's plan are not limited to officers and a few highly paid persons; more than four hundred employees of this Company participate in the plan. Surely it is in the government's best interest, as well as that of these four hundred employees, to encourage financial planning such as that permitted by deferred compensation arrangements. The Proposed Regulation, however, would prevent such planning.

Our plan which we have described and discussed has been in effect for more than eight years and is based on well established principles and widely recognized and accepted interpretations of existing tax law. Such principles and interpretations should not be negated by administrative change. We respectfully submit that the adoption of the Proposed Regulations, under which neither the Government nor any of the affected parties will benefit, is not warranted.

Sincerely yours,

CHARLES A. MCLENDON,
Executive Vice President.

CALIFORNIA LEGISLATURE,
Glendale, Calif., April 7, 1978.

MR. MICHAEL STERN,
Staff Director, Committee of Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Enclosed are five copies of my Senate Joint Resolution 31 which has passed both houses of the California Legislature without a dissenting vote. The resolution passed the Senate on January 19, 1978 with a vote of 38–0. The bill passed the Assembly on April 6, 1978 with a vote of 76–0.

I respectfully request that a copy of the resolution be included in the record of your March 15, 1978 hearing on S. 1587. If you need additional copies of the resolution, please feel free to contact me at the above address.

Sincerely,

NEWTON R. RUSSELL,
Senator, 21st District.

Enclosure.

SENATE JOINT RESOLUTION NO. 31,
INTRODUCED BY SENATOR RUSSELL,
September 9, 1977.

REFERRED TO COMMITTEE ON RULES

Senate Joint Resolution No. 31—Relative to state and local government pension and retirement plans.

LEGISLATIVE COUNSEL'S DIGEST

SJR 31, as introduced, Russell (Rls.). Retirement and pension plans: state and local government.

This measure urges the President and Congress of the United States to reiterate the intent in the Employment Retirement Security Income Act of 1974 that state and local government pension plans are not required to file annual returns and reports under that act.

Vote: majority.

Whereas, The Internal Revenue Service is interpreting Public Law 93-406, the Employee Retirement Income Security Act of 1974, as requiring all state and local government pension and retirement plans to file certain annual returns and reports provided for in ERISA; and

Whereas, ERISA indicates a clear congressional intent that state and local government plans not be regulated or file returns as interpreted by the Internal Revenue Service; and

Whereas, Such interpretation by the Internal Revenue Service threatens the integrity and future of state and local government pension plans by exposing them to potential tax on investment income, as well as the loss of deferred tax treatment granted beneficiaries of qualified plans; now, therefore, be it

Resolved by the Senate and Assembly of the State of California, jointly, That the Legislature of the State of California respectfully memorializes the President and the Congress of the United States to reiterate the intent contained in the Employee Retirement Security Income Act of 1974 that state and local government pension and retirement plans are not required to file annual returns and reports under that act, and to cancel or refund any penalties imposed on such plans in the past for late filing or failure to file those returns or reports; and be it further

Resolved, That the Secretary of the Senate transmit copies of this resolution to the President and Vice President of the United States, to the Speaker of the House of Representatives, and to each Senator and Representative from California in the Congress of the United States.

Statement of Leonard Prewitt, Executive Secretary, Teacher Retirement System of Texas

The National Council on Teacher Retirement (NCTR) supports legislation removing the threat of taxation on the income of public employee retirement funds, insuring that beneficiaries of public employee benefit plans are not burdened with excessive estate taxes, and reinforcing the decision of Congress in the Employee Retirement Income Security Act of 1974 (ERISA) that federal regulation of public pensions should be considered separate from the regulation of private pensions.

The need for this legislation has arisen out of recent attempts of the Internal Revenue Service to use Section 401 (and related provisions) of the Internal Revenue Code to regulate pension systems maintained by state and local governments for their employees.

Section 401(a) permits the qualification of certain pension, profit-sharing, and stock bonus plans for special tax treatment. The primary advantages of qualifying under Section 401(a) are that the employers contributions to the plan are deductable from his taxable income and that, under Section 501(a), the earnings from investments of the plan's funds are exempted from the federal income tax. A plan may also be exempted from tax on investment income if it is an institution listed in Section 501(c), such as an educational institution, fund, or foundation. Beneficiaries of pension funds qualifying under Section 401(a) also receive certain income and estate tax advantages under Sections 101, 402, and 2039.

Section 401 originally was clearly designed for private pension plans. For many years IRS considered the members and beneficiaries of public plans to be eligible for the same estate and gift tax treatment as employees under a private plan without the requirement that the public plan file the application for qualification under Section 401(a). Section 401(a) did not then and does not today satisfy the needs of public plans. When Congress first began to consider qualified retirement plans, not only the income of states and their subdivisions but also the salaries of their employees were considered non-taxable. Even now governmental revenues are not taxable, and, in the opinion of NCTR, neither are the earnings of state and local public pension funds.

The only reason public pension systems now need to qualify their plans under Section 401(a) is to provide their members and the beneficiaries of their deceased members with the same beneficial estate and income tax treatment on benefits that private sector employees enjoy. Section 401(a) standards for qualification generally prevent unequal treatment of classes of employees and, since 1974, provide an enforcement mechanism for ERISA requirements. Most, if not all, of these standards should have no applicability to public pension systems, especially in view of the funding resources for public plans, the constitutional protections for members which apply to public pension laws, and Congress's decision not to apply ERISA to public retirement systems. However, IRS has, in the opinion of NCTR, used Section 401(a) to apply the provisions of ERISA to public plans.

NCTR, therefore, supports enactment of separate, explicit amendments to the Internal Revenue Code which provide tax treatment of benefits from public retirement plans equal to that currently provided private employees who qualify under Section 401(a). Any standards to qualify public systems for this favorable tax treatment should be tailored to the special characteristics of public plans, if Congress should eventually determine there is a need for such standards, and not on the standards of ERISA. Public plans do not have the same characteristics of private plans.

Many public plans have qualified under Section 401(a). IRS has recently attempted to tax the investment income of public plans which have not qualified, reasoning that such plans are not exempt under Section 501(a) and are therefore taxable. It is the opinion of NCTR that public retirement systems are state agencies not subject to federal tax, regardless of their qualification under Section 401(a) and exempt status under Section 501(a). In *New York* v. *United States*, 326 U.S. 572 (1946), United States Supreme Court stated:

"A State may, like a private individual, own real property and receive income. But in view of our former decisions we could hardly say that a general nondiscriminatory real estate tax (apportioned), or an income tax laid upon citizens and States alike could be constitutionally applied to the State's capitol, its Statehouse, its public school houses, public parks, or its revenues from taxes or school lands, even though all real property and all income of the citizen is taxed."

This holding was reaffirmed in *National League of Cities* v. *Usery*, 426 U.S. 833 (1975).

However, since the IRS seems not to have the same understanding of the law, the NCTR believes the most effective way to resolve the issue is to have legislation which explicitly states that the income of such systems is not taxable.

The IRS attempt to tax public systems may simply be the first step in an effort to force all public retirement systems to comply with ERISA standards through qualifying under Section 401(a). Already, public plans desiring 401(a) qualification are being required to file reports with IRS pursuant to Section 1031 of ERISA (Section 6058 of the Internal Revenue Code). This is in direct conflict with the stated intent of Congress to exclude public systems from the application of ERISA.

The ironic result of an effort to enforce ERISA through Section 401(a) may be to endanger the retirement benefits of public employees. If public plans do not meet the requirements of Section 401(a) as interpreted by IRS, public employee benefits stand to be reduced by the threatened taxation on the investment income of the public pension plan and by the full taxation applied to members and beneficiaries of a plan which does not qualify under Section 401(a).

NCTR believes that federal regulation of public pensions, if such is needed, should await Congressional action on the recommendation of Congressionally mandated public pension studies. NCTR also feels that if such regulations are needed they should be administered by a pension commission and not IRS. Congress should prevent actions by federal agencies contradicting the explicit Congressional intent that public plans not be subject to ERISA. However, the IRS should not be allowed to apply overzealously legislative provisions for private pension plans to public plans, especially where the result can be adverse to the very people pension reform is designed to protect.

NCTR supports legislation which extends the same tax treatment to retirement benefits for public employees that applies to those of private sector employees. NCTR also wants legislation which will unequivocally protect employee retirement funds from the threat of double taxation. NCTR will not object to any needed regulation of public pensions that is tailored specifically to the special characteristics of public retirement systems.

TEACHER RETIREMENT SYSTEM OF TEXAS,
March 8, 1978.

HON. JEROME KURTZ,
Commissioner of Internal Revenue,
Washington, D.C.

DEAR MR. KURTZ: As a career state employee and member of the State of Texas deferred compensation plan, I strongly oppose Proposed Treasury Regulation § 1.61–16. I do not believe that the proposed rule is sound on either a revenue producing basis or equitable basis. Furthermore, I sincerely believe that the proposed rule exceeds your constitutional and statutory authority.

As I read this proposed regulation, it will (contrary to Section 451(a) of the

Internal Revenue Code) treat amounts deferred from each payroll check as received and taxable to the employee at the time of deferral.

Under the laws of the State of Texas the amount deferred cannot be received by the employee or his estate until either death or cessation of state employment. At the time it is received, it is fully taxable as well as any increase because of investment gain.

The Legislature of the State of Texas in enacting statutory authorization relied on the provisions of the Internal Revenue Code, judicial interpretations thereof as well as previous rulings by your office. It was an attempt by the Legislature to grant to all state employees and teachers who are members of TRS the same opportunity to defer income that was previously limited to those teachers who were not members of the TRS. After this enactment, your office specifically approved the State of Texas deferred compensation plan which is administered by the Comptroller of Public Accounts, a State Constitutional Officer. The State of Texas deferred compensation plan did away with an inequity previously existing. Your office should not recreate this inequity without a rational basis for the discriminatory classification it attempts to create.

Section 451(a) of the Internal Revenue Code specifically provides that gross income is income for the taxable year in which *received* by the taxpayer. These amounts are prohibited by state law from being received by the employee or his estate before death or cessation of state employment. Your proposed rule is in direct violation of Section 451(a) of the Internal Revenue Code and has been treated accordingly, not only by your office in the past but also by the courts. Under the definition of the cash method of accounting of income, Section 451(a) of the Internal Revenue Code does not tax a individual when earned; rather it taxes a individual when the money is actually received either by actual receipt or by legally enforceable rights thereto (constructive receipt). Since the money is specifically prohibited from being received by state law, it is legally impossible for this to constitute a constructive receipt. Therefore, I respectfully submit that the proposed rule is in violation of and contrary to the Internal Revenue Code which not only grants but limits your statutory authority.

In addition thereto, I respectfully submit that the proposed rule is in violation of the due process clause (as well as the Equal Protection Component) to the Fifth Amendment to the Constitution of the United States. If your proposed rule were an act of Congress, and Congress failed to repeal those provisions of the Internal Revenue Code specifically authorizing Pension and Profit-sharing plans, Keogh plans, Teacher Tax-Deferred Annuity plans and others, such an act of Congress would create a classification not permitted under the Fifth Amendment to the Constitution according to the United States Supreme Court decisions applying the Fifth Amendment to similar provisions. If Congress cannot create such a classification, I respectfully submit that you do not have the authority to do so.

I do not propose to include a brief on your constitutional and statutory authority in regard to the proposed rule as I am aware that your legal staff is capable of doing so. However, I urge you to give careful consideration to the questions raised in this letter. Furthermore, as of this date I am unaware of any publication which outlines the reason why this proposed rule is desirable either from an administrative standpoint or a revenue producing standpoint. For this reason, as of now I can see no justification for the proposed rule.

The Teacher Retirement System of Texas does not have a record of members of the teacher retirement system that are also members of the State of Texas Deferred Compensation Plan. However, we are aware that a number of individuals will be affected by your proposed rule in preparing for their retirement income.

I want to thank you in advance for considering the matters contained in this letter.

Yours very truly,

JOHN REEVES.

STATEMENT OF THE AD HOC COMMITTEE ON PUBLIC EMPLOYEE DEFERRED COMPENSATION PLANS

Mr. Chariman and members of the Committee on Finance, I am here to represent the views of the Ad Hoc Committee on Public Employee Deferred Compensation Plans concerning nonqualified deferred compensation plans for public employees. Deferred compensation simply describes a situation where an employee is taxed upon income received during his retirement which is attributable to work he performed much earlier in life. Recent Treasury actions have cast doubt upon the viability of these type programs for public employees. We feel that these deferred compensation plans allow public employees an excellent opportunity to voluntarily save for their own retirement and therefore should be encouraged.

As the members of this committee are aware, nonqualified deferred compensation plans or agreements have been utilized for many, many years. A landmark case in this area related to Sugar Ray Robinson, a boxer in the 1950's. Equally important to a legal analysis of these type plans were a number of Revenue Rulings issued by the Internal Revenue Service and its regulations concerning the doctrine of constructive receipt.

On the basis of this legal authority, it came to the attention of the Utah legislature that it might be possible to set up a deferred compensation program on a state wide level that public employees could use to plan for their retirement. Pursuant to Utah Statute, such a deferred compensation plan was implemented. On July 7, 1972 the Internal Revenue Service issued a favorable ruling on the tax consequences of this plan. Soon thereafter, the State of Oklahoma received a favorable ruling on the tax consequences of its state wide plan.

Subsequently, a majority of the States and hundreds of other jurisdictions have implemented deferred compensation plans for their employees and these plans have been ruled upon favorably by the Internal Revenue Service. In addition, numerous States and jurisdictions have passed enabling legislation but have not implemented plans as of yet.

While specific details of the deferred compensation plans may vary among the jurisdictions, the principle provisions are similar: (1) An employee may elect to defer specified amounts from his salary and the State makes a contractual promise to pay such amounts to the employee at a future date, generally retirement; (2) The deferred amounts belong solely to the State and are subject to all claims of other creditors of the State. The employee's rights are limited to the unsecured promise from the State to pay amounts at a later date. In short, the employee is a general creditor of the State; and (3) Many plans provide a number of options, one of which may be selected by the participant as a measuring index to determine the amount of the State's contractual obligation. These options may include annuity contracts, life insurance, mutual fund shares, etc. While the State may invest the deferred amounts in the options elected, it is under no obligation to do so. If it does so, the property purchased belongs solely to the State and the employee has no beneficial rights to it.

Of course, the plans have been designed to comply with all Internal Revenue Service and Treasury pronouncements setting forth the requirements for obtaining income tax deferral. Also, every State plan provides that the employee must make the deferral election prior to the period for which the compensation is to be paid.

As stated above, rather than rely on legal analysis that deferral would be successful in any of these plans, almost every State having a plan filed for and received a favorable ruling from the I.R.S. These rulings provide assurance to the employees that amounts they defer will not be included in the employee's income until paid by the State.

On February 3, 1978, about two weeks after the Treasury sent its tax proposals to Congress, it released proposed regulations that effectively destroy these worthwhile public employee deferred compensation plans by reversing this long history of public and private rulings by the Internal Revenue Service. It appears to me that this Treasury action is without legal basis, contrary to their previous administrative position that has been relied upon by hundreds of governmental jurisdictions, adversely affects retirement savings by public employees, and is basically legislation by regulation. The Treasury has usurped the Constitutional function of Congress to write our Nation's laws.

There are two other aspects concerning these proposed regulations that trouble me. For one, the proposed regulations' application to the private sector is unclear. It seems that the deferred compensation arrangements of a number of highly paid executives, entertainers, and athletes will not be affected by these regulations. This is grossly unfair to the public servants around our Nation. If deferred compensation remains a viable concept for the entertainers, executives, and athletes of our country, it certainly should remain so for the very modestly remunerated employees of our State and local governments.

For another, let me emphasize that these public employee deferred compensation plans are available to all public employees and are not utilized as a tax shelter for the highly compensated. Experience with the plans has indicated that they are utilized by employees at the low and medium income levels. According to figures obtained with reference to State plans, approximately 80 percent of the participants earn less than $20,000 annually.

Legislation has been introduced in Congress to reverse this proposed Treasury action. This legislation, sponsored by Congressman Waggonner and Senator Gravel, simply reiterates what until now has been the continuous and consistent Treasury and I.R.S. policy toward these deferred compensation plans. That policy needs to be continued.

From the viewpoint of State and local governments, these plans offer ease of administration and encouragement of voluntary savings for retirement—all at no additional cost to the employer. The employees are offered a practical method of aiding themselves in providing for their eventual retirement. Additionally, these plans directly assist these workers from having to rely on public assistance when they retire. This helps keep Federal costs of government assistance programs from climbing even faster. Everyone benefits by these type plans. I respectfully urge every member of this committee to support legislation that allows these worthwhile programs to continue.

For the information of the committee, the following States have public employee deferred compensation plans in operation or have adopted legislation providing for such plans: Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Delaware, Florida, Idaho, Illinois, Indiana, Kansas;

Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina;

North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Wyoming.

Thank you for the opportunity to appear before the Committee.

MAYER, BROWN & PLATT,
Washington, D.C., March 24, 1978.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In hearings last week, several witnesses urged that the subcommittee favorably report a bill to preserve the present treatment of deferred compensation arrangements for employees of state and local governments. Recently proposed regulations would drastically alter the long-standing treatment of deferred compensation arrangements for employees of both public and private employers. While taking no position on any such bill, several of our clients, including Brunswick Corporation ("Brunswick") and Continental Illinois Corporation ("Continental"), strongly urge that any relief from the Treasury's proposals recommended by the Subcommittee apply to both private and public employees.

Our clients are greatly concerned that the proposed regulations would severely limit their future ability to develop compensation arrangements responsive to the needs of their employees and might adversely affect their existing compensation arrangements. Enclosed are copies of comments by Continental and Brunswick filed with the Internal Revenue Service objecting to the proposed regulations. We request that they be included in the record of your hearings.

Briefly, Brunswick and Continental objected to the proposed regulations on the grounds that they constitute an attempt to legislate by administrative fiat far exceeding the scope of the Internal Revenue Service's authority; that they are unrelated to the section of the Internal Revenue Code under which they are proposed; and that they are in conflict with the long-standing regulations, rulings, and case law interpreting the provisions of the Code governing the timing of recognition of income. Furthermore, as recently as 1969 when the Congress considered, but rejected, changes in the treatment of deferred compensation, there appeared to be agreement that any such changes could be effected only through Congressional action. There has been no development in the succeeding years that changes that fundamental requirement. Accordingly, it is our clients' position that the proposed regulations, if adopted, would be invalid.

Nonetheless, our clients are greatly concerned that, if the Congress should act to ensure the status quo solely for arrangements benefiting public employees, an adverse implication regarding arrangements for private employees might result. The Internal Revenue Service could argue that, having before it a proposed change in treatment of deferred compensation arrangements for all employees, public and private, but acting only to preserve those for public employees, Congress endorsed the change in rules for private employees. Accordingly, we strongly urge that any action taken by the subcommittee apply to both private and public employees.

Respectfully,

EDWARD C. RUSTIGAN.
JERRY L. OPPENHEIMER.

Enclosures.

CONTINENTAL ILLINOIS CORP.,
Chicago, Ill., March 23, 1978.

Re Proposed Treasury Regulation § 1.61-16, 43 Fed. Reg. 4638 (February 3, 1978).

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
(Attention: CC:LR:T (LR-194-77).

DEAR SIR: This comment is submitted on behalf of Continental Illinois Corporation, the principal subsidiary of which is Continental Illinois National Bank and Trust Company of Chicago, in response to the invitation contained in the notice of proposed rulemaking with respect to proposed Treasury Regulation § 1.61-16, appearing at 43 Fed. Reg. 4638 (February 3, 1978). Continental Bank is the seventh largest bank in the United States. Over 10,000 people are employed by the Corporation and the Bank and their various subsidiaries.

Over the long term we are concerned that the proposed regulation, if adopted, would severely limit our opportunities in the future to develop compensation arrangements responsive to the needs of our employees. More immediately, our concern centers on the adverse effect that the adoption of the proposed regulation would have on two of our existing compensation arrangements. Under one, a director may irrevocably defer receipt of his director's fees by an election made prior to the period for which the fees are earned. Under the other, incentive income under certain employee compensation plans can be irrevocably deferred until retirement or earlier termination of employment. Such arrangements were expressly sanctioned by the Internal Revenue Service (the "Service") in Rev. Rul. 71-419, 1971-2 C.B. 220, and Rev. Rul. 69-650, 1969-2 C.B. 106, respectively.

We share the view, expressed by some commentators, that the proposed regulation is an attempt to legislate by administrative fiat far exceeding the scope of authority delegated to the Secretary of the Treasury by section 7805 of he Internal Revenue Code of 1954, as amended (the "Code"). It is unrelated to the section of the Code under which it is proposed, conflicts both with sections 446 and 451 of the Code and with administrative interpretations under those sections and conflicts with established case law. We contend that such legislation by administrative fiat is a usurpation of legislative authority vested in the Congress. For these reasons, we strongly urge that the proposed regulation be immediately withdrawn.

THE AUTHORITY OF THE INTERNAL REVENUE SERVICE TO PROMULGATE REGULATIONS

The Service's authority to promulgate regulations stems from section 7805(a) of the Code, which delegates authority to the Secretary of the Treasury to prescribe "all needful rules and regulations for the enforcement of this title. . . ." However, to the extent that regulations are isued "in excess of . . . statutory authority" or "not in accordance with law," the Administrative Procedure Act dictates that such regulations be held invalid, 5 U.S.C. § 706. Even if a regulation is not expressly inconsistent with the Code, it cannot be sustained if it is unreasonable or unrealistic. *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973).

The standards governing the promulgation of regulations by the Service were articulated in more detail in *Investment Annuity, Inc.* v. *Blumenthal*, C.A. No. 77-810, 164 BNA Pension Reporter D-8 (D.D.C., November 16, 1977) quoting *Eastern Kentucky Welfare Rights Organizations* v. *Simon*, 506 F. 2d 1278 (D.C. Cir. 1974) vacated on other grounds, 476 U.S. 26 (1976) as follows:

Any discretion incorporated into the IRS's authority to promulgate rules and regulations is necessarily limited by the understanding that Congress, not the Treasury, is responsible for the formulation and institution of basic tax policy. It is true, as a matter of jurisprudence and efficient tax administration, that courts have regularly paid deference to the expertise attributable to the IRS in the tax related matters and therefore judicial interference is reluctantly employed. However, this exhibition of restraint is predicated upon the assumption that administrative rulings will *do no more than effectuate, implement and clarify* *the provisions of the Code which have been congressionally enacted* . . . and 164 BNA Pension Reporter D–9 (emphasis added).

INVALIDITY OF THE REGULATION UNDER SECTION 61 OF THE CODE

The proposed regulation does not meet any of the foregoing standards. It does not effectuate, it does not implement, and it does not clarify section 61 of the Code. That section is a definitional section only. Its sole function is to define gross income, *i.e.* to state what items are subject to federal income tax. The proposed regulation does not purport to define gross income to include a mere promise to pay directors' fees or employee compensation. Nor could it under established case law. See for example *United States* v. *Christine Oil & Gas Co.*, 269 F. 458 (1920) ; *C. Florian Zittel* v. *Commissioner*, 12 B.T.A. 675 (1928) ; and *Commissioner* v. *Olmsted Incorporated Life Agency*, 304 F. 2d 16 (8th Cir., 1962). There is no dispute as to whether the actual fees and compensation are items of gross income. The sole issue with respect to them is the taxable year of their inclusion in gross income. That issue has been addresed directly by Congress in sections 446 and 451 of the Code. If it is to be addressed by the Service by way of regulation, it can be properly addressed only by regulations promulgated under those sections.

It appears that the only possible motive for promulgating the proposed regulation under section 61 of the Code is to disguise the sudden and unwarranted about-face taken by the Service. The change in the Service's position with respect to the taxable year in which amounts of deferred compensation are includable in the gross income of a taxpayer conflicts with the express provisions of sections 446 and 451 of the Code, and with the holdings in numerous cases decided under those sections and their predecessor sections. It also conflicts with the Service's own published rules and regulations dating back to regulations promulgated under the Revenue Act of 1918

CONFLICT WITH THE CODE, CASE LAW AND PRIOR RULING

Section 446(a) of the Code provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books". Section 446(c) of the Code provides that one method a taxpayer may use to compute his income is the cash receipts and disbursements method. Regulations promulgated under section 446 refer to section 451 of the Code and regulations issued thereunder for the general rules relating to the taxable year of inclusion of an item of gross income. Section 451 provides, in part, that: The amount of any item of gross income shall be included in the gross income for the taxable year *in which received* by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. (Emphasis added.)

Cases, regulations and rulings published under section 451 make it clear that, that respect to a taxpayer utilizing a cash receipts and disbursements method of accounting, compensation amounts are not received within the meaning of section 451, if they are deferred by action taken prior to the time the amounts are due and payable.

By announcing in its notice of proposed rulemaking that it would reconsider it acquiescences in the decisions of *James F. Oates*, 18 T.C. 570 (1950), unanimously affirmed, 207 F. 2d 711 (7th Cir., 1953), and *Ray S. Robinson*, 44 T.C. 20 (1965), the Service has acknowledged that the proposed regulation is inconsistent with established case law. The Service also acknowledged in its notice that the proposed regulation is in direct conflict with the Service's own published rulings.

The notice of proposed rulemaking was strangely silent, however, with respect to the direct conflict between the proposed regulation and Treasury Regulation § 1.451–2(a) which provides, in part, as follows: Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that *he may draw upon it at any time*, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, *the mere crediting* *on the books of the corporation does not constitute receipt.* (Emphasis added.)

Perhaps the reason the Service was silent on the conflict is found in the fact that the Service itself has acknowledged that Treasury Regulation 1.451-2(a) accords with prior regulations extending back to, and including Article 53 of Regulations 45 promulgated under the Revenue Act of 1918, and that its application does not result in constructive receipts of amounts deferred by action taken prior to the date the amounts become due and payable. Rev. Rul. 60-31, 1960-1 C.B. 174 at 178.

USURPATION OF CONGRESSIONAL AUTHORITY

The Supreme Court of the United States has left no doubt that changes in existing tax laws which would have wide ramifications on taxpayers cannot be made by administrative fiat. "If changes are thought necessary, that is Congress's business. *United States* v. *Consumers Life Insurance Co.*, 430 U.S. 725 750 n. 34 (1977).

There can be no question as to the Congressional position wtih respect to the time at which amounts of deferred compensation are subject to taxation. As recently as the Tax Reform Act of 1976, Congress amended section 1348 of the Code to grant more favored tax treatment to deferred compensation amounts. Furthermore, the entire scheme of federal income taxation of individuals was reviewed by Congress in the late 1960's and that review culminated in the adoption of the comprehensive Tax Reform Act of 1969. In the course of the Congress' development of that legislation, changes in the taxation of deferred compensation amounts were considered in detail by the House of Representatives, the Senate and the Treasury Department, and were ultimately rejected.

Section 331 of the House version of the Tax Reform Act of 1969, H.R. 13270, would have added a new section 1354 to the Code providing that amounts of deferred compensation including director's fees would continue to be taxed as under present law in the year actually received, but, to the extent this exceeded $10,000 in any year, would be taxed at the rates which would have been applicable to the amounts had the compensation been received when earned.

Proponents of the House proposal argued that "the bill represents a *reasonable compromise* between immediate taxation and complete deferral". Opponents of the proposal argued that the primary benefit of deferred compensation is forward averaging which is not tax avoidance and that there is no reason to prevent such averaging. Opponents argued further that deferred compensation should be preserved as an incentive to executives. Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, Summary of H.R. 13270, The Tax Reform Act of 1969 (As Passed by the House of Representatives) 91st Cong., 1st Sess. 53-54 (Committee Print 1969) (emphasis added).

Another reason for deleting the House provision from the Senate bill and from the final bill was that the Treasury Department, in testimony before the Senate Finance Committee, recommended that the provision be deleted. The Finance Committee noted that: The Treasury Department has undertaken a comprehensive study of both qualified and nonqualified employee benefit plans, and it intends, as part of this study, *to develop recommendations* dealing with the tax consequences of deferred compensation arrangements. S. Rep. No. 91-552, 91st Cong. 1st Sess. 307 (1969) (emphasis added).

It was clear to all parties in 1969 that changes in the method of taxing deferred compensation amounts could be effected only through Congressional legislation. There has been no development in the succeeding years that changes that fundamental requirement. If the Treasury Department has completed its study and the Administration desired to make recommendations to Congress, the appropriate time to do so was in the Administration's tax reform proposals submitted to Congress on January 21, 1978. But the Administration opted not to do so. Instead, less than two weeks later, it attemped through publication of proposed regulations, to change the law in a far more drastic manner than the "reasonable compromise" ultimately rejected by Congress in 1969.

CONCLUSION

The proposed regulation far exceeds the rulemaking authority of the Secretary of the Treasury. It is unrelated to the section of the Code under which it is proposed to be promulgated. It conflicts with sections 446 and 451 of the Code and with administrative interpretations under those sections. It also conflicts with established case law.

For these reasons, we feel strongly that the proposed regulation must be immediately withdrawn.

RAY F. MYERS.

MAYER, BROWN & PLATT,
Chicago, Ill., March 24, 1978.

By messenger:

Re Proposed Treasury Regulation § 1.61-16, 43 Fed. Reg. 4638 (February 3, 1978)

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.

(*Attention:* CC:LR:T (LR-194-77) Room 4317).

DEAR SIR: This comment is submitted on behalf of Brunswick Corporation. It is greatly concerned that proposed Treasury Regulation § 1.61-16 would severely limit its future ability to develop compensation arrangements responsive to the needs of its employees. It is also concerned that the proposed regulation would adversely affect two of its existing compensation arrangements. Under one of these arrangements, an employee may irrevocably elect, prior to a period of service, to defer receipt of a portion of his compensation for that service until his retirement or earlier termination of employment. Such an arrangement has been expressly sanctioned in Rev. Rul. 69-650, 1969-2 C.B. 106. Under the other arrangement, employees of Brunswick are compensated, in accordance with individually negotiated employment contracts, by a combination of current compensation and deferred compensation. Such an arrangement has been expressly sanctioned in Rev. Rul. 60-31, 1960-61 C.B. 174, Rev. Rul. 68-99, 1968-1 C.B. 193, and Rev. Rul. 72-25, 1972-1 C.B. 127.

The proposed regulation is an attempt to legislate by administrative decree far exceeding the scope of authority delegated by section 7805. It is unrelated to section 61 under which it is proposed and conflicts with sections 446 and 451, wtih administrative interpretations under those sections, and with established case law. Such legislation by administrative decree is a usurpation of legislative authority vested in the Congress. For these reasons, we strongly urge that the proposed regulation be immediately withdrawn.

THE AUTHORITY OF THE INTERNAL REVENUE SERVICE TO PROMULGATE REGULATIONS

The Service's authority to promulgate regulations stems from section 7805(a) which delegates authority to the Secretary of the Treasury to prescribe "all needful rules and regulations for the enforcement of this title. . .". However, to the extent that regulations are issued "in excess of . . . statutory authority" or "not in accordance with law", the Administrative Procedure Act dictates that such regulations be held invalid, 5 U.S.C. § 706. Even if a regulation is not expressly inconsistent with the Internal Revenue Code, it cannot be sustained if it is unreasonable or unrealistic. *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973).

The standards governing the promulgation of regulations by the Service were articulated in more detail in *Investment Annuity, Inc.* v. *Blumenthal*, C.A. No. 77-810, 164 BNA Pension Reporter D-8 (D.D.C., November 16, 1977), quoting *Eastern Kentucky Welfare Rights Organizations* v. *Simon*, 506 F.2d 1278 (D.C. Cir. 1974) vacated on other grounds, 476 U.S. 26 (1976), as follows: Any discretion incorporated into the IRS's authority to promulgate rules and regulations is necessarily limited by the understanding that Congress, not the Treasury, is responsible for the formulation and institution of basic tax policy. It is true, as a matter of jurisprudence and efficient tax administration, that courts have regularly paid deference to the expertise attributable to the IRS in the tax related matters and therefore judicial interference is reluctantly employed. However, this exhibition of restraint is predicated upon the assumption that administrative rulings will *do no more than effectuate, implement and clarify the provisions of the Code which have been congressionally enacted.* . . . 164 BNA Pension Reporter D-9 (emphasis added).

INVALIDITY OF THE REGULATION UNDER SECTION 61

The proposed regulation does not meet any of the foregoing standards. It does not effectuate section 61. It does not implement section 61. It does not clarify section 61. That section is a definitional section only. Its sole function is to define gross income, i.e., to state what items are subject to federal income tax. The proposed regulation does not purport to define gross income for a cash basis taxpayer to include a mere promise to pay employee compensation. Nor could it under established case law. See for example *United States* v. *Christine Oil & Gas Co.*, 269 F. 458 (1920); *C. Florian Zittel* v. *Commissioner*, 12 B.T.A. 675 (1928);

and *Commissioner* v. *Olmsted Incorporated Life Agency*, 304 F.2d 16 (8th Cir., 1962). There is no dispute that compensation is an item of gross income. The sole issue with respect to it is the taxable year of its inclusion in gross income. That issue has been addressed directly by Congress in sections 446 and 451. If it is to be addressed by the Service by way of regulation, it can be properly addressed only by regulations promulgated under those sections.

Promulgation of the proposed regulation under section 61 disguises the sudden and unwarranted about face taken by the Service. The change in the Service's position with respect to the taxable year in which amounts of deferred compensation are includable in the gross income of a taxpayer conflicts with the express provisions of sections 446 and 451 and with the holdings in numerous cases decided under those sections and their predecessor sections. It also conflicts with the Service's own published rules and regulations dating back to regulations promulgated under the Revenue Act of 1918.

CONFLICT WITH THE CODE, CASE LAW AND PRIOR RULINGS

Section 446(a) provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books". Section 446(c) provides that one method a taxpayer may use to compute his income is the cash receipts and disbursements method. Regulations promulgated under section 446 refer to section 541 and regulations issued thereunder for the general rules relating to the taxable year of inclusion of an item of gross income. Section 451 provides, in part, that: The amount of any item of gross income shall be included in the gross income for the taxable year *in which received* by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. (Emphasis added.)

Cases, regulations and rulings published under section 451 make it clear that, with respect to a taxpayer utilizing a cash receipts and disbursements method of accounting, compensation amounts are not received within the meaning of section 451, if they are deferred by action taken prior to the time the amounts are due and payable.

By announcing in its notice of proposed rulemaking that it would reconsider its acquiescences in the decisions of *James F. Oates*, 18 T.C. 570 (1950), unanimously affirmed, 207 F.2d 711 (7th Cir., 1953), and *Ray S. Robinson*, 44 T.C. 20 (1965), the Service has acknowledged that the proposed regulation is inconsistent with established case law. The Service also acknowledged in its notice that the proposed regulation is in direct conflict with the Service's own published rulings.

The notice of proposed rulemaking does not mention the direct conflict between the proposed regulation and Treasury Regulation § 1.451-2(a), although the Service itself has acknowledged that Treasury Regulation § 1.451-2(a) accords with proper regulations extending back to, and including, Article 53 of Regulation 45 promulgated under the Revenue Act of 1918, and its application does not result in constructive receipt of amounts deferred by action taken prior to the date the amounts become due and payable. Rev. Rul. 60-31, 1960-1 C.B. 174 at 178. Treasury Regulation § 1.451-2(a) provides, in part, as follows: Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available *so that he may draw upon it at any time*, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, *the mere crediting on the books of the corporation does not constitute receipt*. (Emphasis added.)

USURPATION OF CONGRESSIONAL AUTHORITY

The Supreme Court of the United States has left no doubt that changes in existing tax laws which would have wide ramifications on taxpayers cannot be made by administrative decree. "If changes are thought necessary, that is Congress' business." *United States* v. *Consumers Life Insurance Co.*, 430 U.S. 725, 750, n.34 (1977).

There can be no question as to the Congressional position with respect to the time at which amounts of deferred compensation are subject to taxation. As recently as the Tax Reform Act of 1976, Congress amended section 1348 to grant *more favored* tax treatment to deferred compensation amounts. In the course of the Congress' development of the Tax Reform Act of 1969, certain changes in the taxation of deferred compensation amounts were considered in detail by the House of Representatives, the Senate and the Treasury Department, and were ultimately rejected.

Section 331 of the House version of the Tax Reform Act of 1969, H.R. 13270, would have added a new section 1354 providing that amounts of deferred compensation would continue to be taxed, as under present law, in the year actually received, but, to the extent they exceeded $10,000 in any year, would be taxed at the rates which would have been applicable to the amounts had the compensation been received when earned.

Proponents of the House proposal argued that "the bill represents *a reasonable compromise* between immediate taxation and complete deferral". Opponents of the proposal argued that the primary benefit of deferred compensation is forward averaging which is not tax avoidance and that there is no reason to prevent such averaging. Opponents argued further that deferred compensation should be preserved as an incentive to executives. Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, Summary of H.R. 13270, The Tax Reform Act of 1969 (As Passed by the House of Representatives), 91st Cong., 1st Sess. 53–54 (Committee Print 1969) (emphasis added).

In testimony before the Senate Finance Committee, the Secretary of the Treasury recommended that the provision be deleted. Among the reasons cited by the Secretary were the Treasury Department's inability to develop a satisfactory definition of the term "deferred compensation" and the difficulty of developing satisfactory and workable tests for determining the year in which deferred compensation is "earned". Committee on Finance, United States Senate, Statement of the Honorable David M. Kennedy, Secretary of the Treasury, The Tax Reform Act of 1969, 91st Cong., 1st Sess. 52 (Committee Print 1969). Those reasons are particularly cogent with respect to the taxation of amounts of deferred compensation paid pursuant to the terms of an employment contract. As noted by the Service in Rev. Rul. 60–31, "[T]he statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment." Rev. Rul. 60-31, 1960-1 C.B. 174 at 178.

In 1969 the Treasury Department promised to make recommendations to Congress about deferred compensation. The Committee on Finance noted that: The Treasury Department has undertaken a comprehensive study of both qualified and nonqualified employee benefit plans, and it intends, as part of this study, *to develop recommendations* dealing with the tax consequences of deferred compensation arrangements. S. Rep. No. 91–552, 91st Cong. 1st Sess. 307 (1969) (emphasis added).

It was clear to all parties in 1969 that important changes in the method of taxing deferred compensation amounts could be effected only through Congressional legislation. There has been no development in the succeeding years that changes that fundamental requirement. If the Treasury Department had completed its study and the Administration desired to make recommendations to Congress, the appropriate time to do so was in the Administration's tax reform proposals submitted to Congress on January 21, 1978. But the Administration opted not to do so. Instead, less than two weeks later, it attempted through publication of proposed regulations, to change the law in a far more drastic manner than the "reasonable compromise" ultimately rejected by Congress in 1969 and, with respect to deferred compensation paid pursuant to employment contracts, to resort to the type of taxation by speculation rejected in its prior rulings and Congressional testimony.

CONCLUSION

The proposed regulation far exceeds the rulemaking authority of the Secretary of the Treasury. It is unrelated to the section under which it is proposed to be promulgated. It conflicts with sections 446 and 451 and with administrative interpretations under those sections. It conflicts with established case law.

As noted by Senator Gravel in the Congressional Record of March 2, 1978: This is nothing more than the most outrageous of attempts by the Treasury Department to legislate by executive fiat. We have all seen this occur over the past few years in many areas of the administration of our laws. However, this is the most blatant action I have come across so far. If the administration did not like the tax rules under which these rulings were approved, it should have come forward with legislation to overturn them. It appears that the decision was made to pursue the legislation-by-regulation route for fear that Congress would not agree with the Treasury's decision in this area. 124 Cong. Rec. S 2782 (daily ed., March 2, 1978).

For the foregoing reasons, we urge that the proposed regulation be immediately withdrawn.

Very truly yours,

EDWARD C. RUSTIGAN,
JERRY L. OPPENHEIMER.

SMALLEY AND COGBURN,
Griffin, Ga., March 23, 1978.

Re: Hearings on S. 1587 and on the deferral from income of certain amounts deferred under nonqualified deferred compensation plans

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: In press release number 15, Senator Bentsen announced the above hearings and requested comments from the public. Attached is a letter of comment which I wrote to the Commissioner of Internal Revenue Service concerning proposed Treasury Regulations Section 1.61–16 which were published in the Federal Register on February 3, 1978.

As an attorney who represents closely held businesses, I request that the attached letter to be made part of the hearing record and that it receive the careful consideration of the committee and its staff. This proposed regulation would be highly discriminatory toward small businesses, and I urge the committee to take all appropriate steps to have the Department of Treasury and the Internal Revenue Service withdraw the proposed regulation, or in the alternative, to take appropriate action to prohibit its publication.

Respectfully submitted,

JOHN M. COGBURN, Jr.

SMALLEY AND COGBURN,
Griffin, Ga., March 23, 1978.

Re Proposed Regulation 1.61–16 (Dealing with the Deferral From Income of Certain Amounts Deferred Under Non-Qualified Deferred Compensation Plans)

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
Attention: CC: LR: T (LR–194–77).

DEAR SIR: As an attorney who represents closely held businesses, I must strenuously object to the proposed regulation dealing with the elective deferral of compensation by an individual. It would appear that this proposed regulation would effectively prohibit small businesses (particularly those controlled by one or a few shareholders) from establishing nonqualified deferred compensation plans. These plans are, however, increasingly more important to these small businesses particularly in view of the recent increases in the social security tax.

The proposed regulation seems to ignore the existing case law and previous published positions of the Service on these plans.

The proposed regulation does not properly apply the doctrine of constructive receipt or the economic benefit theory. Under the doctrine of constructive receipt, the taxpayer must have an unconditional right to receive income before it is taxed for being constructively received. If an informal deferred compensation arrangement is negotiated before the taxpayer has an unconditional right to receive the income, then this doctrine does not require its inclusion in income. The other way that nonqualified deferred compensation plans have been found by the courts to constitute current income is the economic benefit theory. Under this theory, income is realized (and must be recognized) if the taxpayer receives something with an economic value. The courts have consistently held, however, that deferred compensation has no value if the employee's right to that income consists only of the employer's unsecured promised pay, or if the deferred compensation is forfeitable.

From my standpoint, the most pernicious aspect of this proposed regulation is not the fact that it fails to follow the established tax law, but that it discriminates against small businesses. It would appear that a mandatory deferred compensation arrangement in a non-closely held business would be permitted, because no shareholder-employee would have sufficient control over the business to "individually elect" that some of his compensation be deferred. But in a closely held business, it would appear that a shareholder-employee could never enter into a nonqualified deferred compensation plan which would avoid immediate taxation.

If the Service feels that a regulation of this kind must be adopted, then I strongly recommend that an exception for closely held businesses be included which would permit an employee (regardless of whether he is a shareholder) to negotiate a non-deferred compensation arrangement for future tax years.

Respectfully submitted,

JOHN M. COGBURN, Jr.

NATIONAL CONFERENCE ON
PUBLIC EMPLOYEE RETIREMENT SYSTEMS,
Columbus, Ohio, March 15, 1978.

STATEMENT BY ROBERT E. WETHERILLE, JR., PRESIDENT OF THE NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS

Mr. Chairman, and members of the committee, my name is Robert E. Wetherille, Jr., and I am President of the National Conference on Public Employee Retirement Systems representing over four million public employees. The purpose of the NCPERS is to safeguard and promote the rights of the conference membership and of public employees in general. I am here today to speak in support of S. 1587.

Since its development, section 401(a) of the Internal Revenue Code has been a thorn to public employee retirement systems. The section was developed to cease discriminatory practices against employees in the private sector who were covered by a pension plan. The method by which this is accomplished is the establishment of guidelines for qualification under section 401(a). It is clear that these guidelines or Qualifying Regulations were established strictly with the private sector in mind. The penalty for not qualifying is a tax imposed on the earnings of a private plan's investment portfolio. Members and beneficiaries of a qualified plan also receive some favorable tax considerations. All of this is sound; however, there is considerable reporting required by the IRS in enforcing the section.

These reporting requirements are generally unnecessary and costly for public plans to complete. In addition, the passage ERISA has added to the reporting requirements. The problem is that it appears that the IRS has gone beyond the intent of the law and in addtiion, has been extremely inconsistent in its interpretation of *what is* and *what is not* applicable to the public sector plans. In tracing the legislative history of section 401(a) of the IRC, there is no mention of public plans. Therefore, it is difficult to determine whether or not the Congress ever intended for this section to be applicable to public plans. On the other hand, it seems clear that ERISA is dedicated to private plans. This is set forth clearly by the mandatory study of public plans under ERISA. To mandate that public plans must comply with reporting procedures under ERISA is at least very confusing.

The intent of S. 1587, then, is to clarify certain rather nebulous provisions of law which force public plans to comply with regulations which may or may not be the intent of the law. Regional Offices vary with respect to how or if these reporting requirements are applicable to public plans. In consideration of this, we are of the opinion that this bill will accomplish two things: 1. The bill (S. 1587) clearly states that public plans are not to be subjected to taxes if they do not qualify under Section 401(a) of the Code; and 2. Reporting requirements with respect to public plans are in actuality not applicable in the language of the bill.

We support the programs of this bill and ask for the purpose of the record that, "public employees, their pension plans, and beneficiaries be afforded the favorable tax considerations now afforded under Section 401(a)." This is not specified, but it is our understanding it is implied.

We believe that the Congress has intended to assume that the States can conduct their own business within the intent of section 401(a) and that discriminatory practices with respect to the section will practically be nonexistent.

We, therefore, support S. 1587 and encourage you to report the bill to the full committee for future passage.

We appreciate the opportunity to have appeared before you and hope that you will proceed with this proposed legislation.

Statement of the National Association of Pension Consultants and Administrators, Inc. (NAPCA)

NAPCA is a national organization of consultants and administrators of employee benefit plans of all types. NAPCA's members provide administrative and advisory services to literally thousands of plan sponsors and employee benefit plans. Most clients of NAPCA's members are small businesses and small plans. NAPCA's members frequently advise and assist with the installation and administration of non-qualified deferred compensation arrangements of the type considered in the proposed regulation.

NAPCA strongly objects to the proposed regulation and urges that it be withdrawn. NAPCA's objection is based on policy as well as legal grounds. With respect to policy NAPCA submits that in this period of increasing concern over the availability of adequate provision for retirement, it is sound tax policy to encourage all taxpayers to provide for income in their retirement years, and that actions should not be taken to discourage such provision. Furthermore, NAPCA submits that if any changes are to be made with respect to non-qualified deferred compensation arrangements, such changes should be made only after a careful and comprehensive study of the impact of such changes on the entire retirement sector. With respect to legality, NAPCA submits that the proposed regulation is so broadly drafted that it would deny tax deferral, in a number of situations, in direct conflict with long-established case law.

Objections on Policy Grounds

A. Premature to Act Prior to Study

It is premature to fundamentally revise rules relating to non-qualified deferred compensation at a time when the entire area of employee benefit plans, both public and private, is scheduled for, and is in dire need of, a thorough re-examination. In recent months a plethora of proposed rules, regulations, legislation and policy statements in the employee plan area have been issued on an ad hoc basis by the administration and the Congress. Many of these propose very fundamental changes in law and policy. However, it would appear that no one has examined the relationship of these proposals to one another or to the whole area of private qualified plans, private nonqualified plans, public plans and social security. We contend that such an examination is sorely needed prior to any further changes.

The 1977 social security legislation provided for the establishment of a National Commission on Social Security which is charged, among other matters, with examining certain relationships of qualified plans with Social Security. The recently announced (and funded) Presidential Retirement Commission will examine the relationship of private and public plans with social security. The Congress is in the midst of hearings relating to social security and private plans and will shortly begin hearings relating to public plans. Legislation in both Houses of Congress (S. 1587; H.R. 10746) has beeen introduced which would require withdrawal of the subject proposed regulations as they relate to public employees. It is clear that the entire retirement and employee benefit sector is in a state of flux and is to be the subject of extensive study.

We contend that any fundamental change in rules and regulations relating to employee and retirement plans in general, and specifically the proposed regulation relating to deferred compensation arrangements, must be postponed until the Administration, the Congress and the public have had the benefit of the recommendations of the various study commissions, and until the direction of this country's policy relating to such plans have been determined.

B. Administrative Difficulty of Enforcement

The proposed regulation would be administratively difficult to monitor and enforce. The key inquiry of whether the deferral of income receipt was made at the taxpayer's individual option or was mandated by the employer would be vulnerable not only to abuse, but to honest differences of opinion and interpretation. The proposed regulation could well encourage contrived negotiations and documentation in an effort to literally comply with their requirements, and it would be extremely difficult to distinguish such contrived situations from legitimate ones.

C. Discrimination Against Self Employed and Small Business

In focusing on the exercise of individual taxpayer option, the proposed regulation would discriminate against the self-employed and individual taxpayer-employees who were not in a position to bargain collectively. As a practical matter, such individuals would simply be unable to participate in non-qualified deferred compensation arrangements. Small businesses would similarly have great difficulty in establishing such arrangements for key personnel due to questions of de facto control. For example, it would appear that under the proposed regulation, a stockholder or officer of a small, closely held corporation could never negotiate a non-qualified retirement arrangement. The inability to do this would severely disrupt orderly retirement and transition to younger owners and managers.

On the other hand, mandatory arrangements in non-closelyheld corporations would be permitted, since no individual taxpayer would have sufficient control to make a "tained" election. Mandatory collectively-bargained arrangements would similarly avoid "tainted" individual elections.

OBJECTIONS ON LEGAL GROUNDS

The proposed regulation would not restate or clarify the existing law regarding taxation of deferred compensation. Rather, the proposed regulation would extend substantially beyond long-established law.

We find it highly pertinent that the specific basis of the proposed regulation is not stated. Rather, the preamble simply cites cases and revenue rulings of long-standing, which the Service now deems incorrect. Publications of the proposed regulation under Section 61 of the Internal Revenue Code is, in our view, indicative of the Service's difficulty in locating authority for its position.

Section 61 properly relates to the definition of income, not to the taxable year of inclusion in income. No one denies that compensation, deferred or otherwise, is income. However, we contend that the proper year of inclusion must be determined under applicable law, and that there is no law, statutory or court-created, which justifies the broad scope of the proposed regulation.

The basic statutory provision for the proper year of inclusion is section 451, which basically provides that an item of income shall be included in income "for the taxable year in which received by the taxpayer", unless the particular method of accounting used by the taxpayer requires inclusion in a different period. Taxpayers using the cash method of accounting are thus not required to include an item in income until the item is received, either actually or constructively. Treas. Reg. § 1.451-2 specifically provides that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions". The doctrine of constructive receipt has been part of the Treasury Regulations for a substantial number of years and under the theory of legislative re-enactment, should not be altered by administrative fiat, but only by legislation.

Section 83, which deals with the proper year of inclusion of property transferred in connection with the performance of services, has been specifically construed by the Service not to apply to "an unfunded and unsecured promise to pay deferred compensation". Prop. Treas. Reg. § 1.83-3(e). The statutory language and the legislative history of Section 83 fully support this interpretation.

Indeed, the fact that Congress found it necessary to deal with restricted property transfers by legislation in the form of section 83 is convincing evidence that the Internal Revenue Service lacks the requisite statutory authority to deal administratively with other non-qualified deferred compensation arrangements in the manner contemplated by the proposed regulation. In other words, if the Internal Revenue Service has the present authority to issue the proposed regulations, then section 83 was not needed to deal with restricted property transfers.

It is our view, that there are but two theories on which the Service could base its position in the proposed regulation: the often overlapping theories of constructive receipt and economic benefit. However, the proposed regulation would go far beyond either of these theories.

A. CONSTRUCTIVE RECEIPT

As a general matter, the Internal Revenue Service has attempted to tax currently amounts which, while not actually received, were "made available" to the taxpayer without substantial restrictions". As interpreted by the courts, this constructive receipt takes place only where (1) the taxpayer is immediately entitled to the item of income, (2) the item is immediately available to the taxpayer, and (3) the taxpayer's failure to receive the item is due to his or her own volition. Thus, for example, in *Deupree* v. *Commissioner*, 1 T.C. 113 (1942), the

Service successfully invoked the doctrine to tax currently the president of a company on amounts he directed the company to pay into an annuity in lieu of having the amount paid directly to him as a bonus, as he was entitled under his employment contract. On the other hand, the Service has not been successful in situations where the amount deferred was uncertain or was not immediately available to the taxpayer, or where receipt was subject to certain conditions. For example, in *Viet* v. *Commissioner*, 8 T.C. 809 (1947), taxpayer, in November 1940, was able to persuade his employer to defer from 1941 to 1942 payment of 1940 profit shares due for services rendered throughout 1940. The Court rejected the Commissioner's contention that the profit share was constructively received in 1941, noting that at the time of deferral, the taxpayer's profit share was uncertain and thus the agreement to defer was not a mere sham. In a second case, involving the same taxpayer, *Veit* v. *Commissioner*, 8 T.C.M. 919 (1949), the taxpayer, in December 1941, arranged with his now former employer to have his now determinable 1940 profit share paid in equal installments from 1942–45, rather than all in 1942. The court rejected the Commissioner's argument that the entire profit share should be included in gross income for 1942, noting that the deferral agreement was entered into at the behest of the employer prior to the time the first 1942 installment was due. Thus, the profit share was not immediately available to the taxpayer at the time of this second deferral. Nor was the Service successfull in invoking the constructive receipt doctrine where the employee had to meet certain conditions in order to obtain the deferred benefits. In *Hall* v. *Commissioner*, 15 T.C. 195 (1950), aff'd. 194 F.2d 538 (9th Cir. 1952), a corporate promoter was held taxable on the value of stock when he received the shares and not when he signed a contract entitling him to the shares upon completion of services for the corporation over a two year period. The court noted that if the promoter had not performed the contract services, he would have forfeited the stock. See also, *Oates* v. *Commissioner*, 18 T.C. 570 (1952). To summarize these cases, the doctrine of constructive receipt applies only where the taxpayer in fact turns his back on available income currently due to him. See Warner, "The IRS freeze on Deferred Compensation Rulings—Prospects for the Future", *The Compensation Planning Journal*, January, 1978. (Portions quoted.)

B. ECONOMIC BENEFIT

In *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945), the Supreme Court stated that taxable income may include "any economic or financial benefit conferred on the employee as compensation, whatever the form or more". The Service has relied on this theory in attempting to tax currently earnings which employers have agreed to defer until later years on the theory that the unqualified promise of a solvent employer, if capable of being valued, is a current economic benefit to the employee. Unlike the constructive receipt theory, whereby the entire amount deferred is includible in gross income as being effectively under the taxpayer's dominion, the economic benefit theory provides only that the present value of the employer's promise to pay be includible in income. The key factor in determining whether the economic benefit doctrine can be invoked is that of valuation. Where the employer's promise is to pay an uncertain amount, the promise cannot be valued and the economic benefit theory will not apply. In *Drysdale* v. *Commissioner*, 277 F.2d 413 (7th Cir. 1960), the court refused to tax currently an amount placed in trust for an employee where the employee was required to do consulting work for, and not to compete with, his employer after he retired, in order to be eligible to receive the amounts placed in trust. While the court emphasized that these requirements prevented the taxpayer from assigning and thus currently enjoying the amounts placed in trust, a more direct conclusion would be that the requirements made the promise to pay the deferred amounts impossible to value because of the uncertainty as to whether the employee would fulfill the requirements. In general, courts have refused to value unfunded and unsecured promises by employers to pay deferred amounts to cash basis employees on the ground that the employee has no more right to the amounts from the employer, who could become insolvent prior to the time of payment, than has any general creditor. *Robinson* v. *Commissioner*, 44 T.C. 20 (1965). This refusal to apply the economic benefit theory where the employer has not secured its promise to pay occurs even when the employer takes out an insurance or annuity policy with the amounts attributable to the deferred amounts. However, where the deferred amounts are placed in escrow, in an effectively irrevocable trust, or in an insurance or annuity policy owned by the employee, the economic benefit theory will apply, absent any forfeiture provisions, because the employee has an enforceable interest which is free from competing claims of the employer's other creditors, and thus is capable of valuation. See Warner, *supra.* (Portions quoted).

C. SUMMARY

To summarize, we contend that the proposed regulations are directly contrary to established law in at least the following particulars: 1. The proposed regulations are directly contrary to Treas. Reg. § 1.451-2 which states, in part, that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions"; 2. The proposed regulations are directly contrary to established case law to the extent that they provide that income tax deferral is unavailable where the election to defer is made *prior* to the taxpayer's rendition of the services which would give rise to the compensation. In such situations, the taxpayer has no immediate right to the income in question, and possession of such right is essential to application of the doctrine of constructive receipt. See *Deupree* v. *Commissioner*, 1 T.C. 113 (1942); and 3. The proposed regulations are directly contrary to established case law to the extent that they provide that an unsecured promise to pay, subject to conditions of forfeiture, is capable of valuation and therefore taxable under the doctrine of economic benefit.

Respectfully submitted.

HENKEL & LAMON,
Pension Consultants.
CHARLES E. ELROD, Jr.
Special Counsel.
HARRY V. LAMON, Jr.
General Counsel.
STANLEY H. HACKETT,
Associate General Counsel.

STATEMENT OF ROBERT D. PARTRIDGE, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE: My name is Robert D. Partridge. I am Executive Vice President and General Manager of the National Rural Electric Cooperative Association, (NRECA) which is the National Trade Association of some 1,000 Electric cooperatives in 46 states.

Among the services offered by NRECA, are benefit programs for employees of member cooperatives. One such program provides an opportunity for our member system employees to defer a portion of their compensation until they retire. This permits the employee to spread income over a greater number of years and to thereby postpone some Federal income tax liability. Briefly the plan is as follows:

An employer (an NRECA member Cooperative) and an employee, agree to defer a portion of the employee's compensation until he or she leaves the service of the employer. The agreement is made before the employee renders the service for which compensation is deferred. The money so deferred, is held in a bookkeeping reserve to be paid out over the number of installments as agreed by the employer and employee. The money is not held in trust; and the agreement is merely an unsecured promise to pay at a later date.

The regulation proposed by the Treasury Department on February 3, 1978 (43 FR 4638), if adopted, would eliminate NRECA's Deferred Compensation Program, thereby depriving participants of the opportunity to spread their income more equitably.

Nationally, there are approximately 900 electric cooperative employees who deferred approximately one and three quarters million dollars in compensation during 1977. Although the average annual amount deferred is relatively small, $2,000 . . . management salaries in Rural Electric Cooperatives are low by private industry standards . . . the deferred compensation program is an important element in the overall financial planning of the employees. Now suddenly, without explanation, the Treasury Department has proposed a regulation which would effectively destroy this program.

The Association on behalf of its member cooperatives systems, believes that the proposed regulation should be withdrawn, because: (1) There has been no change in the law or court decisions to warrant the proposed rules. The net effect of the rule is to render deferred compensation plans, long recognized in published revenue rulings and court decisions, ineffective for the future. Such plans are expressly authorized by Revenue Ruling 60-31 and Revenue Ruling 69-650 as well as other revenue rulings and court decisions which are cited in the proposed rules and which have been on the books for over 35 years; (2) Under the proposed rule the mere promise of an employer to pay a sum of money at a future date would constitute income for Federal tax purposes. The courts have never gone so far as to hold such a promise to be income. The value of such a promise is obviously totally dependent upon the financial status of the employer and, at best, it is incapable of valuation; and (3) Congress is currently considering tax reform and if there is to be a change in the tax status of deferred compensation plans, Congress is the branch of the government to make the decision. Congress considered the problems of Deferred compensation in enacting the Tax Reform Act of 1969 and rejected proposals to change deferred compensation arrangements.

Mr. Chairman, your Subcommittee is currently considering Senate Bill S. 2627, which would clearly permit Deferred Compensation plans for units for State and Local Government. We support this bill but feel that it should not be limited to employees of state and local governments.

We respectfully urge the Subcommittee to understand that the beneficial effect of S. 2627 would be limited to employees of units of state and local government only. The proposed I.R.S. Regulations by contrast, would wipe out an entire major category of deferred compensation plans which are widely used throughout the business world as a fringe benefit for hundreds of thousands of employees. We wholeheartedly support the concept of this legislation, but we suggest that there are other categories of employees who are deserving of the deferred compensation protections embodied in S. 2627. Certainly, we include in this category the employees of non-profit electric cooperatives which we represent.

If the Subcommittee is really concerned about possible abuse of such programs, it might incorporate reasonable limitations with respect to the amount of compensation which might be so deferred.

We thank the Subcommittee for this opportunity to express our views.

OHIO PUBLIC EMPLOYEES, DEFERRED COMPENSATION PROGRAM,
Columbus, Ohio, April 7, 1978.

Re proposed regulation section 1.61-16 concerning non-qualified unfunded deferred compensation arrangements

SENATE FINANCE COMMITTEE,
Dirksen Senate Office Building,
Washington, D.C.
(Attention: Michael Stern, Staff Director).

GENTLEMEN: Enclosed please find our response to your invitation for written comments on Proposed Regulation 1.61-16 concerning nonqualified unfunded deferred compensation arrangements. Before discussing the Proposed Regulation and the plan modifications we suggest as a possible Treasury alternative to the Proposed Regulation, allow us to briefly review the more pertinent provisions and results of our Program.

On July 24, 1974, the Ohio General Assembly enacted legislation creating the Ohio Public Employees Deferred Compensation Board which was authorized to implement the Ohio Public Employees Deferred Compensation Program (the "Program") for the benefit of all Ohio public employees.

Under the Program all Ohio public employers are authorized to contract with their individual public employees for the deferral of compensation. The first Ohio public employer to offer a deferred compensation plan to its employees was the State of Ohio. The State of Ohio plan received a favorable Internal Revenue Service ruling on July 30, 1976. This favorable ruling was further expanded by the Internal Revenue Service on September 22, 1976. Subsequently, forty-one additional Ohio public employers also received favorable IRS rulings on their respective plans established under the Program, upon which they relied in implementing plans of deferred compensation for their employees.

Presently, over 10,000 Ohio public employees are participating in the Program. Eightly-one percent of these participants have incomes of less than $15,000 per year. Every employee of each employer has or will be offered an opportunity to participate in the Program. There has been no discrimination among the employees offered participation. The average participant contribution is $1,334 per year.

The deferred compensation plan agreement between each employer and its respective employees provides that the employee must agree to a deferral of compensation within thirty days from the date the Program is first offered and explained to the employee. The employees election to defer compensation is made prior to the period for which services are rendered and it is irrevocable. Prior to November 30th the employee may elect to change the amount of compensation to be deferred in the subsequent calendar year. Such amendment can only be made with respect to compensation earned after January 1st of the following calendar year. The amounts of compensation irrevocably deferred may only be received upon his retirement or other termination of employment unless a real and unforeseen financial hardship were to occur. Upon execution of the Plan, the employee specifies one of five investment indices available under the Plan. The employer is not obligated to invest the deferred amounts in the investment index specified; he is only obligated to pay the benefits as if they had been invested in such indices. Though there is no limit on the amount of compensation an employee can defer, the average deferral is, as stated, $1834 per year. All deferred amounts remain the sole property of the employer; the employee is a general creditor to the employer, having no interest in the deferred amounts. The deferred amounts are subject to all claims of the employer's creditors.

A great deal of time, effort and money has gone into the establishment of the Ohio Public Employees Deferred Compensation Program. If Proposed Regulation 1.61-16 is adopted by the Treasury, the Program will be obliterated, and the participants' contributions will cease, to the severe economic detriment of all concerned. We believe, for the reasons hereinafter stated, that the Proposed Regulation is unlawful, unreasonable, and capricious and should, therefore, not be adopted.

It is difficult to determine what legal principle or principles the Commissioner is asserting as the basis for the Proposed Regulation. The Regulation will obliterate, in one stroke, an established body of case and administrative law represented by court decisions in which the Commissioner has announced public acquiescences and numerous public and private revenue rulings issued by the Commissioner over an eighteen year period.

These decisions and rulings rested on the salutary principle that taxability, and the timing of taxability, should be determined by a rule of law rather than by exercise of human caprice and they reflected the clear intent of Congress in the enactment of Section 451 of the Internal Revenue Code that a cash basis taxpayer will not be deemed to have received income for services rendered unless and until that income is made available to him for payment. Accordingly, the rulings were that if an employer and an employee entered into a bona fide contract of employment which provided that the employee would be paid for his services in a year later than that in which the services were rendered, and if the contract was entered into before the services were rendered, the employee would be taxed in the year in which he was paid pursuant to his contract. The operative criterion was therefore a rule of law, leaving for factual determination only the question of whether a contract of employment was validly entered into and what were its terms.

In place of this workable and eminently sensible rule, based on Section 451 of the Code, the Proposed Regulation offers a substitute for which there is apparently no legal precedent or legislative support. Thus, the official statement accompanying the issuance of the proposal explains that the long series of published rulings based on contractual provisions will no longer apply and judicial precedents to the same effect, in which the Commissioner had acquiesced, will be reconsidered. The critical factor in determining when compensation becomes taxable, under the proposal will be *who instigated the idea of deferment*. If, as stated in the Proposed Regulation, payment is deferred "at the taxpayer's individual option," or if the employee "individually chooses" to have some portion of his current compensation deferred and paid in a later year, the compensation will be taxed in the earlier year, not in the year of payment. Apparently, the terms of payment fixed in the contract of employment are irrelevant or inconsequential.

Aside from the dubious legality of the new test, the proposal raises more questions than it solves. In fact, it is difficult to conceive of a more impractical or subjective guideline for the administration of a tax law; and it is safe to predict that if the proposal is adopted endless and massive problems of administration and interpretation will follow in its wake, creating difficulties far exceeding any now experienced under present rulings.

In order to bring themselves within the provisions of the Proposed Regulation, it may be expected that employees or other persons engaged in the negotiation of deferred compensation arrangements will make every effort to cast the transaction as employer motivated. Gamesmanship rather than substance will thus become the determinant of tax liability. In each such negotiation, a question of fact, hinging on the "state of mind" of the negotiating parties, will be presented for resolution by the Service or its agents in ruling on the tax consequences of the arrangement. It takes little imagination to foresee the enormous complications that will arise in making such individual determinations, without even considering the difficulties of trying to harmonize the different subjective interpretations that will undoubtedly be made by different revenue agents endeavoring to read the state of mind of individual taxpayers. These hair-splitting decisions will become even more difficult when interpreting the provisions of the Proposed Regulation which define compensation as including not only basic or regular compensation but supplements, increases and bonuses.

For example, suppose a football player is under a three-year contract calling for the payment of $100,000 per year. At the conclusion of his contract, his agent negotiates a contract calling for $450,000 for a three year term, to be paid $100,000 each year with a lump sum payment of $150,000 deferred to retirement. The question arises whether the football player is taxable on $450,000 pro-rated to each of the three years, notwithstanding that $150,000 of this amount will not be received until retirement. Who will make the determination as to the state of mind of the player's agent or of the club owners at the time the contract was negotiated?

Or take the case of a certain class of employee, say a mineworker, who is being paid $9.00 an hour for work for which the "going rate" is apparently $10.00 per hour. He negotiates a contract with a *new employer* calling for $10.00 per hour, with $9.00 to be paid currently and $1.00 to be deferred until retirement. Has such an employee received an "increase in pay"? Is he to be taxed currently on compensation of $10.00 per hour even though $1.00 of this amount is deferred, and if so, is there an economic or legal justification for such a position? We don't think so. However, under the Proposed Regulation, if the employee were to negotiate the same increase of $1.00 per hour of deferred retirement pay from his *existing employer* he would clearly be taxed currently on the total of $10.00 per hour. Is the determination of taxability to hinge on whether he receives an increase from an existing employer or a new employer?

Or assume that employee X is considering whether he should negotiate for a higher salary to be paid currently or for an additional amount to be paid on retirement. Realizing that, under the Proposed Regulation, he cannot initiate any discussion regarding deferred pay, he forms a bargaining unit, acceptable to his employer, with 20 other employees in his department. Upon a vote of the collective bargaining unit, 10 of these 20 employees, in addition to X, favor taking the increase as retirement pay and therefore such a binding contract is negotiated with the employer. When is the increase taxable to X and the other 10 employees who opted for the retirement pay? If the increase is taxable only at retirement, gamesmanship obviously has determined the timing of tax liability. An employee's individual election to defer compensation would result with the deferred amounts being currently taxable to him *only* if he could not form an effective collective bargaining unit. If the increase is taxable currently, what is the tax situation of the 10 employees who voted against the deferred pay arrangement since they desired to take the increase currently in cash? Are they to be taxed currently on income they are precluded from enjoying until retirement, by vote of a mere majority of their co-workers?

The above examples are not merely rhetorical or conjectural. They are real life situations which will arise if the Proposed Regulation is adopted and are a fair measure of its impracticality and inequity.

The materials distributed by the Treasury, both to certain individual Congressmen and at your Senate Finance Subcommittee hearing, lack any mention of the fact that under deferred compensation plans such as our Program the election to defer is made prior to the period of time during which the services are rendered. It is not therefore a case of a taxpayer "turning his back on income" much like the taxpayer who refuses to go to the bank and collect interest earned on his savings account. The two situations are not at all analogous. A participant under our Program is never confronted with a choice as to cash or as to deferred pay after he has a right to the income. The election to defer is made before the period during which the services are rendered—before the right to the income arises. It is extremely disturbing to us that this critical distinction is not made in the materials distributed by Treasury as aforementioned.

If the Proposed Regulation is issued as a Final Regulation, the Internal Revenue Service will, in our opinion, be forced to examine endless constructive receipt decisions that represent settled law and the entire application of the cash basis of accounting could be disturbed. For example, if a cash basis employee is required to treat as taxable, in the year earned, compensation that he has not yet received and does not have the right to receive until a subsequent taxable year, will a cash basis employer be permitted to deduct, in the year earned, the amount that that will not be payable to the employee for perhaps 10 or 20 years hence? What effect will this change in the concept of constructive receipt have on an installment sale under Section 453, or a tax free reorganization? The uniform application of the well established doctrine of constructive receipt will be brought into serious question if the Proposed Regulation is finalized.

The Proposed Regulation will discriminate unfairly against those taxpayers whose compensation is fixed by custom or by statue. Highly paid executives or independent contractors, principally private sector taxpayers, who are not compensated according to any fixed rate or schedule, have bargaining leverage in negotiating contracts and consequently are more apt to receive favorable contract proposals from prospective employers or payors than rank and file employees whose compensation is fixed and negotiating circumstances limited. The most common criticism of deferred compensation plans is that they favor the highly paid, and yet the Treasury now proposes a regulation that will discriminate in favor of these same highly paid employees and give them an enormous tax advantage over those less fortunately situated.

The aforementioned materials disrtibuted by Treasury indicate that Proposed Regulation 1.61–16 was prompted by the Treasury's determination that some physicians and other highly paid governmental employees, not totally dependent upon their governmental income to provide day to day living expenses, deferred up to 90 percent of their governmental income. We have also heard that certain other abuses have crept into deferred compensation plans such as an employee ceasing to defer income in the year in which the original election to defer was made; and employees withdrawing benefits from the plan prior to retirement or other termination of employment.

We concur that such abuses need to be remedied and that deferred compensation plans cannot be utilized as a device for a taxpayer to "turn his back on income" or to regulate the flow of income from one month or year to another, to suit the ever changing needs of the participant/taxpayer.

We feel, however, that these abuses can be remedied without resort to adopting a regulation that goes beyond curing the abuses to abolishing arms-length bona fide deferred compensation plans which provide state and local governmental employees a means of augmenting a modest retirement income.

Accordingly, we respectfully suggest the Treasury should consider adopting regulations which would permit the establishment of deferred compensation plans for public employees subject to the following modifications. These additional limitations would in our view remove the potential for abuses while not conflicting with the well established doctrine of constructive receipt.

(a) Election to Defer. The election to defer income must be made before income is earned and payable and be irrevocable as to amounts deferred.

(b) Revocation of Election. Once the election to defer income has been made, it cannot be revoked for two plan years.

(c) Interim Withdrawals. Once compensation is deferred it could not be withdrawn from the plan until retirement or other termination of employment. No provisions for benefits in the event of financial hardship would be available.

(d) Assignability of Benefits. No deferred amounts can be assigned or alienated by the employee under any conditions.

Finally, we would suggest that the IRS adopt a policy on deferred compensation rulings which would provide that the following limitations apply.

(a) Investment of Deferred Amounts. The employee, besides not being entitled to designate where the deferred amounts were to be invested, would also not have an option to select one or more investment indices pursuant to which benefits would be paid. The benefits would be paid to the employee pursuant to the terms of the plan agreement which would, of course, take into account the fact that the deferred amounts will earn interest throughout the deferral period.

(b) Limit on Contributions. The curent limitation on contributions to qualified plans of 25% of an employees compensation could be applied to non-qualified unfunded deferred compensation plans.

Deferred compensation plans implemented in accordance with the foregoing criteria, would eliminate the chance for abuse which the Treasury has determined exists and yet preserve the bona fide plans.

It is also most important that any plans established by public employers in reliance upon past IRS rulings be granted at least six months prior notice to allow for the orderly transition from the existing plan to that prescribed by the Internal Revenue Service.

In Summary, we believe that Proposed Regulation 1.61-16 is in direct conflict with the provisions of Section 451 of the Internal Revenue Code; that it is also at variance with the consistent administrative interpretation of Section 451 by the Service in the form of many published and private rulings that are of such long standing and consistency as themselves to have acquired the force of law; and that if adopted, the Regulation will not only run counter to this respectable and established body of law, but will also result in massive legal and administrative complications and inconsistencies.

We, therefore, respectfully submit that Proposed Regulation 1.61-16 should be withdrawn; and that the Commissioner should resume issuance of rulings in accordance with the established body of law until Congress has had sufficient time to consider this matter further.

We respectfully request that your Subcommittee and other members of Congress support this opportunity for our public employees to continue to supplement their modest retirement incomes. New 1977 retirees from our Public Employees Retirement System are to receive a modest pension averaging $4400 per year after contributing an average of nineteen years of service. This retirement income is in lieu of social security retirement benefits for which they are ineligible and which, for the same average retiree, would have been approximately $6000 per year. No other pension or tax-favored opportunity to supplement this $4400 exists for our public employees, except the Program. These facts make it painfully clear that tax incentives such as those available under our Program are required to help our public employees help themselves in planning for a reasonable retirement income.

Our Program serves as an effective means for all Ohio public employers to attract and retain energetic and dedicated public employees, including those who are better able to cope with their retirement income needs. Also, the availability of our Program tends to equalize the opportunities for tax-sheltered savings offered our public employees with those currently enjoyed by teachers under TSA plans; and by private sector employees under IRA, Keogh, Pension/Profit Sharing and other thrift plans.

Finally, the Treasury's Proposed Regulation is an usurpation of the function reserved for Congress alone. Surely, any such major change in settled tax law should result from the considerations of Congress, not as a result of an executive fiat issued by the Treasury Department.

We thank you for this opportunity to inform you of our grave concerns concerning Proposed Regulation 1.61-16.

Very truly yours,

JOSEPH M. MOLLMANN,
Administrator.

INTERNATIONAL BUSINESS MACHINES CORP.,
Armonk, N.Y., April 4, 1978.

Re hearings of Subcommittee on Private Pension Plans and Employee Fringe Benefits.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Bldg., Washington, D.C.

DEAR MR. STERN: In connection with the referenced hearings, and in particular in connection with the subject of deferral from income of amounts payable under non-qualified deferred compensation plans, I enclose a copy of a letter of comment submitted by IBM to the Internal Revenue Service on its proposed regulations as published in the February 3 Federal Register, 43 F.R. 4638. We respectfully request that this letter be made part of the hearing record for consideration by the Subcommittee.

Very truly yours,

E. T. BUHL,
Corporate Counsel.

Enclosure.

INTERNATIONAL BUSINESS MACHINES CORP.,
Armonk, N.Y., April 3, 1978.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.
(Attention: CC:LR:T (LR-194-77)).

DEAR SIR: International Business Machines Corporation (IBM) submits these comments on proposed regulations relating to deferred compensation published in the Federal Register on February 3, 1978, 43 F.R. 4638. For the reasons set forth, we believe the proposals are ill-conceived and should be withdrawn.

We understand that these proposed regulations were originally conceived to address deferred compensation plans instituted primarily for state and local government employees. As written, however, the proposals would appear to encompass virtually all private deferred compensation plans containing any type of optional deferral feature.

Deferred compensation plans have long been an integral part of the total compensation and benefits programs provided by private industry. The tax treatment of such plans, including voluntary deferral features, has been well established by case law and IRS rulings and confirmed and approved by Congressional action. Companies have relied on this well-established law in designing these plans, and their employees have relied on it in their financial and estate planning. For the IRS to now propose to change this well-established law by the simple expedient of a regulation appears to us to be clearly improper. If any change in the law is warranted—and it is not at all clear to us that such is the case—the only proper way is through legislation by Congress after a thorough review of the proposals and their probable effect.

IBM has long had a series of deferred compensation plans for its key employees. IBM's present plan, known as the IBM Variable Compensation Plan ("the Plan"), is typical in many respects of the plans found throughout private industry. Eligible participants include key corporate and division executives whose responsibilities and decisions are critical to the performance of the total corporation and of its major business units. Awards under the Plan, which are in addition to a fixed salary, are made at the end of each year based on the performance of the total corporation, business unit, or individual during the year. In addition, special awards under the Plan may be made to any employee for outstanding contributions to the business. As a rule, awards are payable in three equal annual installments beginning in the year following the year for which the award is made ("mandatory deferral period") provided the employee remains employed by IBM throughout this period.

The Plan also contains a voluntary deferral feature, which permits an employee who is the recipient of an award to defer any installment to a later date certain or until retirement, at which time the employee may specify when the payments are to be made following retirement. Any amounts thus deferred remain subject to the forfeiture provision; i.e., the employee must remain employed by IBM throughout the deferral period, or, if he or she retires, must agree thereafter to render advisory or consultative services as requested and avoid entering competitive employment. A deferral election must be made no later than November 30 of the year prior to the year in which payment would otherwise have been made, or prior to retirement in the case of amounts deferred to retirement.

In preparing this Plan, IBM relied on the well-established law in this area, particularly Rev. Rul. 60-31, Rev. Rul. 67-449, and Rev. Proc. 71-19, all of which would now be nullified by the unilateral act of the IRS.

The IRS proposals seem not to recognize that there are valid business reasons for including a voluntary deferral feature in a plan such as this, quite apart from any tax benefits that may or may not deserve reconsideration.

For example:

1. Plans such as IBM's typically contain an incentive feature, i.e., awards are based on annual performance measurements, whether corporate, divisional or individual. Because the measurements may vary greatly from year to year, wide swings in compensation may occur. Such swings are most pronounced and unpredictable in certain industries (e.g., automotive) where awards are based directly on profits and where revenues are most susceptible to factors affecting consumer spending. Voluntary deferral offers one way for the employee to achieve some degree of income leveling and predictability.

2. Any deferral, whether mandatory or voluntary, puts the award payments at

risk, i.e., subject to forfeiture if the employee leaves IBM. The company is thereby assured the continued services of valued employees, which is one of the major purposes of deferred compensation plans. To the extent that voluntary deferral is elected by the employee, this "holding power" benefit to the corporation is maximized by being extended beyond the initial period of mandatory deferral to cover the entire period of voluntary deferral. The added benefit to the Corporation is thus directly proportional to the period of added deferral. Under the proposed regulations, in order to achieve this same "holding power" potential, the Plan would have to require a longer mandatory deferral period, which would deny needed flexibility to those employees having greater present cash needs.

3. Because it offers added benefit to the Corporation, the voluntary deferral feature is also a favorable feature from a stockholder viewpoint. The interest of stockholders in retaining key employees is equal to that of the Corporation. Most large publicly held corporations submit these plans to stockholders for approval—IBM did so in 1973—and the plan deescription in the proxy statement, as required by SEC rules, would include the material features of the plan, including the voluntary deferral feature. It is likely, therefore, that this feature would have been a favorable factor in securing stockholder approval.

If the proposed regulations were adopted, these non-tax benefits would be virtually eliminated. Few if any employees would elect voluntary deferral since any such election would require the employee to pay tax immediately on an amount which would not be received until much later, if at all, considering the risk of forfeiture.

Treasury officials have stated publicly that deferred compensation plans such as these do not respect the principle of nondiscrimination, and therefore must be penalized. The argument is specious. There is no universal principle demanding that all compensation plans must be nondiscriminatory, particularly where no extraordinary tax benefit is sought. The fact that ERISA specifically exempted excess benefit plans for executives is ample evidence of Congressional recognition of this fact. Certain plans, e.g., qualified retirement plans, enjoy special tax benefits, such as immediate deductibility for the employer despite postponement of taxation to the employee, for which an assurance of nondiscrimination is extracted. Unfunded deferred compensation plans enjoy no such privilege. They seek merely to grant the employee a degree of flexibility, for which the employer *foregoes* a current tax deduction. Moreover, since IBM's Plan, and most other industry plans, provide for compensation over and above base salary (see, e.g., enclosed pages from IBM's 1978 proxy statement), there is little or no opportunity afforded for abuse, such as deferral of 100% of compensation. Finally, there is little or no revenue loss to the Treasury from permitting voluntary deferral since deferred compensation is now subject to the maximum tax by virtue of the 1976 Tax Reform Act, and since, by accelerating the imposition of tax on the employee, the proposals would also accelerate the corporation's offsetting tax deduction.

The foregoing discussion suggests the hazards for business which the proposals present. We can only guess at the impact on the financial and estate plans of all those individuals employed in private industry who have relied on the established law in this area. This is an area where stability, indeed permanence, is desirable. It is not a fitting subject for will-o'-the-wisp tax policy, the more so since the changes will not, could not, produce any significant revenue for the Federal Government.

For the foregoing reasons, we strongly urge IRS to withdraw the proposals. If IRS nevertheless insists that some change in the law in this area is warranted, it should propose specific legislative measures to Congress which can then consider them in the broader context of all forms of deferred compensation.

Very truly yours,

E. T. BUHL,
Corporate Counsel.

Enclosure.

REMUNERATION FOR THE YEAR 1977

Name and position held	Salary and fees	Variable compensation plan awards: Cash	Variable compensation plan awards: Shares of restricted stock[1]	Estimated annual retirement benefit
Frank T. Cary, chairman of the board	$332,500	$337,345	500	$120,000
John R. Opel, president	237,500	251,750	400	120,000
George B. Beitzel, senior vice president	172,500	191,330	300	120,000
Paul J. Rizzo, senior vice president	172,500	186,295	300	120,000
Nicholas deB. Katzenbach, vice president and general counsel	176,667	120,840	300	51,675
64 directors and officers as a group (including the above)	7,011,344	3,099,622	5,350	

[1] For 1976 performance, stock awards shown above in shares were made in 1977 by the Executive Compensation Committee of the board of directors to 20 officers. These stock awards which are restricted from being sold, transferred, or assigned until mandatory retirement, were in addition to previously reported awards for 1976. The aggregate value of these stock awards, in the amount of $1,370,292, has been charged against the available 1976 variable compensation fund. Total awards for 1976, including the value of the stock awards, was $6,345,339. The total fund available was $18,847,740.

VARIABLE COMPENSATION PLAN

Under the IBM Variable Compensation Plan adopted by stockholders, certain executives, designated as participants by the Executive Compensation Committee of the Board of Directors, are eligible to receive, in addition to a fixed salary, annual awards based upon their performance and that of the company as a whole or a business unit thereof. Special supplemental awards for extraordinary achievement may be made to any employee. The Executive Compensation Committee is composed of directors who are not eligible to participate in this plan. Awards may be in cash, capital stock of the Corporation, or both. The awards in aggregate may not exceed 1.5% of the Corporation's adjusted net earnings (i.e., consolidated net earnings after taxes less 10% of stockholders' equity at the end of the preceding year) for the year with respect to which awards are made. For this purpose shares of stock awarded are valued at the average closing price on the New York Stock Exchange for the 30 calendar days prior to the award date.

Cash awards are payable in annual installments over a period not exceeding five years, beginning in the year following the year for which the award is made; or, the executive may irrevocably defer payments to later years, to be paid with interest, currently at 5% compounded annually. Stock awards may be restricted against sale for varying periods. Payment of unpaid amounts, whether cash or stock, is subject to the proviso that the executive remain with IBM or, upon retirement, render consulting services to the Corporation and not enter the employ of a competitor.

The amounts shown in the Variable Compensation Plan Awards cash column in the preceding table, are awards made with respect to 1977. The aggregate amount of such awards was $4,981,477. The limitation of the fund available for 1977 awards is $21,667,281. Additional awards in the form of capital stock, which have not been determined at the date hereof, may be made later in 1978.

The aggregate compensation earned under the Variable Compensation Plan for the five years, 1973 through 1977, by the following persons was: Mr. Cary, $1,389,323 and 700 shares; Mr. Opel, $979,935 and 600 shares; Mr. Beitzel, $760,050 and 500 shares; Mr. Rizzo, $719,460 and 500 shares; Mr. Katzenbach, $575,900 and 500 shares; by present directors and officers as a group, $12,632,352 and 7,000 shares; and by all participants as a group, $20,763,148 and 8,150 shares.

Some company subsidiaries and divisional units also have incentive compensation plans under which certain executives are eligible to receive, in additon to a fixed salary, annual awards based upon performance. The total amounts awarded under these plans were approximately the following: 1973, $2.4 million; 1974, $2.9 million; 1975, $3.5 million; 1976, $2.2 million; 1977, $3.0 million.

RETIREMENT PLAN

The Corporation has had a formal Retirement Plan for U.S. employees since 1945, which has been amended from time to time. The Plan, under which benefits normally begin at age 65, is noncontributory by the employee and the company's contributions are not allocated to the account of any particular employee. The Plan provides benefits based on service and earnings with a reduction in the benefit formula for employees electing early retirement from age 55 through 59.

Officers participate in the Plan on the same basis as the approximately 178,000 other employees of the Corporation and its domestic subsidiaries who are covered by the Plan, which is a qualified plan under the Internal Revenue Code. However, officers are required to retire upon reaching age 60. The maximum annual retirement benefit to any employee is $120,000. To the extent that retirement income exceeds the limit established by the Employee Retirement Income Security Act for payments from qualified trust funds, the difference will be paid from the general operating funds of the Corporation.

SAFFER & ASSOCIATES, INC.,
Phoenix, Ariz., March 29, 1978.

Re: Hearings on S. 1587 and on the deferral from income of certain amounts deferred under non-qualified deferred compensation plans; and, Tax Reform Proposals

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As a member of The National Association of Pension Consultants and Administrators, Inc., The American College of Life Underwriters and The National Association of Life Underwriters, I am in complete accord with the stand adopted by The National Association of Pension Consultants and Administrators, Inc., as defined in their letter to you dated March 13, 1978 (copy attached).

I urge you to give full consideration to these issues, as put forth in that letter, and the letter from NAPCA to the Honorable Al Ullman, Chairman of the Ways and Means Committee on Tax Reform Proposals (copy enclosed).

Yours truly,

RONALD G. SAFFER, CLU,
President.

Enclosure.

THE NATIONAL ASSOCIATION OF PENSION CONSULTANTS AND ADMINISTRATORS, INC.,
Atlanta, Ga., March 13, 1978.

Re: Hearings on S. 1587 and on the deferral from income of certain amounts deferred under nonqualified deferred compensation plans

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: In Press Release #15, Senator Bentsen announced the captioned hearings and solicited comments from the public. These comments are submitted with respect to Proposed Treasury Regulations § 1.61-16 which were published in the Federal Register on February 3, 1978, and which relate to the taxation of non-qualified deferred compensation arrangements.

The attached comments are submitted on behalf of the National Association of Pension Consultants and Administrators, Inc. (NAPCA). We request that these comments be made part of the hearing record and that they receive the careful consideration of the Committee and its staff. We further request the Committee, in the exercise of its general oversight function regarding the Department of Treasury and the Internal Revenue Service, to urge the Department and the Service to withdraw the proposed regulations or, in the alternative, to take appropriate action to prohibit their publication.

Respectfully submitted,

STANLEY H. HACKETT,
Associate General Counsel.

STATEMENT OF THE NATIONAL ASSOCIATION OF PENSION CONSULTANTS AND ADMINISTRATORS, INC. (NAPCA), REGARDING PROPOSED TREASURY REGULATION; SECTION 1.61-16 PRESENTED TO SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS, COMMITTEE ON FINANCE, UNITED STATES SENATE, MARCH 15, 1978

NAPCA is a national organization of consultants and administrators of employee benefit plans of all types. NAPCA's members provide administrative and advisory services to literally thousands of plan sponsors and employee benefit plans. Most clients of NAPCA's members are small businesses and small plans. NAPCA's members frequently advise and assist with the installation and administration of non-qualified deferred compensation arrangements of the type considered in the proposed regulation.

NAPCA strongly objects to the proposed regulation and urges that it be withdrawn. NAPCA's objection is based on policy as well as legal grounds. With respect to policy, NAPCA submits that in this period of increasing concern over the availability of adequate provision for retirement, it is sound tax policy to encourage all taxpayers to provide for income in their retirement years, and that actions should not be taken to discourage such provision. Furthermore, NAPCA submits that if any changes are to be made with respect to non-qualified deferred compensation arrangements, such changes should be made only after a careful and comprehensive study of the impact of such changes on the entire retirement sector. With respect to legality, NAPCA submits that the proposed regulation is so broadly drafted that it would deny tax deferral, in a number of situations, in direct conflict with long-established case law.

OBJECTIONS ON POLICY GROUNDS

a. Premature to act prior to study

It is premature to fundamentally revise rules relating to non-qualified deferred compensation at a time when the entire area of employee benefit plans, both public and private, is scheduled for, and is in dire need of, a thorough re-examination. In recent months a plethora of proposed rules, regulations, legislation and policy statements in the employee plan area have been issued on an *ad hoc* basis by the Administration and the Congress. Many of these propose very fundamental changes in law and policy. However, it would appear that *no one* has examined the relationship of these proposals to one another or to the whole area of private qualified plans, private non-qualified plans, public plans and Social Security. We contend that such an examination is sorely needed prior to any further changes.

The 1977 Social Security legislation provided for the establishment of a National Commission on Social Security which is charged, among other matters, with examining certain relationships of qualified plans with Social Security. The recently announced (and funded) Presidential Retirement Commission will examine the relationship of private and public plans with Social Security. The Congress is in the midst of hearings relating to Social Security and private plans and will shortly begin hearings relating to public plans. Legislation in both Houses of Congress (S. 1587; H.R. 10746) has been introduced which would require withdrawal of the subject proposed regulations as they relate to public employees. It is clear that the entire retirement and employee benefit sector is in a state of flux and is to be the subject of extensive study.

We contend that any fundamental change in rules and regulations relating to employee and retirement plans in general, and specifically the proposed regulation relating to deferred compensation arrangements, must be postponed until the Administration, the Congress and the public have had the benefit of the recommendations of the various study commissions, and until the direction of this Country's policy relating to such plans has been determined.

b. Administrative difficulty of enforcement

The proposed regulation would be administratively difficult to monitor and enforce. The key inquiry of whether the deferral of income receipt was made at the taxpayer's individual option or was mandated by the employer would be vulnerable not only to abuse, but to honest differences of opinion and interpretation. The proposed regulation could well encourage contrived negotiations and documentation in an effort to literally comply with their requirements, and it would be extremely difficult to distinguish such contrived situations from legitimate ones.

c. Discrimination against self-employed and small business

In focusing on the exercise of *individual* taxpayer option, the proposed regulation would discriminate against the self-employed and individual taxpayer-employees who were not in a position to bargain collectively. As a practical matter, such individuals would simply be unable to participate in non-qualified deferred compensation arrangements. Small businesses would similarly have great difficulty in establishing such arrangements for key personnel due to questions of *de facto* control. For example, it would appear that under the proposed regulation, a stockholder or officer of a small, closely held corporation could never negotiate a non-qualified retirement arrangement. The inability to do this would severely disrupt orderly retirement and transition to younger owners and managers.

On the other hand, mandatory arrangements in non-closely-held corporations would be permitted, since no individual taxpayer would have sufficient control to make a "tainted" election. Mandatory collectively-bargained arrangements would similarly avoid "tainted" individual elections.

OBJECTIONS ON LEGAL GROUNDS

The proposed regulation would not restate or clarify the existing law regarding taxation of deferred compensation. Rather, the proposed regulation would extend substantially beyond long-established law.

We find it highly pertinent that the specific basis of the proposed regulation is not stated. Rather, the preamble simply cites cases and revenue rulings of longstanding, which the Service now deems incorrect. Publication of the proposed regulation under Section 61 of the Internal Revenue Code is, in our view, indicative of the Service's difficulty in locating authority for its position.

Section 61 properly relates to the definition of income, not to the taxable year of inclusion in income. No one denies that compensation, deferred or otherwise, is income. However, we contend that the proper year of inclusion must be determined under applicable law, and that there is no law, statutory or court-related, which justifies the broad scope of the proposed regulation.

The basic statutory provision for the proper year of inclusion is Section 451, which basically provides that an item of income shall be included in income "for the taxable year in which received by the taxpayer", unless the particular method of accounting used by the taxpayer requires inclusion in a different period. Taxpayers using the cash method of accounting are thus not required to include an item in income until the item is received, either actually or constructively. Treas. Reg. § 1.451-2 specifically provides that "income is not constructively received if the taxpayer's control of its receipt is subject to substatial limitations or restrictions". The doctrine of constructive receipt has been part of the Treasury Regulations for a substantial number of years and under the theory of leigslative re-enactment, should not be altered by administrative fiat, but only by legislation.

Section 83, which deals with the proper year of inclusion of property transferred in connection with the performance of services, has been specifically construed by the Service *not* to apply to "an unfunded and unsecured promise to pay deferred compensation". Prop. Treas. Reg. § 1.83-3(e). The statutory language and the legislative history of Section 83 fully support this interpretation.

Indeed, the fact that Congress found it necessary to deal with restricted property transfers by legislation in the form of Section 83 is convincing evidence that the Internal Revenue Service lacks the requisite statutory authority to deal administratively with other non-qualified deferred compensation arrangements in the manner contemplated by the proposed regulation. In other words, if the Internal Revenue Service has the present authority to issue the proposed regulations, then Section 83 was not needed to deal with restricted property transfers.

It is our view, that there are but two theories on which the Service could base its position in the proposed regulation: the often overlapping theories of constructive receipt and economic benefit. However, the proposed regulation would go far beyond either of these theories.

a. Constructive Receipt

As a general matter, the Internal Revenue Service has attempted to tax currently amounts which, while not actually received, were "made available" to the taxpayer without "substantial restrictions". As interpreted by the courts, this constructive receipt takes place only where (1) the taxpayer is immediately entitled to the item of income, (2) the item is immediately available to the taxpayer, and (3) the taxpayer's failure to receive the item is due to his or her own volition. Thus, for example, in *Deuper* v. *Commissioner*, 1 T.C. 113 (1942), the Service successfully invoked the doctrine to tax currently the president of a company on amounts he directed the company to pay into an annuity in lieu of having the amount paid directly to him as a bonus, as he was entitled under his employment contract. On the other hand, the Service has not been successful in situations where the amount deferred was uncertain or was not immediately available to the taxpayer, or where receipt was subject to certain conditions. For example, in *Viet* v. *Commissioner*, 8 T.C. 809 (1947), taxpayer, in November 1940, was able to persuade his employer to defer from 1941 to 1942 payment of 1940 profit shares due for services rendered throughout 1940. The Court rejected the Commissioner's contention that the profit share was constructively received in 1941, noting that at the time of deferral, the taxpayer's profit share was uncertain and thus the agreement to defer was not a mere sham. In a second case involving the same taxpayer, *Veit* v. *Commissioner*, 8 T.C.M. 919 (1949), the taxpayer, in December 1941, arranged with his now former employer to have his now determinable 1940 profit share paid in equal installments from 1942–45, rather than all in 1942. The court rejected the Commissioner's argument that the entire profit share should be included in gross income for 1942, noting that the deferral agreement was entered into at the behest of the employer prior to the time the first 1942 installment was due. Thus, the profit share was not immediately available to the taxpayer at the time of this second deferral. Nor was the Service successful in invoking the constructive receipt doctrine where the employee had to meet certain conditions in order to obtain the deferred benefits. In *Hall* v. *Commissioner*, 15 T.C.' (1950), aff'd. 194. F.2d 538 (9th Cir. 1952), a corporate promoter was held taxable on the value of stock when he received the shares and not when he signed a contract entitling him to the shares upon completion of services for the corporation over a two year period. The court noted that if the promoter had not performed the contract services, he would have forfeited the stock. See also, *Oates* v. *Commissioner*, 18 T.C. 570 (1952). To summarize these cases, the doctrine of constructive receipt applies *only* where the taxpayer in fact turns his back on available income currently due to him. See Warner, "The IRS Freeze on Deferred Compensation Rulings—Prospects for the Future", *The Compensation Planning Journal*, January, 1978. (Portions quoted).

b. Economic Benefit

In *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945), the Supreme Court stated that taxable income may include "any economic or financial benefit conferred on the employee as compensation, whatever the form or more". The Service has relied on this theory in attempting to tax currently earnings which employers have agreed to defer until later years on the theory that the unqualified promise of a solvent employer, if capable of being valued, is a current economic benefit to the employee. Unlike the constructive receipt theory, whereby the entire amount deferred is includible in gross income as being effectively under the taxpayer's dominion, the economic benefit theory provides only that the present value of the employer's promise to pay be includible in income. The key factor in determining whether the economic benefit doctrine can be invoked is that of valuatios. Where the employer's promise is to pay an uncertain amount, the promise cannot be valued and the economic benefit theory will not apply. In *Drysdale* v. *Commissioner*, 277 F.2d 413 (7th Cir. 1960), the court refused to tax currently an amount placed in trust for an employee where the employee was required to do consulting work for, and not to compete with, his employer after he retired, in order to be eligible to receive the amounts placed in trust. While the court emphasized that these requirements prevented the taxpayer from assigning and thus currently enjoying the amounts placed in trust, a more direct conclusion would be that the requirements made the promise to pay the deferred amounts impossible to value because of the uncertainty as to whether the employee would fulfill the requirements. In general, courts have refused to value unfunded and unsecured promises by employers to pay deferred amounts to cash basis employees on the ground that the employee has no more right to the amounts from the employer, who could become insolvent prior to the time of payment, than has any general creditor. *Robinson* v. *Commissioner*, 44 T.C. 20 (1965). This refusal to apply the economic benefit theory where the employer has not secured its promise to pay occurs even when the employer takes out an insurance or annuity policy with the amounts attributable to the deferred amounts. However, where the deferred amounts are placed in escrow, in an effectively irrevocable trust, or in an insurance or annuity policy owned by the employee, the economic benefit theory will apply, absent any forfeiture provisions, because the employee has an enforceable interest which is free from competing claims of the employer's other creditors, and thus is capable of valuation. See Warner, supra. (Portions quoted).

c. Summary

To summarize, we contend that the proposed regulations are directly contrary to established law in at least the following particulars:

1. The proposed regulations are directly contrary to Treas. Reg. § 1.451–2 which states, in part, that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions".

2. The proposed regulations are directly contrary to established case law to the extent that they provide that income tax deferral is unavailable where the election to defer is made *prior* to the taxpayer's rendition of the services which would give rise to the compensation. In such situations, the taxpayer has no immediate right to the income in question, and possession of such right is essential to application of the doctrine of constructive receipt. See *Deupree v. Commissioner*, 1 T.C. 113 (1942).

3. The proposed regulations are directly contrary to established case law to the extent that they provide that an unsecured promise to pay, subject to conditions of forfeiture, is capable of valuation and therefore taxable under the doctrine of economic benefit.

Respectfully submitted,

HENKEL & LAMON, P.C.,
CHALES E. ELROD, Jr.,
Special Counsel.
HARRY V. LAMON, Jr.,
General Counsel.
STANLEY H. HACKETT,
Associate General Counsel.

HENKEL & LAMON, P.C.,
Atlanta, Ga., March 2, 1978.

Re: Tax Reform Proposals.

Hon. AL ULLMAN,
Chairman, Ways and Means Committee, U.S. House of Representatives, Washington, D.C.

DEAR MR. ULLMAN: The Ways and Means Committee recently requested comments from the public with respect to the Administration's proposals for tax reduction and tax reform.

These comments are submitted on behalf of the National Association of Pension Consultants and Administrators, Inc. (NAPCA). We request that these comments be inserted in the hearing record and receive the Committee's most careful deliberation.

NAPCA is a national organization of consultants and administrators of employee benefit plans. NAPCA's members provide administrative and advisory services to literally thousands of plan sponsors and employee benefit plans of all types, including qualified and non-qualified pension plans, and welfare plans. Most clients of NAPCA's members are small businesses and small plans.

NAPCA strongly objects to the Administration proposal relating (1) to integration of qualified retirement plans with Social Security and (2) to employee welfare benefit plans.

1. INTEGRATION OF QUALIFIED RETIREMENT PLANS WITH SOCIAL SECURITY

The Administration has proposed to replace the present integration rules with new rules designed to prevent "unfair discrimination" in favor of highly paid employees. The Administration apparently has given little thought to the basic justification for integration or to the long-term implications of its proposal.

(a) Contrary to the assertion of the Administration, integration does not "unfairly discriminate" in favor of the higher paid. Integration is a fair and practical response to the basic fact that lower paid workers have more of their salary replaced on retirement by Social Security than do higher paid workers. Furthermore, under present law, Social Security benefits to the lower paid vis-a-vis the higher paid are programmed to become even more disproportional than present to the amounts paid in by the employer and the worker. As Social Security taxes and benefits increase, integration becomes even more justified and, in fact, essential, to preserve even a semblance of fairness in the system.

(b) In our opinion, it is not desirable to enact a major structural change in pension laws so soon after the adoption of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA has required virtually all employee pension benefit plans to be substantially redesigned. This involves not only redrafting the plan, and submitting for agency approval, but also preparing new summary plan descriptions and other required disclosure material, and establishing appropriate administrative procedures and programs. Sponsors of prototype and master plans which depend on master and prototype plans are still awaiting approval by to the revisions. Plans are still in the process of making these adjustments to the new law and are still feeling the burdens and costs involved. In fact, many plans which depend on master and prototype plans are still awaiting approval by the Internal Revenue Service of the amendments that are required to conform to ERISA and, accordingly, still face the heavy burdens of preparing new plan documents and descriptions. To impose another substantial structural change on pension plans in the form of a fundamental revision of the integration rules would require many plans and companies to go through this upheaval again. The inevitable result would be to retard the development of pension plans at a time when they are already under strain. Additional terminations could well follow. It has been reported that in the last three years, more than 34,000 private pension plans have been terminated, mostly by small and medium-sized businesses. We believe that a particular concern must be the impact of any modified integration rules on existing small plans, and on creation of new small plans.

(c) In our opinion, it is premature to fundamentally revise the integration rules at a time when the entire public and private retirement system is scheduled for a thorough reexamination which will include the relationship between private pension plans and Social Security.

The 1977 Social Security legislation provided for the establishment of a bipartisan National Commission on Social Security which, among other things, is specifically charged with examining the integration of the Social Security system with private retirement programs. Furthermore, at the time ERISA was passed, a study was authorized to examine integration. Neither study has yet been completed. The new Presidential Retirement Commission and the Social Security Advisory Council are also charged with the responsibility of examining the relationship between private pension plans and Social Security. Moreover, based on the public outcry of recent months, it appears likely that the Congress will re-examine the financing of Social Security in the near future.

Accordingly, we strongly urge the Congress to defer any changes in the integration rules until all concerned have had the benefit of the recommendations of the various commissions and until the intentions of the Administration and the Congress with regard to the broader issues involving private plans and Social Security become clearer. To act now involves the serious danger of acting without the necessary information to even speculate as to the long-term effects of the proposal.

2. EMPLOYEE WELFARE BENEFIT PLANS

The President's tax reform proposals contain a requirement that, in order to continue to qualify for the current tax treatment, group life and health insurance plans must be written on a nondiscriminatory basis in terms of both participation in the plan and benefits provided under the plan. The proposal also contains a severe limitation on benefits for shareholder employees.

Consideration of this proposal should also be deferred for further study. Specifically, a whole new and inevitably complex nondiscrimination structure should not be imposed on plans until the specific problem areas have been identified and the rules tailored to meet them. Moreover, careful consideration must be given to the impact of such new requirements on the growth of life and health insurance coverage.

Respectfully submitted,

HARRY V. LAMON, Jr.,
General Counsel.
STANLEY H. HACKETT,
Associate General Counsel.

OREGON PUBLIC EMPLOYEES RETIREMENT SYSTEM,
Portland, Oreg., March 27, 1978.

MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

REQUEST FOR PUBLIC HEARINGS

GENTLEMEN: As suggested in the Federal Register, Vol. 43, No. 29, Friday, February 10, 1978, the Oregon Public Employes Retirement System requests that public hearings be held in the matter of the promulgation of rules which would require the filing of annual ERISA 5500 reports by this fund and all other public retirement trusts in the United States.

COMMENTS

It is almost unbelievable in the face of the recently published House Pension Task Force report on public systems, imminent Congressional public fund legislation and hearings recently held on S. 1587 and H.R. 9118, that the Treasury Department would, at this time, seek to interject itself into this area through the publication of questionable administrative rules. We have always contended that Congress never intended disclosure by public systems under present ERISA 5500 forms, and circumventing that intent by administrative rules appears to usurp Constitutional legislated authority. We request that the proposals either be totally withdrawn or clearly made more limited and specific.

This public system has a statewide consolidated membership of over 100,000 (police, fire, school, academic and general service employees). Our annual budget is approximately $1½ million; includes a substantial information and retirement counseling program and audit, as well as investment and fiduciary responsibility controlled by state legislation. The current economic actuarial assumptions adopted by the Board include a salary inflator percentage of 5% and a 7% assumed interest rate. We feel that we are fiduciarily responsible in the handling of our investment portfolio of $1.2 billion. Our employer contribution rates (the current rate is 7.6% of payroll) will be increased over a four-year period, with the ultimate employer rate on July 1, 1981 scheduled to be 11.44% for the state categories and 13.06% for school districts. A 30-year amortization period is used and the supplemental present value to be funded on a termination basis is less than 2½ years of continuing contributions at the current level. Simply stated, our reserve assets versus liabilities for current service on a 30-year amortization basis places us in a position of being over 100% funded.

As we read the proposed regulations, the Department, through the Secretary, would now have this well administered, funded and invested trust treated as an unfunded pay-as-you-go, non-public system administered by a controlled, in-house board who invest all funds in company stocks and bonds and operates in a totally private market. The proposed regulations would suggest that the public governmental funds of the 50 states and their political subdivisions be as involved in the disclosure/fiduciary/funding/insurance process as this non-comparable corporate entity. The comparison is so apparent and ludicrous it almost denies comment.

SUGGESTIONS

We urge you to regress from administrative rule action and leave Congress, through S. 1587 and H.R. 9118 and imminent PERISA legislation and hearings, to resolve any ambiguities.

If, however, you must act, then clearly restrict disclosure responsibility for the public funds to no more than your recent demands. This we could live with in any interim period.

As is quite apparent, most of the queries and the general format of the present 5500 forms and attached schedules are simply not appropriate for the governmental plans. On top of this obvious fault, your new proposed rules would not even allow the Secretary the right to waive any section of the form which was not pertinent. Clearly, if ever the form is absolutely required of public entities, it should be drastically altered to conform to the funds' abilities to respond in a reasonable, prompt and meaningful manner, at a minimal expenditure of income.

We would also hope that if hearings are to be conducted that they not be held only in Washington, D.C., but at least in the major geographic areas of the U.S. (including the Northwest). This would keep our unbudgeted out-of-state travel costs to a minimum. Most of the public systems, as ours, operate on investment income and *all* administrative costs are directly deductible from portfolio reserves and are only authorized by our legislature biennially.

Respectfully submitted,

JAMES L. MCGOFFIN,
Director.

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