MISCELLANEOUS PENSION BILLS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 209, S. 511, S. 989, S. 1089, S. 1090, S. 1091, S. 1092, S. 1240, and S. 1958

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CONTENTS

PUBLIC WITNESSES—Continued

COMMUNICATIONS

ADDITIONAL INFORMATION

MISCELLANEOUS PENSION BILLS

WEDNESDAY, DECEMBER 5, 1979

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, at 2:30 p.m., pursuant to call, in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Bentsen and Matsunaga.

Senator BENTSEN. The subcommittee will come to order.

Because of the great number of witnesses who have asked to be heard, and the limitations that we have this late in the session, we have had to put a rather severe limitation on your oral presentation. Your written presentation will be put in the record in its entirety.

Mr. Allen, if you would proceed, please.

STATEMENT OF EDDIE ALLEN, NATIONAL ASSOCIATION FOR EMPLOYEE BENEFITS

Mr. ALLEN. I am Mr. Allen, president of the National Association for Employee Benefits. I would like to thank you for appearing before this subcommittee. My associate, Harry Lister, chairman of the Pension Committee of the Investment Company Institute, is also with me.

My issue with S. 511, and in being in favor of S. 511 is for the benefit of tax exempt organizations to be competitive with State and local governments, rather than tax-exempt organizations to be competitive with private institutions.

Prior to ERISA, the Internal Revenue Service did issue many rulings, at least 100 rulings for our corporation alone, on behalf of clients on a broad base for all employees, rank and file, for unfunded, nonqualified deferred compensation. There was no clause that eliminated highly compensated employees from the rank and file.

The Revenue Act of 1978, and ERISA complicated the issue of tax-exempt organizations in the following manner. ERISA stated that unfunded, nonqualified deferred compensation was primarily for a select group of highly compensated employees or managers. The 1978 Revenue Act eliminated tax-exempt organizations from being covered.

Today, the Treasury is trying to end unfunded deferred compensation for tax-exempt organizations.

The truth about tax-exempt organizations, in my mind anyway, is the following: Many of these organizations cover rank and file in the following manner, and rank and file as much as the highly compensated.

When an employee has been working—I will give you 17 Archdiocese in the Catholic Church—for the archdiocese as a teacher, and the majority of tax exempt are teachers, they do not have a pension plan, the majority of them, so if the teacher has worked for 20 or 30 years, or if a nurse has worked 20 or 30 years, they compensate her in retirement by saying: "We will pay you, $5,000, $6,000, or $7,000 a year, or whatever it is, in retirement."

That is an unfunded liability, and it occurs all over the United States for the 10 major foundations in America.

The unfunded deferred compensation may benefit more critically the highly compensated, but in your State alone there are seven foundations.

There is a boys' home in Amarillo, Tex., that uses this heavily. If they were not able to get houseparents for $10,000, $11,000, or $12,000 a year and tell them that at 65 years old they would benefit them in a discriminatory manner over those who don't stay as long, which you cannot do in a qualified plan, and you cannot do with 403(b), they would not have these housemothers and housefathers. The same thing holds true with the Boys Towns, the Youth Cities of America in California, and on and on.

In Senator Matsunaga's State of Hawaii, there are three such organizations that do exactly the same thing. They benefit employees in retirement. That cannot be done in a discriminatory manner in a qualified plan nor a 403(b).

Further 403(b) does not cover independent contractors, which so many of these tax exempt organizations use.

Lastly, my bottom line to why we want this program, it is to modify the program of S. 511 and bring a more realistic deferral amount. We are not satisfied with the $7,500 limit. We are more interested in a limit closer to the 403(b) limits for deferred compensation, to avoid the utterly confusing formulas that salesmen have to perpetrate on their clients with 403(b). Make it a simple 25 percent of gross.

We are also in favor of modifying S. 511 to include this, and have a rollover provision from the previous 60–31 laws to the current deferred compensation laws under the 1978 Revenue Act.

Thank you.

Senator Bentsen. You make some very interesting points. I look forward to seeing some more of your testimony.

You have extended testimony you are putting in the record, do you not?

Mr. Allen. Yes.

[The prepared statement of Mr. Allen follows:]

Statement of Eddie D. Allen, on Behalf of the National Association for Employee Benefits

My name is Eddie D. Allen. I am the President of the National Association for Employee Benefits, Newport Beach, California. I appear before the Subcommittee today on behalf of the National Association for Employee Benefits, (NAFEB).

The National Association for Employee Benefits is a nationwide organization which acts as a business consultant, investment and insurance counselor and pension and administrative advisor to a broad range of clients including State and Local Governments, Tax-Exempt Organizations and private corporations. NAFEB is wholly owned by James Kelly, former chief deputy corporate commissioner of California and myself.

Among the bills the Subcommittee has under consideration is S. 511 dealing with unfunded non qualified deferred compensation for Tax-Exempt Organizations. The National Association for Employee Benefits wishes to call to the attention of the Subcommittee the broad implications of a modified S. 511. My testimony, in favor of a modified S. 511, is complex and does not address the pure legal issue of whether Tax-Exempt Organizations should be placed under the laws that govern State and Local Governments or private plans for the benefits of unfunded non qualified deferred compensation. Rather, my purpose is to insure that Tax-Exempt Organizations are competively equal to State and Local Governments in the area of recruiting and retaining qualified personnel thru the use of deferred compensation.

Prior to ERISA, under the provisions of Revenue Ruling 60-31 and 64-279, the IRS issued advanced private letter rulings on behalf of an employer/employee arrangement for unfunded non qualified deferred compensation plans. These letter rulings did not take into consideration whether an employee was highly compensated or not. Numerous Tax-Exempt Organizations across the Country offered, on a voluntary basis, unfunded non qualified deferred compensation programs to all employees. One of the primary reasons for this posture was to be competitive with the State and Local Governments that were offering these plans to all their employees.

Now, as a result of ERISA and the 1978 Revenue Act, there is great concern regarding the competitive attitude of the Tax-Exempt Organizations in their ability to recruit, train, and keep qualified employees thru deferred compensation. When ERISA became law the Act created new requirements of eligibility for participants of unfunded non qualified deferred compensation plans. To be exempt from the Participation and Vesting requirements of ERISA, an unfunded plan had to be maintained "primarily to provide deferred compensation to a select group of management or highly compensated employees"; (Act Secs 211(b) 306(c) 1017(a) and (b). The Labor Dept., as of this date, has not defined the term "primarily for a select group of management or highly compensated employees". (In October of this year I met with the Labor Dept. Committee responsible for this section of the Act and was informed that the definition would be very narrowly defined, potentially eliminating many participants currently in these type plans). Quite naturally, this has caused confusion and concern with the Tax-Exempt Organizations. However, most Tax-Exempt Organizations, that I am familiar with, continue to offer these benefits to all employees as a matter of competitive necessity.

The 1978 Revenue Act further complicated matters by excluding Tax-Exempt Organizations from the Act. The Treasury has issued proposed regulation which would end unfunded non qualified deferred compensation plans for Tax-Exempt Organizations. It appears certain that unless S. 511 passes, Tax-Exempt Organizations may have to face the Treasury in the courts in order to offer these deferred compensation plans. Further, should the Treasury win in the Tax Courts, it is possible that private plans of deferred compensation may be effected. The 1978 Revenue Act, Section 132, states in part "private deferred compensation plans shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1st, 1978". In order for the Treasury to prevail against the Tax-Exempt Organizations, the decisions referenced above may be "overturned".

If S. 511 is not passed, then Tax-Exempt Organizations desiring to offer unfunded non qualified deferred compensation face court action. Further, even if a number of Tax-Exempt Organizations win in the courts, the plans will be extremely discriminatory in favor of a "select group of highly compensated employees", in order to comply with ERISA. On the other hand, if S. 511 states that Tax-Exempt Organizations will be treated, in all respects, as if they were a State or Local Government for purposes of deferred compensation, then it appears that all employees would be covered which should eliminate the ERISA problem as well as the Treasury issue.

The real "concern" of certain Tax-Exempt Organizations is the fact that highly compensated employees may be drastically limited in the amount of deferral of compensation should S. 511 become law. To this extent I agree. An Educational Organization or someone working for a Home Health Service Agency can defer considerably more than the limits of deferred compensation. These 403(b) plans create great confusion with absurd "formulas" for deferral. 501(c)(3) employees are faced with tax liability for "overcontributing" because of these complicated "formulas" which few salesmen can understand much less calculate. It would appear to be most prudent to have a simple maximum 25 percent gross compensation, with no makeup or catchup provision for both 403(b) and deferred compensation programs. I believe the Treasury would be receptive to the simplified form of contribution, even with the "25 percent of Gross" concept for both 403(b) plans and deferred compensation plans, if no makeup or catchup provision was available to either plan. It would appear that the administrative cost and the legal cost to "control" the formula system of deferral would not be exceeded by the flat "25 percent of Gross" concept. As a matter of fact, normally, where simplification has occurred cost has gone down. Without the passage of S. 511 and the simplification of deferrals Tax-Exempts are at a great disadvantage to State and Local Governments.

There is a serious problem that exists with pre 1, January 79 deferred compensation plans and the 1978 Revenue Act. Deferred compensation plans under Revenue Ruling 60-31 required that a participant elect the form of retirement distribution at the time of deferral of income. The 1978 Revenue Act allows a participant to elect the form of contribution at the time of termination or retirement. To avoid costly dual administrative costs, (two types of deferred compensation plans for the same organization) and to avoid penalizing participants of pre 1978 Revenue Act Deferred Compensation Plans, a provision should be offered which would permit participants of Deferred Compensation under Revenue Ruling 60-31 to "roll over" their assets under the provisions of the 1978 Revenue Act.

In summary, if S. 511 does not pass, most participants of Tax-Exempt deferred compensation plans, that I am familiar with, will be excluded from this benefit. Further, unnecessary and costly court costs will be required if the Tax-Exempt Organizations desire to be competitive with the State and Local Governments and offer a plan. As stated before, should a Tax-Exempt Organization win in the courts the deferred compensation program will be highly discriminatory in favor of a select group of highly compensated employees. In addition, the extremely flexable investment election opportunities and favorable forms of retirement benefits under the 1978 Revenue Act, will not be available to organizations whose plans are adopted under Revenue Ruling 60-31. Tax-Exempt Organizations, in large, do not normally have the same Pension benefits as State and Local Governments. To eliminate or restrict the Tax-Exempt Employer's ability to be competitive with State and Local Governments would be a serious mistake. To eliminate the ability for all employees to have an opportunity to defer a portion of their compensation until retirement would be sad. Not only are these employees investing in America, they are willing to sacrifice now for a brighter future. S. 511, with the modifications, gives them this opportunity.

Thank you for permitting me to appear before your Subcommittee.

Senator BENTSEN. Go ahead, Mr. Rosensteel.

STATEMENT OF JOHN ROSENSTEEL, AETNA LIFE & CASUALTY CO.

Mr. ROSENSTEEL. Thank you, sir.

My name is John Rosensteel, and I am director of tax deferred annuities and deferred compensation sales for the Aetna Life & Casualty Co.

Senator BENTSEN. Could you introduce the gentleman with you?

Mr. ROSENSTEEL. I am accompanied by Richard Skillman of the firm of Kaplan & Drysdale.

I appreciate the opportunity to appear here today, and I am especially grateful for your interest in the subject of deferred compensation for tax exempt organizations.

As you are aware, the proposed regulation that was issued by the Treasury Department in February of 1978 put the entire matter of deferred compensation into a state of disarray. That regulation would have reversed in excess of 50 years of subtle law, and would attempt to convert an unsecured future promise into current income.

This conflicts with our basic principles of taxation. The related controversy caused this matter to be brought to the attention of Congress. Their response was to create a special rule for plans of governmental organizations, and to reconfirm the validity of the current state of the law as far as private corporations are concerned. However, that legislation did not address plans established for tax-exempt organizations.

Our purpose in being here today is to seek your assistance in overriding an apparent assumption on the part of the Treasury Department that the omissions of tax-exempt from the Revenue Act of 1978 is some form of inferential authority for them to go forward with the application of this regulation on tax-exempt organizations.

To begin with, let me say that I am most surprised by some of the comments of Mr. Allen. As comments will illustrate, we differ rather sharply on many points of both law and policy. With all due respect, we do not believe that S. 511, which would subject tax exempt deferred compensation arrangements to the rules established for public employee plans under Code section 457, is the right answer. We have several reasons for our convictions in this regard.

First of all, public employee plans are unique, and 457 responds to very specific concerns that were presented by such plans. Specifically, utilization of these arrangements in the public sector is broad based and not subject to the restrictions imposed under the Employee Retirement Income Security Act of 1974.

Additionally, the growth of these plans was perceived to represent a potentially significant impact on revenue.

Finally, the general taxing authority of most public entities is believed by many to blunt the inherent risks associated with an unfunded plan.

We wish to specifically emphasize that none of these considerations are present or applicable to tax-exempt organization programs.

Next, contrary to what Mr. Allen has said, deferred compensation cannot be used by tax exempt organizations for rank and file employees. The law simply prohibits it. Furthermore, we concur that it is fundamental to ERISA that such employees not be exposed to the risk of an unfunded arrangement.

Third, a large majority of tax exempt organizations are already eligible for the far superior benefits afforded under section 403(b). Individuals so eligible would be ill-advised to consider a 457 plan in lieu of 403(b) participation. Indeed, in my company, our stated policy is that we will not employ an unfunded arrangement with any individual who is eligible for a 403(b) annuity.

Fourth, tax-exempt organizations employ this concept in exactly the same way that private corporations do. Hospital, colleges, universities, trade associations, members of commerce, co-ops, labor unions, et cetera, all utilize this concept to individually tailor compensation arrangements for executives. This is critical for them to continue to be able to compete with private industry while containing the costs associated with those compensation arrangements.

Finally, section 457 was established to accommodate deferral patterns of typical rank and file employees in governmental plans, as well as to insure the flexibility and smooth functioning of large-scale retirement programs. Such rules are simply inappropriate to organizations whose utilization of the concept is restricted to executive level personnel.

I have a summary statement, Senator, but I will withhold it.

Senator BENTSEN. We will enter your full statement in the record.

You presented, obviously, a conflicting viewpoint.

Mr. ROSENSTEEL. Yes, sir.

Senator BENTSEN. We will see to it that we cover both sides of the question before we reach our judgment.

Thank you very much.

Mr. ROSENSTEEL. Thank you.

[The prepared statement of Mr. Rosensteel follows:]

STATEMENT OF JOHN W. ROSENSTEEL, DIRECTOR, TAX DEFERRED ANNUITY AND DEFERRED COMPENSATION SALES, AETNA LIFE INSURANCE CO.

My name is John W. Rosensteel. I am Director of Tax Deferred Annuity and Deferred Compensation Sales for Aetna Life Insurance Company of Hartford, Connecticut. We are most grateful for the opportunity to appear before the Subcommittee today to discuss S. 511 introduced by Senator Matsunaga on March 1, 1979.

First let me express our appreciation for the interest of Senator Matsunaga and the members of the Subcommittee in the subject of deferred compensation for tax-exempt organizations. As pointed out by the Senator in his introductory message, the entire subject of deferred compensation was placed in a state of disarray by the Treasury Department when it issued proposed regulations on February 3, 1978.

The regulation sought to reverse over 50 years of settled law as established through judicial decision and published revenue rulings. This regulation would override the fundamental tenets of the doctrines of constructive receipt and economic benefit. It is important to recognize the nature of an unfunded nonqualified deferred compensation plan. In essence, such an arrangement is a contractual promise to pay a benefit in the future for services performed currently. This promise is unsecured and predicated upon the creditworthiness of the promisor. Efforts to convert such a promise into current income conflicts with basic principles of taxation.

The highly critical response to the regulation caused the matter to come to the attention of Congress. As you well know, the Revenue Act of 1978 addressed deferred compensation plans for state and local governments and private for-profit corporations. Plans maintained by tax-exempt organizations were not covered by the Act, although the Senate version would have accorded them the same treatment given to private corporations under section 132 of the Act.

This brings us to why we are here today. Were it not for the persistence of the Treasury Department in seeking finalization of the proposed regulation for tax-exempt organizations, this hearing would be unnecessary. Apparently the Department of Treasury perceives that Congress' decision to omit tax-exempt organizations from the Revenue Act was a mandate to go forward with the regulation, thereby effecting a change in established law with respect to plans maintained by tax-exempt organizations. Since we strongly believe this was not the intent of Congress, we need your help. However, we do not believe that S. 511, which would subject tax-exempt deferred compensation arrangements to the rules adopted by Congress in 1978 for public employees (Code section 457), is the answer.

REASONS FOR ADOPTING § 457 FOR GOVERNMENTAL PLANS

With this in mind, one might ask why the legislation regulating public employee plans was thought needed in the first place. Public employee plans were and are unique. Since governmental plans are exempt from ERISA, state and local governments, unlike tax-exempts and other private organizations, are able to offer deferred compensation to *all* employees without meeting ERISA restrictions. As pointed out by Senator Matsunaga, there was a growing perception at Treasury that the use of deferred compensation in the public sector was expanding rapidly and creating a potentially large revenue impact. Finally, given the general taxing authority of most public entities, some believed that the obligation of such entities was virtually equivalent to a secured promise.

In response to these concerns, Congress created new Code section 457 for state and local government plans. The limitations on deferrals imposed by section 457 were intended to accommodate the level of deferrals made by the typical, rank and file participant in governmental plans. Moreover, it is significant that section 457 substantially liberalized the operation of governmental plans, introducing elements of flexibility not available under previous rules, but which were needed for the smooth-functioning of such large-scale retirement programs.

REASONS FOR TREATING EMPLOYEES OF PRIVATE AND TAX-EXEMPT ORGANIZATIONS ALIKE

At the same time, Congress recognized that the concerns posed by public employee plans were not present in private sector plans and therefore acted to confirm the validity of the settled state of the law. Plans of tax-exempt organizations were omitted, creating the confusion that exists today. Of great significance, however, and, a point we wish to emphasize, is that the basic concerns raised with respect to public plans are not applicable to tax-exempt plans.

In fact, deferred compensation plans in the tax exempt sector are employed in precisely the same way as in the private sector. Within the tax-exempt community, deferred compensation is relied upon by a wide variety of enterprises—hospitals, colleges and universities, trade associations, chambers of commerce, co-ops, credit unions, labor unions, etc. The common thread is that limited resources are available to secure the services of the best possible people, and custom-tailored compensation arrangements are designed to meet the unique financial needs of both the employee (or independent contractor) and the employer. To drive a wedge between the two with respect to the rules or availability of deferred compensation plans is to further impair the ability of exempt organizations to compete with private industry, while containing the cost of meeting their responsibilities to the publics they serve.

The primary argument advanced by Treasury in opposition to treating tax-exempts the same as private corporations is the so called "tax tension" theory. This concept suggests that, unlike tax-exempt plans, the absence of a current tax deduction establishes a significant check on the scope of such plans in the private sector. From a practical standpoint, we can attest to the fact that the deferral of a tax deduction is at best a marginal consideration in the establishment of a plan by private employers and certainly does not have sufficient substance to justify statutory distinction.

THE IMPACT OF S. 511 ON TAX-EXEMPT ORGANIZATIONS

Turning back to S. 511, it is appropriate to ask how the rules of Code section 457—which were specifically designed for public employment plans—would effect deferred compensation in the tax-exempt sector. In the first place, it is important to emphasize that ERISA restricts the use of deferred compensation by tax-exempt organizations to management level employees and professionals. Deferred compensation is not and cannot be used by tax-exempt organizations to provide retirement income to rank and file employees. Enactment of S. 511 plainly would not alter this ERISA requirement, and we believe it is fundamental to ERISA that rank and file employees not be exposed to the risks of an unfunded plan.

Limitations on deferral, such as those contained in S. 511, simply are inappropriate if tax-exempt organizations are to effectively compete with private industry for key personnel. The limitations of section 457 were determined by reference to the deferral patterns of public employees, not by reference to the compensation packages offered by private industry to executive-level personnel.

In addition, the level of deferral available under S. 511 would have no value at all to most employees of tax-exempt organizations. Most such employees are eligible for section 403(b) annuities, which provide benefits and deferral rights superior to those available under section 457. Since S. 511 would effectively require those employees to choose between deferred compensation and section 403(b), it is clear that prudently-advised tax-exempt organizations would never offer section 457 plans in preference to section 403(b) annuities. (Indeed, the marketing policy of my company dictates that unfunded deferred compensation not be employed as a substitute for a section 403(b) plan.)

Moreover, if the varied plans of tax-exempt employers were placed under section 457, subjective and largely unadministrable rules would be necessary to avoid harsh and anomalous results. The result, another baroque provision totally inconsistent with the Congressional desire to simplify the tax laws.

In sum, S. 511 is unnecessary for exempt organizations who currently can enjoy the availability of IRC Section 403(b); nor, in our opinion, will it accomplish much for other exempt organizations. It will, however, unnecessarily complicate the tax law, and, more importantly, hamper the effective operation of tax-exempt organizations. If legislation is thought needed, then we submit that an amendment to section

132 of the Revenue Act of 1978 giving tax-exempt organizations identical treatment to the private sector is the most appropriate and responsible course of action.
Thank you.

Senator BENTSEN. I will be putting my introductory remarks in the record. In order to save time, I will not be presenting them.

OPENING STATEMENT OF SENATOR LLOYD BENTSEN

Senator BENTSEN. This afternoon the Private Pension Subcommittee resumes hearings on several pension bills including the ERISA Simplification Act, S. 1089, which I introduced earlier this year.

My bill has the following provisions:

First, the bill would abolish the unnecessary PBGC filing requirement. IRS would collect the insurance premium as part of the form 5500 and the proceeds would then be forwarded to PBGC. This would be similar to the present IRS system of collecting social security payroll taxes. About 85,000 pension plans would be relieved of the annual PBGC filing requirement under this proposal.

Second, my bill would repeal the requirement to furnish summary annual reports. However, in order to continue to make information available to pension plan participants, the legislation would require employers to simply post a notice at the workplace of the employees which includes specified information.

Third, taxpayers would specifically be given the option to file pension forms at the same time as income tax returns.

Fourth, the bill would direct IRS to prepare a bookkeeping guide for pension plan sponsors to assist small businessmen in keeping necessary pension records.

Fifth, the bill would give the Secretary of the Treasury the same authority to bring a civil action to enforce minimum ERISA standards as the Secretary of Labor has under present law. The IRS power to disqualify plans—to remove tax-exempt status—is not always the most effective method to enforce ERISA. Full equity powers would provide much-needed flexibility. Disqualification of a pension plan results in a tax burden on plan participants. Clearly, we do not want to penalize pension plan participants for a violation of ERISA committed by an employer, union or pension plan administrator. It make no sense to penalize innocent parties.

We shall go on to the next panel, Mr. Theodore Groom, Groom & Nordberg; and Mr. William T. Gibb, American Council of Life Insurance.

We had some scheduled ahead, but frankly I want to be sure that Senator Matsunaga is here at that time, and he has been held up. I think that he is probably with Cy Vance right now.

Mr. GIBB. I think that Mr. Groom has been held up, too. I am Mr. Gibb of the American Council of Life Insurance, and this is Paul Mason who is another counsel for the council.

Senator BENTSEN. You may proceed, then.

Mr. GIBB. We still start, and then maybe Mr. Groom will come.

Senator BENTSEN. All right.

STATEMENT OF WILLIAM T. GIBB, COUNSEL, AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY PAUL MASON, CHIEF COUNSEL

Mr. GIBB. We appreciate very much this opportunity to summarize briefly our views on S. 209 and S. 1089. We are still preparing a detailed statement on these, as well as possibly other of the bills included in these hearings, and we will file our statement prior to the December 21 deadline set forth in your press release.

We supported and certainly continue to support the basic objectives of ERISA. However, we agree that it is time to review the pluses and minuses of this landmark legislation and to enact new or correcting legislation where necessary. We applaud the efforts of this subcommittee in this regard, Mr. Chairman.

Senator BENTSEN. Thank you very much.

Our review of ERISA has led to two conclusions:

ERISA overregulates in some areas and, in so doing, is thwarting, instead of fostering, the growth of employee benefit plans.

The affirmative steps taken in ERISA to encourage the growth of employee benefit plan coverage have proved inadequate.

We applaud the provisions in S. 209 and S. 1089 which would seek to rectify these shortcomings, including the sections dealing with:

First, reporting and disclosure.

Second, fiduciary responsibility. Mr. Groom will go into more detail on this aspect of S. 209, and we endorse his recommendations.

Third, tax incentives for employee contributions, and

Fourth, the special master plan program of S. 209.

We will suggest certain revisions and expansions of these proposals in our detailed statement.

On the other hand, we strongly urge that new requirements be imposed only where absolutely necessary to protect plan participants. Employee benefit plans are only just now beginning to recover from the upheavel caused by ERISA. Sending them through another round of amendments at this time would put extreme pressure on the system.

Particularly in this regard, we believe that the marginal benefits to be gained from the joint and survivor annuity benefit amendments in S. 209 do not warrant the huge administrative and cost fallout that would occur.

Senator BENTSEN. Let me ask you on that. Would you anticipate on the smaller plans that there would be a substantial increase in cost, apart from amending the plans?

Mr. GIBB. The cost that would be involved would be the cost of having to explain to each plan participant what the options are. Probably the cost of the new benefits would not be that great, because the new benefits don't provide that much.

So you would be putting these plans through the amendment process, and also the process of explaining to each participant what his options are for what really would be a relatively small benefit for the beneficiary were that participant to die.

Senator BENTSEN. All right, sir.

Mr. GIBB. Briefly, let me discuss just two sections of S. 209.

First, we strongly endorse the amendment made by section 155 to the extent that it would extend ERISA's preemption to cover State laws which mandate benefits that must be included or made available in group insurance policies used to fund employee benefit plans.

At present, practically all States have such laws—but they differ from State to State, and many times they conflict, and these laws place a very heavy burden on insurance companies and employers to comply.

Moreover, these laws do not generally apply to uninsured plans, and probably cannot by virtue of ERISA's preemption clause.

Thus, there is presently a heavy incentive for employers to go the uninsured route—a development which is clearly not in the interest of employee benefit plans and their participants.

Section 155 of S. 209 would correct this situation by preempting State insurance laws that mandate benefits.

Section 155, as amended by the Senate Labor and Human Resources Committee, would also provide an exception to ERISA's preemption provision to accommodate the Hawaiian Health Care Act and other similar State laws, and you will be hearing about this from other witnesses.

We do not question the validity of those laws, or the purpose of those laws, but we do question whether a bill amending ERISA is the proper forum for considering the issue of what type of health care is to be permitted or required in this country. Moreover, the structure of the amendments would permit the proliferation of nonuniform State laws. As mentioned above, this is a problem that we are now facing with the State insurance laws, and this problem would just be carried over to health care laws generally under the provision in S. 209.

Finally, with regard to the provisions in S. 209 that deal with changes in the Federal securities laws. Two of the three sections—both of which we opposed—were deleted by the Labor and Human Resources Committee. The section that remains, section 154(a)(3), provides that the interest of an employee in an employee benefit plan is not a security for purposes of the antifraud provisions of the securities laws. We think that that provision is good as far as it goes, but we would urge that it be extended to provide that such an interest is not a security for purposes of the securities laws generally, and not just the antifraud provisions.

Senator BENTSEN. I can see some additional points on that, and why you would say that.

Mr. GIBB. Thank you very much, Mr. Chairman.

Mr. Mason and I will be happy to try to answer questions.

Senator BENTSEN. Mr. Groom, your timing is exemplary. If you would proceed, please.

STATEMENT OF THEODORE GROOM, ESQUIRE, GROOM & NORDBERG, COUNSEL FOR PRUDENTIAL INSURANCE CO. OF AMERICA, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., CONNECTICUT GENERAL LIFE INSURANCE CO., AETNA LIFE & CASUALTY

Mr. GROOM. Thank you, Mr. Chairman. I am sorry for being late. I thought that I was going to be on later.

My name is Ted Groom. I am a member of the Washington, D.C. law firm of Groom & Nordberg. I am here today on behalf of five leading U.S. life insurance companies, Prudential, Equitable, John Hancock, Connecticut General, and Aetna.

Senator BENTSEN. Those names seem fairly familiar.

Mr. GROOM. These companies are interested in many of the provisions of S. 209 and S. 1089, including the provisions that Mr. Gibb has just testified on. I might say that we support Mr. Gibb's testimony.

We do hope to submit within the time allotted by the committee a more detailed statement that covers a number of issues. We would like to devote our limited time today to discussing just one aspect of ERISA with which S. 209 deals, and that is the prohibited transaction provisions.

We believe the prohibited transaction provisions of ERISA present a classic case of statutory overkill that has led to Government over-regulation. We believe that this committee is presented with the opportunity in this bill to eliminate some unnecessary Government regulation, to simplify the administration of the law, and to reduce cost.

The prohibited transaction provisions, unless some exemption is available, make thousands of routine financial transactions illegal. We could go on for a very long time about the number of these transactions and what they are, but just to give one very simple example:

Prudential's real estate separate account, which is a commingled investment fund in which over 100 of the leading pension plans in the United States partipate, owns many office buildings. For example, it owns the International Office Building located down on K Street in Washington, D.C. That building, of course, leases out to regular tenants, including many businesses.

In the absence of an exemption, if any lease is made in that building to any one of the employers whose plan participates in our account, we have a prohibited transaction. Even if we get an exemption, as we have in this particular case, it results in our having to continuously police the transactions to be sure that we have not unintentionally violated the law. In many cases, it may result in our losing an investment opportunity.

Senator BENTSEN. It obviously was not intended to apply to situations like that. That is one of the problems that we have in drafting legislation.

Mr. GROOM. Certainly that is right. I was here at the time, and we did not think that it was going to happen. We did not realize that it would happen until we really started getting into the actual application of the law, and coming across these actual situations which cropped up, and until we saw how the Labor Department interpreted the law, which it did in our view very broadly, to cover many of these types of situations.

Senator BENTSEN. What you find time and time again, when you get to the interpretation, is somebody that says: "Let's interpret it just as tight as we can make it, therefore, no one will ever blame me."

Mr. GROOM. Yes, but to some extent, the law once enacted takes on its own life, as you know, Senator. To some extent I don't blame the people in the Labor Department. They see this law that prohibits all of these things, and they say, "If Congress said it, they must have meant it."

Senator BENTSEN. No; I don't buy that.

Mr. GROOM. I try to stick up for them.

Senator BENTSEN. I know. You have got to work with them every day. [Laughter.]

Mr. GROOM. In any event, the application of these rules has resulted in the loss of many good investment opportunities for plans. It has resulted in unintentional violations of rules. It has uncontestably resulted in the incurrence of substantial costs of administration.

Many loan opportunities are lost for plans because when a borrower comes to an insurance company or a bank, and says: "I want to borrow some money, a private placement, for example." As soon as the borrower finds out that you are going to be lending funds which the Labor Department regards to be plan funds, and he finds that you must go through an ERISA compliance requirement, which requires all sorts of representations and cross-representations to be made, which requires divulging all of your relationships with partners, and all sorts of other people, he immediately says, if he has got good credit, "I will go someplace else, and get my money from a lender which is not subject to these rules." As a result of that, we have lost many good investment opportunities for plans.

Senator BENTSEN. Your time has expired, but I will defer to my good friend, the Senator from Hawaii, who has been, as I thought, listening to the Secretary of State's briefing on Iran. I came here instead, and I will get from him a second-hand briefing later as to what he learned.

Now, I have a conflict, so I will let my friend chair this for a while.

Senator MATSUNAGA. Thank you, Mr. Chairman.

As you have indicated, I was detained by the State Department's confidential briefing on Iran. Things, disclosed behind closed doors seem to have an intriguing, even a compelling force to hold one. The briefing is still going on. I had to force myself to break away. Had my bills not been the subject of these hearings, I would probably still be at the briefing.

The Iranian situation, as you know, is a truly serious one. The Senate is briefed by the State Department on developments every 3 or 4 days.

I regret that I have not had a chance to listen to you. I regret also that you are opposed to S. 511.

Mr. GROOM. No; we have not testified on that.

Senator MATSUNAGA. You have not?

Mr. GROOM. No. My testimony was basically addressed to the prohibited transaction provisions of ERISA. Senator Bentsen told me that my allotted time had expired, but I was about ready to wind up, if I can say it in a sentence, Senator Matsunaga, by saying that we believe that the prohibited transaction provisions of ERISA have been counterproductive, particularly for professional investment managers.

We think that a revision of the statute can be made that will eliminate unnecessary Government regulation and reduce the cost of administering this act, without any sacrifice in the necessary safeguards. We have proposed a series of amendments designed to that end, and we hope to be working with the committee and its staff in furtherance of those amendments, as well as the amendments that Mr. Gibb has discussed on behalf of the American Council of Life Insurance.

Mr. GIBB. I think that it was the folks before us who were dealing with S. 511.

Senator MATSUNAGA. Thank you very much, and I apologize for not being here on time to listen to you.

Mr. GROOM. Thank you.

[The prepared statements of Messrs. Gibbs and Groom follow. Oral testimony is continued on p. 527.]

STATEMENT BY WILLIAM T. GIBB, ON BEHALF OF AMERICAN COUNCIL OF LIFE INSURANCE AND HEALTH INSURANCE ASSOCIATION OF AMERICA

My name is William T. Gibb, and I am Chief Counsel for Texes and Pensions of the American Council of Life Insurance of Life Insurance. I am accompanied by Paul J. Mason, Chief Counsel, Securities. We are appearing on behalf of the Council and the Health Insurance Association of American. The Council has a membership of 494 life insurance companies which, in the aggregate, have 95 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans. The HIAA has over 300 members which, collectively, have in force over 90 percent of health and accident policies in the United States. Most of the members of the Council are also in the business of health and accident insurance.

I appreciate having this opportunity to summarize briefly our views on S. 209 and S. 1089. We are still preparing a detailed statement on these, as well as possibly over ot the bills included in these hearings, and will file it by the December 21st deadline set forht in your press release.

We supported, and continue to support, the basic objectives of ERISA. However, we agree that it is time to review the pluses and minuses of this landmark legislation and to enact new or correcting legislation where necessary. We applaud the efforts of this Subcommittee in this regard.

Our review of ERISA has led to two conclusions:

ERISA over-regulates in some areas and, in so doing, is thwarting, instead of fostering, the growth of employee benefit plans.

The affirmative steps taken in ERISA to encourage the growth of employee benefit plan coverage have proved inadequate.

We applaud the provisions in S. 209 and S. 1089 which would seeek to rectify these shortcomings, including the sections dealing with—

(1) Reporting and disclosure.

(2) Fiduciary responsibility. Mr. Groom will go into more detail on this aspect of S. 209, and we endorse his recommendations.

(3) Tax incentives for employee contributions.

(4) The special master plan program of S. 209.

We will suggest certain revisions and expansions of these proposals in our detailed statement.

On the other hand, we strongly urge that new requirements be imposed *only* where absolutely necessary to protect plan participants. Employee benefit plans are only now beginning to recover from the upheavel caused by ERISA. Sending them through another round of amendments at this time would put extreme pressure on the system. Particularly, we believe that the marginal benefits to be gained from the joint and survivor benefit amendments in S. 209 do not warrant the huge administrative and cost fallout that would occur.

In my remaining few minutes, I would like to briefly discuss two sections of S. 209:

First, we strongly endorse the amendment made by section 155 to the extent that it would extend ERISA's pre-emption to cover state laws which mandate benefits that must be included or made available in group insurance policies used to fund employee benefit plans.

At present, practically all states have such laws—but they differ from state to state, and many times actually conflict, placing a heavy burden on insurance companies and employers to comply.

Moreover, these laws do not generally apply to uninsured plans, and probably cannot by virtue of ERISA's pre-emption clause. Thus, there is presently a heavy incentive for employers to go the uninsured route—a development which is clearly not in the interests of employee benefit plans and their participants.

Section 155 of S. 209 would correct this situation by pre-empting state insurance laws that mandate benefits.

Section 155, as amended by the Senate Labor and Human Resources Committee, would also provide an exception to ERISA's pre-emption provision to accommodate the Hawaiian Health Care Act and other similar state laws. While I do not mean to question the effectiveness of these laws, I do question whether ERISA legislation is the proper forum for considering the issue of what type of health care is to be permitted or required in this country. Moreover, the structure of the amendments would permit the proliferation of non-uniform state laws. As mentioned above, this is an extremely undesirable situation.

The other area we would like to highlight concerns the three provisions in the original version of S. 209 that dealt with changes in the federal securities laws. Two of the three sections—both of which we opposed—were deleted by the Labor and Human Resources Committee. The section that remains (section 154(a)(3)) provides that the interest of an employee in an employee benefit plan is not a security for purposes of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934, the principal anti-fraud sections of these statutes.

We believe that this provision is appropriate as far as it goes. However, we believe that it does not go far enough; and should be expanded to provide that the interest of an employee in an employee benefit plan is not a security for purposes of the federal securities laws generally, not just for the anti-fraud provisions of those laws.

I appreciate having this opportunity to present the views of the Council and the HIAA. Mr. Mason and I will be happy to attempt to answer any questions you may have.

Statement by the American Council of Life Insurance and the Health Insurance Association of America

This statement is submitted by the American Council of Life Insurance and, insofar as it relates to welfare benefit plans, by the Health Insurance Association of America. The Council has a membership of 494 life insurance companies which, in the aggregate, have 95 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans. The HIAA has 320 members which, collectively, have in force over 90 percent of health and accident policies in the United States. Most of the members of the Council are also in the business of health and accident insurance.

We are pleased to have this opportunity to comment on the important issues addressed in S. 209, S. 1089 and S. 511. This statement supplements the short oral statement presented by us on December 5, 1979.

General Comments

We supported, and continue to support, the basic objectives of ERISA. However, now that ERISA has been in place for over five years, two facts have become apparent:

First, to a significant extent, ERISA has been counterproductive. It has impeded the establishment of new plans and even led to the loss of coverage which existed before its enactment. This undesirable result is attributable in large degree to overregulation, particularly in terms of additional paperwork and other administrative burdens. Moreover, the design of the pre-emption clause provides an incentive to welfare benefit plans to drop valuable insurance coverage in favor of uninsured arrangements.

Second, the affirmative steps taken in ERISA to encourage expansion of employee benefit plan coverage have proved to be inadequate. In fact, much of the positive incentives that were provided have been negated by the burden of additional regulation.

We strongly believe that the time has arrived for Congress to deal with these unintended fallouts from ERISA. Thus, we urge that this Subcommittee report meaningful legislation as soon as practicable.

SPECIFIC COMMENTS ON S. 290 AND S. 1089

Within this context, we would like to comment specifically on S. 209 and S. 1089. Our comments on these bills essentially track those which we made to the Senate Labor and Human Resources Committee. We have, however, developed certain new proposals, particularly affecting small plans, which are included in the discussion below.

Reduction of burdens on small pension plans

It would be redundant to dwell on the problems—in terms of paperwork, other administrative burdens, and increased levels of administrative expenses—that ERISA has presented to plans of small employers. Others have documented the fact of small plan terminations and the slowdown in growth of new plans.

Moreover, in evaluating the impact of ERISA, it is important to look both at the burdens placed directly on employee benefit plans and at the burdens placed on those who sell and service these plans, such as insurance companies. For, in both situations, the ultimate cost falls on the plan. Likewise, in devising solutions, it is not enough to merely shift paperwork and other administrative workloads from the plans to the insurance companies, banks, etc., who may be servicing them. The burdens will still be there, and the plans will continue to bear their cost. Thus, substantive, and not solely procedural, changes are necessary. This is not to say, however, that significant streamlining and consolidation cannot also be achieved by assigning some of the reporting and disclosure requirements to insurance companies and other master plan sponsors, as would be done under the special master plan program proposed in Title III of S. 209, as discussed below. But, standing alone, this would not be a complete solution.

Suggested program

Within this context, a positive program should be adopted for alleviating the burdens and complexities imposed by ERISA on employee benefit plans of small employers. It should, at a minimum, contain the following specific components:

(1) *Elimination of the Summary Annual Report*—The summary annual report requirement is burdensome and costly (even in the revised form proposed by the Department of Labor), while the financial information called for is of little interest to plan participants. Thus, we strongly endorse section 113 of S. 209 which would repeal this disclosure item.

Section 3 of S. 1089 would also repeal the summary annual report, but would require, in its place, that a plan administrator post a brief description of the current financial status of the plan, a copy of the latest summary plan description and a statement explaining an employee's rights under the plan. We urge that section 3 of S. 1089 be revised so as to require, at most, that a notice be posted informing participants that they may inspect the annual report. In its present form, section 3 would, in effect, require the preparation of a summary annual report to be posted; thus, most of the work would still need to be done to produce a document of questionable value to employees. In addition, section 3 would require posting a document and information (i.e., summary plan description and statement of rights) which must also be distributed to each participant. This seems redundant. If it is thought important to post information as to these documents, the notice should refer plan participants to their summary plan description or tell plan participants where to get a summary plan description if they don't have one.

Some have argued that the SAR should be retained because it provides plan participants with needed financial information and serves an enforcement function (i.e., it enables a participant or the Department of Labor to spot prohibited transactions). We disagree. The financial information most plan participants are interested in is their accrued benefit. That information is available to the participant on his or her individual benefit statement which the participant is entitled to on request, at least annually, and which is provided annually by many employers as a matter of course.

For enforcement purposes, the SAR does not and cannot, in a summary fashion, provide any information, for the most part, that is intelligible. The document that provides more detailed information which may expose ERISA violations is the annual report itself, a document that is available to plan participants and that should be in the possession of the Department of Labor.

(2) *Utilization of Age 25 and One Year of Service with a Single Entry Date for Small Plans*—In order to minimize administrative work and cost, for both the employer and insurance company, plans which use individual insurance contracts as a funding media find it helpful to deal with the mechanics of the plan as of one day each year, *i.e.*, the plan's anniversary date. However, because of ERISA's participation provisions, in order to utilize such a single entry date, many pension plans are able to establish only a six month eligibility period, in lieu of the one-year period generally available. This results in added expense to the plan of having to temporarily cover short-term employees who will leave before qualifying for benefits. Therefore, ERISA should be amended to permit small pension plans to qualify for the generally applicable one-year eligibility period without having to forfeit the convenience of a single annual entry date. Specifically, such plans should be permitted to grant eligibility on the first anniversary date following one year of service.

In this regard, section 123 of S. 209 deals with a similar problem and could be modified to extend to the situations described above.

In addition to the specific items described above, we endorse the other proposed amendments in S. 209 and S. 1089 that would streamline the reporting and disclosure requirements of ERISA. In this regard, with respect to section 4 of S. 1089, which is intended to conform ERISA and tax filing dates, we urge that it be made clear that the purpose is to extend the date for filing ERISA forms, not to contract them where the tax return date is earlier. As respects section 5 of S. 1089, which would, in part, require the Treasury Department to publish a booklet on IRA's we note that the IRS has already issued such a guide (IRS Publication 590).

(3) *Exemption from Actuarial Certification Requirements for Small Plans*—Currently, the ERISA requirement (section 103(d)) for annual actuarial certifications by enrolled actuaries is causing a significant burden in the small pension plan area. There are several aspects to this burden:

(a) *Financial*—In small plans, the cost of the actuarial certification for defined benefit plans can be a very significant percentage of the total plan contribution. For example, in a ten life plan, the annual contribution might be from $10,000 to $15,000, and the cost of the actuarial certification could range up to $2,000, depending on the vendor of the services.

(b) *Additional complexity*—most small plan sponsors are not knowledgeable in the employee benefit plan area and do not have an in-house staff of employee benefit experts. The requirement for an annual actuarial certification for defined benefit plans by an enroller actuary is a significant complicating factor.

(c) *Enrolled actuary*—the Joint Board has only enrolled a few thousand actuaries, and only a small percentage of these actuaries work in the small plan area. Thus, enrolled actuaries in the small plan area are forced to provide actuarial certification on a mass production basis when actuarial certification is not the type of task that lends itself to mass production techniques.

Proposal

We propose, as a solution to this problem, that small pension plans (i.e., those with fewer than 100 participants) be exempted from the ERISA actuarial certification requirement provided that certain conditions are met. These conditions would be patterned after those applicable to so-called "insurance contract plans" (defined in section 301(b) of ERISA), which presently are exempted form, among other things, the actuarial certification requirements. We would be happy to work with your staff on the details of this proposal.

(4) *Improvement of Target Benefit Plan Benefit Limitations.*—Targe benefit (or assumed benefit) plans should be subject to the defined benefit plan benefit limintations of Internal Revenue Code section 415 rather than, as at present, the Code section 415 limitation on contributions for defined contribution plans. This change would permit targe benefit plans to provide older employees, at the time of the plan's inception, with a benefit which takes into account past service (and, thus, might not be able to be funded under the annual defined contribution limitation). Such a benefit can be provided under a target benefit plan with more predictable costs for the employer than under a defined benefit plan, since, under the former type of plan, it is the participant's account balance that determines the actual benefit to be paid; therefore, the level of employer contributions is not subject to the plan's mortality or investment experience. Also, since the target benefit plan is not a defined benefit plan, the heavy expense of an actuarial certification can be

avoided (see item (3) above). This combination of factors would make target plans more marketable to small employers and thus contribute to the spread of pension coverage.

(5) *Faster Amortization for Past Service Liabilities.*—ERISA should be amended to allow employers to fund past service liabilities under pension plans with the right to deduct contributions, over a period of less than 10 years, rather than being limited to amortizing the liability—with appropriate dedictions—no faster than over 10 years as under the current law. Permitting a faster amortization schedule, with deductions, would (i) provide employers with flexibility to match contributions and deductions with profitable years and, thusly, make adoption of a plan more attractive, and (ii) provide plan participants with the security of a more fully funded accrued benefit. Faster funding is a goal of ERISA and should be further encouraged.

(6) *Simplification of the Notice to Interested Persons.*—The Council urges the adoption of a provision which would allow for the simplification of the Notice to Interested Persons that must be furnished to participants when IRS approval of a plan or plan amendment is being requested (section 3001(a) of ERISA). At present, the notice must set forth a complicated series of dates (geared to the date on which the request for approval is filed) by which the participant must take action, depending on whether he comments directly to the IRS or asks the Labor Department to comment on his behalf. These dates are confusing to the employees and time-consuming to compute for a service provider that is servicing a number of plans. We recommend that the procedure be simplified by prescribing simplified time periods, e.g., the notice procedure could require that comments must be filed with the IRS or that the Labor Department must be requested to act on behalf of the participant within 30 days after the approval request is filed by the plan sponsor. If the Labor Department is asked to, but does not, comment, the participant would have 30 days, after being so notified, to comment himself.

Special master or prototype plans

Title III of S. 209 would establish a "special master plan" program to ease the paperwork and other burdens of adopting and operating pension plans, particularly by small employers. The core of the proposal is to shift many of the statutory responsibilities arising out of the plan from the employer to the sponsor of the plan, in our situation, a life insurance company.

As indicated above, we wholeheartedly endorse the idea of simplifying the administration of employee benefit plans. Within this context, we support the basic concept of the "special master plan" program.

However, as also noted above, we urge that such a program constitute only one facet of an attack on the complexities and burdens of ERISA—for it must be recognized that shifting the responsibility to perform certain functions does not eliminate the burdens they create; it merely puts the burdens on someone else. Thus, it is extremely important that emphasis also be place on eliminating or stream-lining the various requirements themselves.

Moreover, we believe certain modifications in the provisions of Title III are important for the program to operate efficiently from the standpoint of both the employer and the sponsor.

(1) *Responsibilities assigned to the sponsor.*—We believe that the responsibilities shifted to the sponsor should be limited to reporting and disclosure and maintaining individual accounts for participants. By denominating the sponsor as "administrator" and "fiduciary", Title III would apparently also make the sponsor responsible for the day-to-day operations of the plan. We do not believe this is feasible or desirable, since the sponsor is not the premises, and, in fact, may be located in another part of the country.

Moreover, Title III provides that the sponsor must have the power to "manage, acquire, or dispose of any asset of an adopting employer's plan." We do not understand how this would operate in the case of an insured plan; although we recognize that it would not charge the sponsor with any obligation respecting the employer's decision to adopt his master plan. Thus, we strongly recommend that Title III of S. 209 be revised as follows:

(a) The law should set out the specific responsibilities that are to be shifted to the sponsor. We believe these should be limited to reporting and disclosure and maintaining participant accounts. In this regard, we support the provision in the bill that the employer may be made responsible for distribution of summary plan descriptions and other documents that are required to be distributed to plan participants and beneficiaries.

(b) The sponsor should not be labeled with any of the statutory terms, such as "plan administrator" or "fiduciary". These labels carry correlative responsibilities and consequences which should not automatically be placed on the sponsor. For example, a fiduciary is automatically subject to the co-fiduciary rules; a plan administrator cannot qualify for Prohibited Transaction Exemption 77-9, etc. Thus, the duties of the sponsor should be set forth specifically; not by use of general labels.

(c) Correspondingly, it should be made clear that the labels put on various plan officials do not make them accountable for the duties assigned by the law to the sponsor.

(2) *Certainly.*—In order to give employers some certainty as to the status of their plans, we suggest the following additional features be added to the special master plan program:

(a) A Special Master Plan should be immune from retroactive IRS disqualification because of discrimination in operation;

(b) A Special Master Plan should have to be amended and recertified only once every five years; consequently, a plan should not have to be amended in order to comply with new regulations published within five years of the date of the last certification; and

(c) As a companion to item (a), five year vesting or "4/40 vesting" could be a minimum vesting requirement for a special master plan in order to assure an absence of discrimination in operation.

Tax incentives

As specified in the press release, we are not addressing the tax deduction and incentive provisions of S. 209. We covered these provisions in our statement to the Senate Labor and Human Resources Committee as well as in a statement filed earlier this year with this Subcommittee.

Preemption—State mandated group insurance coverage

We strongly support that portion of section 155(1) of S. 209 which would amend section 514 of ERISA to preempt the many nonuniform state laws which mandate benefits that must be included or made available in group insurance policies used to fund employee benefit plans.

Background

Section 514 of ERISA attempts to set forth the basic areas of regulatory responsibility—as between the states and the federal government—respecting employee benefit plans. The Council and the HIAA believe that the provisions of this section, as particularly applied to employee welfare benefit plans and as currently interpreted by the courts, continue to permit extraordinary burdens to be placed upon insured employee welfare benefit plans and further have encouraged such employee welfare benefit plans to become uninsured. We do not believe either result was intended by Congress or is in the best interest of sound regulation in this area.

More specifically, *Dawson* v. *Whaland*, 562 F.2d 70, decided by the United States Court of Appeals for the First Circuit on September 1, 1977, with certiorari denied by the United States Supreme Court on April 17, 1978, holds that a state mandated insurance benefit (a New Hampshire insurance law mandating the inclusion of mental health coverage in all group insurance policies issued in that state) was not preempted by ERISA. The court concluded "that ERISA does not preempt application of state law to group insurance policies when such policies are purchased by employee benefit plans." On the other hand, however, the court makes it clear that "a state may not regulate an employee benefit plan simply because the plan serves as self-insurer on all of its benefits." The net result of the decision in *Dawson* is to preempt state mandated benefit laws from applying to uninsured (self-insured) plans but *not* to preempt such laws from applying to insured plans.

Necessity for remedial legislation

We believe it is extremely important for Congress to clarify this situation in the interest of sound regulation of insurance and the protection of the benefits provided by employers under employee welfare benefit plans. In the first place, we support sound state regulation of insurance, yet we do not believe that a scheme where states mandate the coverages contained in group insurance policies in a nonuniform and often conflicting manner is sound state regulation of insurance. In the second place, we believe that the present effect of the ERISA preemption clause is to encourage plans to become uninsured and thereby lose the protection of important state regulatory controls.

(a) *"Mandated Coverage" Problem.*—The problem for insured plans when states are permitted to mandate coverages in group insurance policies can be easily discerned from an examination of the proliferation of nonuniform state laws and regulations.

Twenty-four states have passed laws relating to health insurance benefits for alcoholism treatment. Some mandate benefits for inpatient care, but not for outpatient; some require the reverse. Each law has different limitations of coverage; some require coverage only in certain treatment facilities.

Nine states have passed laws relating to health insurance benefits for drug addiction treatment. Some set mimimum benefits, some set maximum benefits. All nine laws are different in their approaches to inpatient and outpatient treatment.

Nineteen states have passed laws relating to insurance benefits for treatment of mental illness. Some require the coverage for inpatient treatment; others require it for outpatient treatment. The outside limits required range from $500 to $10,000. Coinsurance limits range from 25% to 90%.

Forty-nine states have passed laws relative to coverage for newborn children. While the American Academy of Pediatrics developed a Model Newborn Children Act with the cooperation of the HIAA, many states saw fit to change the Model, thereby creating many substantive and compliance problems for both group insurers and multistate employer operations.

While we could continue to cite examples of nonuniform state laws and regulations affecting insured employee benefit plans, it should be clear that the situation is chaotic for insurers and their customers, the employers. Both the insurers and the employers must keep track of the types and variations of mandated coverages in each state in which they operate. These laws are constantly changing, making the mechanics of compliance increasingly burdensome.

The situation is frequently complicated by union bargaining agreements which cover employees in more than one state.

The employer ultimately is the party that bears the additional burden of costs associated with handling the aberrations. These additional and unwanted costs are naturally resisted by the employer, and often it is forced to reduce desired benefits in order to keep costs reasonable or to seek to become uninsured to avoid these laws.

Furthermore, several of the states have applied their laws mandating coverage to group policies issued outside their state which cover residents of their state. The tendency for this to occur with greater frequency is most alarming. Thus, an employer may negotiate or determine benefits for his employees in the state where it is headquartered in accordance with that state's laws and find that such benefits when purchased under an insurance policy issued in that state are not in accordance with a neighboring state's law, or the neighboring state may require an additional benefit or benefits for employees in its state. This not only removes the freedom of selecting among the benefits most desired by the employer and employees but impossibly complicates the benefit structure for employers with multistate operations. Moreover, providing a benefit mandated for a few employees located in a state other than the principal state of the employer may increase costs such that the majority of the employees lose valuable coverage more widely desired by them.

In summary, the increasing number of nonuniform state laws mandating coverages in group insurance policies has made it increasingly more burdensome for insurers to provide insured coverage to employee welfare benefit plans. Moreover, these laws make it difficult and costly for the employer to provide the kind of benefits and the benefit mix most desired by the employees through an insured plan.

(b) "*Movement to Become Uninsured*" *Problem*—As indicated, under ERISA, as currently interpreted, employee welfare benefit plans utilizing group life and health insurance are not protected from the hodgepodge of state mandated coverages, while employers which choose to be uninsured are free to provide coverages without regard to state laws. This has led many employers to become uninsured and numerous more to consider such a move. We view this as alarming both from the standpoint of placing insurers in an untenable competitive disadvantage with uninsured plans and from the standpoint of eroding the protection afforded employees by the traditional state regulatory controls that protect their coverages. While some large employers may be able to provide benefits to their employees without insurance, the recent experience of the uninsured multiple employer trusts indicates, for example, that other employers cannot.

In short, we do not believe Congress intended by the preemption language of ERISA to motivate employers to drop insured plans in favor of uninsured plans.

Section 155(1) of S. 209

Our associations have made it clear in previous testimony before Congress that we support state regulation of the life and health insurance business. It has proven in almost every area to be responsive to the needs of both the public and the insurance business that serves the public. We, therefore, seek to preserve that system of regulation and believe that the amendment proposed in Section 155(1) is consistent with that objective.

More specifically, we believe that the first sentence added by Section 155(1) will resolve many of the problems created by state mandated group insurance benefits and the consequent movement to uninsured plans; and, thus, we strongly support it. Moreover, we urge that the first sentence be extended to also preempt a state insurance law which provides that a particular class or classes of individuals must be provided benefits. The addition of the first sentence (as so amended) would quite properly leave undisturbed the state's mechanism which regulates the insurance business, *i.e.*, regulation of solvency, policy forms, agents' licensing, unfair trade practices, unfair claim practices, etc.

The second sentence added by Section 155(1) would, specifically, preserve state laws which require that a contract or policy of insurance issued to an employee benefit plan permit an individual to convert or continue insurance coverage after he ceases to be covered under the employee benefit plan. The same nonuniformity and, thus, disincentive to insure problem is presented by these laws in many health insurance situations as is presented by laws that mandate benefits. In this regard, at least twelve states currently have laws which require the insurers of employee health insurance plans to make available to former plan participants the privilege of converting to an individual health insurance policy upon discontinuance of their eligibility under the group insurance policy. Each of these laws specifies the types and/or levels of benefits to be provided in the conversion policy; and the requirements differ from state to state. In fact, some of the states require that the insurer make available varying types of health conversion policies, each of which must meet minimum standards, which, in turn, differ in each of the states.

While the Council and HIAA have always been, and continue to be, strong advocates of the principle that individuals should have the right to provide for continued health insurance protection after leaving a covered group, we believe that state laws which mandate the benefits to be made available to *former* plan participants in a nonuniform manner lead to the same result as those state laws which mandate the coverages to be contained in the group insurance policy itself. Thus, we urge that the second sentence be eliminated or revised so as to deal with the problem, and we would like to work with your staff to this end.

Section 155(2) of S. 209

This provision would take out from under ERISA's preemption clause state laws which mandate that employers provide health care benefits and services or which regulate arrangements under which such benefits or services are provided. We seriously question whether ERISA legislation is the proper forum for dealing with the question of mandating health care programs. This question is under consideration, in one form or another, by various committees of the Congress considering national health insurance proposals. Moreover, this amendment would allow for the nonuniformity of state laws which is one of our major concerns. We urge that, if action is necessary in this area, the approach be taken of dealing specifically with the particular state laws at issue in the context of a "grandfather clause". In addition, we have certain technical comments in the wording of the amendment which we plan to discuss with your staff.

Fiduciary provisions

S. 209 would make a number of changes in the fiduciary provisions of ERISA. While they would alleviate some specific problem areas, we strongly believe that a much more thorough re-examination and reworking of ERISA's fiduciary rules—particularly, the prohibited transaction section—is necessary if the law is to work efficiently and without unnecessarily disrupting business practices and transactions. To this end, we recommend the following package of amendments, many of which reflect, or build upon, proposals in S. 209:

Status of general asset account

We urge adoption of an amendment to make clear that, in the case of a plan which is funded by a contract issued by an insurance company and based on the company's general account, it is the contract that constitutes the plan asset, and not the underlying assets of the insurance company's general account. We firmly believe that this is the intent of present law, but that clarifying legislation is needed to remove any possible doubt and, thus, reticence on the part of persons to enter into transactions with a life insurance company in the pension business. A contrary result would place impossible restrictions on an insurance company's investment activities in its general account by reason of the broad range of possible technical violations that could occur through dealing with "parties-in-interest".

Section 141 of S. 209 deals with the status under ERISA of the assets in a life insurance company's general account. However, we urge that this provision be revised to clearly provide that such assets are not plan assets, leaving no ambiguity revolving around, for example, the question of whether the contract is technically an "insurance" contract.

Application of Prohibited Transaction Provisions to Life Insurance Companies

One of the most troublesome aspects of ERISA is the application of the strict prohibited transaction restrictions to many transactions by life insurance companies. For example, as interpreted by the Government agencies, the prohibition against dealing with any party-in-interest to a plan is applicable to transactions entered into by a life insurance company separate account (whether or not pooled) since it has been held that the assets in the account are "plan assets" as respects employee benefit plans participating in the account. Thus, thousands of investments and real estate transactions must be screened to avoid inadvertent violations arising from one or many plans utilizing an account. The current class exemption—Prohibited Transaction Exemption 78-19—still leaves many open situations (e.g., where the plan has more than a five percent interest in a separate account) that will cause unnecessary problems. Another example of the problems for life insurance companies concerns the possible impact of the self-dealing rules on the ability of a company to exercise discretionary authority (where granted) to move assets from one account to another.

We believe that the present statutory framework of prohibiting large blocks of transactions without qualification, including many that constitute long-standing normal business practices, and leaving exceptions to the time-consuming administrative exemption procedure, is an example of clear over-regulation for institutional type investment managers which are subject to strict regulation by state or federal agencies. Thus, it is recommended that the prohibited transaction rules be amended so as to make them inapplicable to transactions by (or caused by) a fiduciary which is an investment advisor, bank or insurance company, provided such transactions meet an "arm's length" standard. The Labor Department could be given the authority, however, to reinstitute the exemption process as to a category of transactions if a pattern of abuse has been established. It should be noted that, under this recommendation, the criteria for determining whether a life insurance company is a fiduciary would not be changed, for example, assets of separate accounts would still be "plan assets" (pursuant to current Government interpretation) and the insurance company would still be subject to fiduciary standards of conduct with respect thereto.

If such a change is considered too broad, we recommend at a minimum that the recommended procedures be established for party-in-interest transactions described in section 406(a) and that streamlined exemption procedures be established for so-called "self-dealing" transactions described in section 406(b).

Tax on Prohibited Transactions (Section 4975 of the Internal Revenue Code)

We recommend that the excise tax automatically imposed by the Internal Revenue Code on parties-in-interest involved in a prohibited transaction be repealed consistent with the new alignment of responsibilities that gives the Department of Labor responsibility for administering the prohibited transaction rules. A conforming change should be made to section 502(i) of ERISA (the companion to section 4975) to extend its coverage to qualified plans presently covered by section 4975 of the Internal Revenue Code. Besides conforming to the new jurisdictional alignment, such an amendment would inject needed flexibility into the ERISA enforcement provisions, since the imposition of the penalty under section 502(i) is discretionary on the part of the Labor Department.

Other Comments

We have a number of other comments and suggestions in the fiduciary area which we would like to discuss with the staff at the appropriate time.

Joint and survivor annuities

Section 127 of S. 209 would significantly revise the requirements for "early survivor annuities", as enacted by ERISA. Basically, ERISA provides that each participant in a pension plan must be given the right to elect a survivor annuity for his spouse in the event he dies after early retirement age (or, if later, age 55). S. 209 would make two substantial changes in this provision:

(1) The provision of a survivor annuity (payable to the spouse) would be automatic unless the participant elects out of such a benefit form; and

(2) The survivor annuity benefit option would have to be provided to every participant once he has 10 years of service credited towards vesting under the plan We believe that these changes would operate against the best interests of many participants and plans and, thus, we urge that, if any change is to be made, it be in a form which would better balance the benefits to participants and survivors with the complexities and costs for plans, their sponsors and their participants.

More specifically, the amount of a survivor annuity that could be provided by the value of the accrued benefit for a relatively young employee who has 10 years of service for vesting purposes would, in many cases, be very small. In this regard, it should be noted that not only may the absolute amount of accrued benefit be small, but the survivor benefit, itself, would (unless heavily subsidized by the employer) be only a small fraction of that amount since it will have gone through several actuarial reductions—for example, to reflect the fact that the survivor benefit is only 50 percent of the primary benefit, which itself will have been reduced to account for the survivor benefit, and to account for the fact that the survivor benefit must begin at early retirement age. Based on currently used actuarial assumptions, the survivor benefit would likely fall in the range of 15-20 cents for each dollar of accrued benefit payable to the participant at normal retirement age.

To be balanced against the marginal additional protection that would be available to surviving spouses is the considerable complication and expense that will be added for plans, their sponsors and participants. Specifically, a comprehensive election form would have to be given and explained to every employee shortly before he reaches 10 years of service. These documents are often confusing to employees and, based on past history, most of them will take the road of least resistance; in this case, that means accepting a small amount of survivor benenfit protection, possibly at the price of a reduction in their ultimate pension if they survive. This result would occur in many cases even though the employer has an adequate life insurance program.

Besides this direct complication, indirect complications and costs will flow to plans since the survivor benefit will have to be valued by the actuary each year and reported to the participants where this is the practice of the employer.

Alternative suggestion

We believe that, if it is felt necessary to make a change, many of the disadvantages can be dissipated, without significant loss in meaningful protection, if the provision is revised so that the survivor annuity election need be provided only to active participants who have 10 years of service *and* have reached age 45 or 50. Such a change would tend to limit the survivor annuity requirement to cases where the protection is significant and the likelihood of death greater. Moreover, surviving spouses of younger participants represent a group that is likely to pick up survivor protection from other sources, since they have many more years left before reaching retirement age.

Effective date

We urge that subsection (c) of section 127 be revised to indicate that the new requirements shall apply only if the employee was an active participant in the plan on the effective date of the section.

Whatever the decision on the basic proposal, we urge enactment of the following important clarifications in the Joint and Survivor Annuity provisions:

(i) *Profit-Sharing and Money Purchase Plans.* We strongly support the concept embodied in subsection (a) of section 205 of ERISA, as proposed to be amended by S. 209; that is, it is permissible to provide a non-annuity type payment as the automatic benefit form in a pension plan so long as any annuity options include a qualified joint and survivor annuity.

The particular fact situation involved are the thousands of profit-sharing (including thrift) plans which provided for a lump-sum payment of the participant's accumulated account value as the automatic benefit form, but which also offered the participant the option to elect to receive part or all of his account in the form of annuity payments. Under final Treasury rules,[1] these plans have had to be fundamentally restructured to provide an annuity as the basic benefit form or (as is more likely) drop the opportunity for a participant to elect an annuity benefit form. Moreover, a new defined contribution plan cannot be designed to provide a lump-sum as the automatic benefit form, if it desires to provide an annuity option.

(ii) *Automatic Death Benefits.* We urge that the law be amended to make clear that a plan does not have to establish election procedures (either "in" or "out") for an early survivor annuity, where the plan automatically provides a pre-retirement

[1] We strenuously opposed this provision during the development of the regulations and again after their issuance, but were unsuccessful.

death benefit at least equal in value to the required early survivor annuity. The Treasury Department regulations presently provide that the election procedures do not have to be applied in a defined contribution plan which meets this condition; but such a provision is not extended to defined benefit plans, although there are many such plans which contain a pre-retirement death benefit which, by definition, exceeds in value the minimum early survivor annuity specified in the law. To require this type of plan to offer and explain an early survivor annuity option creates unnecessary expense and confusion.

(iii) *Beneficiary.* Finally, we urge that the law be clarified to provide that a plan may permit a participant to elect to have the pre-retirement survivor annuity paid to a person other than his or her spouse, and that, if made previously, this election need not be remade at the time the participant attains 10 years of service or whatever other standard may be prescribed, so long as he has the continuing right to change it There are various reasons, many times related to estate planning, why a plan participant may desire to have survivor payments made to a person other than the spouse. The law should not be inflexible in this regard. On the other hand, a plan should not be required to provide a survivor benefit other than to the spouse.

Reduction in disability benefits

Section 126(a)(1) and (2) of S. 209 would prohibit an employee welfare benefit plan from reducing a participant's disability benefit by reason of any increase in the disability benefit levels payable under the Social Security Act.

While the Council and HIAA vigorously endorse the public policy behind such a legislatively mandated Social Security "freeze", we feel equally strongly that such a mandate should only be applied prospectively. Specifically, we urge that section 126 be amended to permit existing employee welfare benefit plans which do not include a Social Security "freeze" on the effective date of the Act to add such a "freeze" on the first plan anniversary date which is more than 60 days after such effective date. Moreover, any such "freeze" should only be required to be applied to those persons becoming disabled after inclusion of the contractual provision.

Civil enforcement actions by the Treasury Department

Section 6 of S. 1089 would allow the Secretary of Treasury to bring a civil action to enforce compliance by a plan or a trust with certain minimum standards of the Internal Revenue Code. The apparent intent of this provision is to give the IRS an enforcement tool, short of plan disqualification. The council does not feel that this provision is necessary or desirable.

While the current system is not perfect, to a large extent it works, and most plans do not suffer disqualification prior to having an opportunity to bring the plan into compliance. Where civil enforcement proceedings are desirable, the Department of Labor, upon request by the Internal Revenue Service, has the authority under ERISA (section 502(b)) to use civil enforcement against certain plans. A provision giving the IRS similar power creates a duplication that seems to serve little purpose. Moreover, the creation of another enforcement threat could well create a deterrent to plan formation. The existing paperwork and penalties are frightening enough to an employer contemplating the establishment of a plan; adding one more burden may, for an employer, tip the balance against establishing a plan.

Applicability of the securities laws to interests in employee benefit plans and funding vehicles

In considering both the "old" statute and the "new" or revised version insofar as they relate to the federal securities laws, it is important to keep in mind that each statute deals with two distinct kinds of "interests" which, though related, must nevertheless be considered separately. Each type of interest is important. Each is also substantially different from the other. The two interests are, first, the interest of the employee in an employee benefit plan and, second, the interest of the employee benefit plan in the funding vehicle.

It is also helpful to keep in mind that there are two related but different legal areas involved. The first deals with disclosure. What disclosure should be made to an employee with regard to his employee benefit plan, and what disclosure should be made to an employee benefit plan with regard to its interest in the funding vehicle? The second legal area of concern deals with the issue of what anti-fraud provisions should be imposed for violation of the disclosure provisions. In commenting on the old bill the Council discussed provisions dealing with both kinds of interests and both legal areas.

(1) *Interests of Employees in Employee Benefit Plans.*—Section 154(a)(3) of the "old" bill would have added a new paragraph (2) to section 514(d) of ERISA. This paragraph would have specified that the interest of an employee in a benefit plan is

not a security for purposes of the anti-fraud provisions of the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). This provision is retained verbatim in the new bill.

As we pointed out in commenting on the old bill, we believe that this provision provides a valuable clarification in the law as far as it goes. However, the provision does not go far enough. By stating that the interest of an employee in any employee benefit plan is not a security only for purposes of the anti-fraud provisions of the 1933 and 1934 Acts the section implies that it leaves to the SEC the authority to require plan sponsors or trustees to register any interest in an employee benefit plan which the SEC determines is a security for purposes of the registration provisions of the federal securities laws.

How significant this would be as a practical matter is not entirely clear. With one narrow exception,[2] the SEC had never claimed, prior to the *Daniel* case, that employee interests in employee benefit plans must be registered. However, it is worthy of note that the Supreme Court found in *Daniel* that the position taken by the SEC in that case was a complete reversal of its long-established position with regard to employee interests in compulsory, non-contributory pension plans. Accordingly, we believe that there is no reason to leave plan sponsors and trustees with the uncertainty that the SEC might change its position. Sponsors and trustees are already subject to the provisions of ERISA and ought not to have to be concerned with the question of whether they must comply with the registration provisions of the federal securities laws as well.

We agree with the position taken by the Supreme Court with respect to the plan before it in the *Daniel* case, that is, that an interest in an employee benefit plan is essentially an incident of the employment relationship and is not a security. For that reason, we believe that neither the anti-fraud nor the registration provisions of the federal securities laws should apply to the employee interest in an employee benefit plan. This position is consistent with the holding of the Supreme Court in *Daniel* and with the holdings of several courts in cases since *Daniel*.[3]

We suggest, therefore, that the language of proposed Section 514(d)(2) be changed by replacing the words "for purposes of section 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934" with the words "for purposes of the federal securities laws." Accordingly, we support the adoption of proposed section 514(d)(2) if it is modified in this way.

(2) *Interests of Employee Benefit Plans in Funding Vehicles.*—In its presentation to the Committee on Labor and Human Resources regarding the old bill, the Council commented upon Section 514(d) insofar as it would have added a new section 516 to ERISA. This section 516, would, in effect, have shifted the responsibility for regulating disclosure with regard to interests in funding vehicles from the SEC to the Department of Labor ("Labor"). The Council pointed out that rather than reducing regulation, this provision would grant to Labor regulatory authority over some plan interests not currently subject to regulation. The Council also pointed out that this provision would remove jurisdiction over certain plans from the SEC, which has demonstrated competence and expertise in regulation of funding vehicles, and would transfer this jurisdiction to Labor, which has little experience in the area of financial interest disclosure. This provision does not appear in the new bill, and we believe its deletion is appropriate.

S. 511

Finally, we would like to comment on S. 511, a bill which would treat deferred compensation arrangements for employees of tax-exempt organizations under the same tax rules as were enacted in 1978 for public employees. We support the comments and recommendations on this bill which were made by John W. Rosensteel, Aetna Life Insurance Company, in testimony before the Subcommittee on December 5, 1979. As he indicated, the limitations contained in S. 511 would make it extremely difficult for tax-exempt organizations to compete with private industry for key personnel. We agree that, if legislation is thought needed, it should be in the nature of an amendment giving these organizations identical treatment to the private sector (see section 132 of the Revenue Act of 1978).

[2] The Commission has always taken the position that an interest in an employee benefit plan which invests amounts other than the employer's contribution in securities of the employer is a security and must be registered.

[3] *Black* v. *Payne*, 591 F.2d 83 (9th Cir. 1979); *Tanuggi* v. *Grolier, Inc.*, CCH Fed. Sec. L. Rptr., ¶96,880 (S.D.N.Y., May 7, 1979); *Newkirk* v. *General Electric Company*, No. C-78-2537-WAI (N.D.Cal., August 31, 1979); cf. *Leonard* v. *Drug Fair, Inc.*, Civil Action No. 78-1335 (D.C.D.C., October 19, 1979)—all cases involving voluntary, contributory plans.

CONCLUSION

The Council and the HIAA appreciate having the opportunity to present views on the important issues involved in these hearings. As indicated at the outset, we believe that the experience under ERISA to date has clearly established the need for certain corrective amendments if the law is to fulfill its laudatory objective of strengthening and extending th4 vital financial protections provided by employee persion and welfare benefit programs. We would be happy to attempt to furnish any additional information which the Subcommittee might think helpful.

TESTIMONY OF THEODORE R. GROOM ON BEHALF OF THE PRUDENTIAL INSURANCE CO. OF AMERICA, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., CONNECTICUT GENERAL LIFE INSURANCE CO., AETNA LIFE & CASUALTY

SUMMARY OF PRINCIPAL POINTS

1. The prohibited transaction provisions of ERISA represent a classic case of statutory overkill resulting in governmental overregulation.

(a) Thousands of routine, desirable financial transactions are made illegal by the prohibited transaction provisions, in the absence of exemption.

Example: ERISA owns the International Office Building in Washington, D.C.: a lease to any one of thousands of employers would be a party-in-interest violation.

(b) The rules have resulted in the loss of good investments and services for plans, in the unintential violation of the rules, and in the incurrence of substantial costs of administration.

(c) The party-in-interest prior restraint rules serve no useful function in the case of professional asset managers.

2. The administrative exemption procedure has not worked well.

3. As currently structured, the administrative exemption process will never deal adequately with routine financial transactions by institutional fiduciaries.

4. Amendments are proposed to enable responsible professional asset managers to make investments on behalf of plans without undue impediments. The amendments would:

(a) Only apply to "qualified professional asset managers";

(b) Remove prior restraint rules for party-in-interest transactions;

(c) Retain prior restraint rules for self-dealing, etc., prohibitions but mandate expeditious processing;

(d) Simplify the procedures for accounting for employer securities and real property;

(e) Provide ample safeguards to preclude abuse.

Mr. Chairman: My name is Theordore R. Groom. I am a member of the Washington, D.C. law firm of Groom and Nordberg. My testimony is given on behalf of five of the leading life insurance companies of the United States. The Prudential Insurance Company of America, The Equitable Life Assurance Society of the United States, John Hancock Mutual Life Insurance Company, Connecticut General Life Insurance Company and Aetna Life and Casualty.

These companies are interested in many of the provisions of S. 209 and S. 1089, including particularly provisions relating to insurance company general asset accounts, joint and survivor annuities, special master and prototype plans, and reporting and disclosure provisions. Some of these issues will be discussed briefly today in the testimony—which we support—of my colleague, Mr. Gibb, Counsel for the American Council of Life Insurance. We also intend to file a more detailed written statement on the issues.

We thought we would use our very limited time today to focus on a single issue, the prohibited transaction provisions of ERISA.

As applied to institutional fiduciaries such as life insurance companies and banks, the prohibited transaction provisions of ERISA present a classicial case of statutory overkill resulting in government overregulation.

In the absence of an exemption, literally thousands—possibly tens-of-thousands—of desirable financial transactions in which insurance companies engage on behalf of employee benefit plans would be illegal. These would include routine loans, leases, and purchases of stocks and bonds in the ordinary course of business.

We are familiar with many actual cases where plans have been deprived of good investments or services because of these rules, or where parties have inadvertently engaged in perfectly proper, but nevertheless prohibited, transactions. For example:

Equitable, as the Government's approved fiduciary for the Central States Fund, has been unable to use State Street Trust's Short-Term Investment Fund to earn a return on cash balances because State Street has purchased debt securities issued by a few major banks which happen to provide unrelated services to the Fund.

A commingled account maintained for pension plans by Prudential was unable to make a loan to a quality borrower because that borrower feared that its relations with Taft-Hartley plans would ultimately make the loan a prohibited transaction.

The subsidiary of one insurance company issued its commercial paper to a bank trustee who, it was later learned, was purchasing the obligation on behalf of a plan that had placed other unrelated assets with the insurance company. Thus, a prohibited transaction occurred.

To deal with these problems, the statute provides an administrative exemption procedure. During the initial years following the enactment of ERISA, it was generally agreed that the procedure worked very poorly, when it worked at all. For example, a major class exemption that involved insurance company separate accounts took over four years to process. Recently, we have seen some improvement in the administration of the procedure. Certainly, it is clear to us that the Department of Labor is making genuine, good faith efforts to make the program work. Moreover, we believe that Department officials are not unsympathetic with many of our problems.

Nevertheless, we currently have on file three applications whose pendency can be measured in years. Additionally, notwithstanding that five years have expired since the enactment of ERISA, regulations have never been issued construing many of the key statutory prohibited transactions and exemption provisions.

More importantly, the current procedure for granting exemptions for routine individual investment transactions entered into by institutional fiduciaries is inadequate to deal with these transactions because of the time delays inherent in the exemption process. Even where an exemption application is processed expeditiously (i.e., within 60 to 90 days), the delays are too long because decisions on most transactions must normally be made within 30 days, and frequently within only a few hours or days. Needless to say, the process of identifying potentially prohibited transactions, applying for an exemption and policing subsequent transactions to determine compliance with the exemption is an expensive one, and these costs are ultimately passed on to participating plans.

Class exemptions that are currently available have not eliminated these problems. For example, the insurance company pooled separate account exemption (PTE 78-19) requires insurance companies to go through complex analytical procedures in connection with almost all separate account investments in order to determine whether, and under what conditions, the exemption is available for the transaction involved. These procedures have proved to be much more costly and burdensome to apply than had been expected and have already resulted in troublesome delays and confusion.

There have been a number of occasions in which investments have been lost—primarily loans—where the borrower was in a position to readily place the loan and the prospect of delays and uncertainties resulting from an "ERISA search" was sufficient to deter the lender or the borrower from using separate account facilities.

Also, while the companies have been working with ERISA's prohibited transaction provisions for nearly five years, and have identified many of the major areas of concern, we continue to identify new problems on a regular basis. For example, we are currently working on several new exemption requests.

To deal with these problems, we propose that amendments be made that would reduce substantially these problems in the case of professional, institutional fiduciaries without sacrificing any essential safeguards for plans whose assets are being managed. Specifically the amendments would incorporate the following principal features:

1. Institutional fiduciaries would not be required to obtain advance approval from the Department of Labor to engage in party in interest transactions. However, advance approval would still be required for transactions involving potential self-dealing, conflicts, etc.

2. The current advance approval requirement would only be removed in the case of a "qualified professional asset manager". To be a qualified professional asset manager, a person would have to meet the following requirements:

(a) Be a bank, insurance company or registered investment adviser; and

(b) Satisfy certain existing Department of Labor reguations relating to financial responsibility (DOL Reg. § 2550.404b-1(a)(2)(i)).

3. After a determination on the record that there has been a pattern of abuse, the Department of Labor could reinstate the advance approval requirement with respect

to a class of professional asset managers or with respect to a class of transactions or it could impose more rigorous financial responsibility safeguards.

4. The transaction must be on arm's-length terms. The burden of proof of establishing compliance with this requirement would be on the professional asset manager in any proceeding where compliance is in issue or if DOL requests the professional asset manager to furnish an affidavit setting forth compliance information.

5. Where exemption applications are still required, the Department would be required by statute to process expeditiously applications by qualified professional asset managers. While certain standards might be suggested by Committee Report, the proposal does not contemplate the imposition of statutorily specified mandatory time requirements.

6. A special rule would be provided to lessen the problems of accounting for employer securities and real property in commingled accounts.

We appreciate this opportunity to testify and look forward to working with the Committee and its staff on details of this and other proposals.

TESTIMONY OF THEODORE R. GROOM ON BEHALF OF THE PRUDENTIAL INSURANCE CO. OF AMERICA, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., CONNECTICUT GENERAL LIFE INSURANCE CO., AETNA LIFE & CASUALTY

This statement is submitted on behalf of The Prudential Insurance Company of America, The Equitable Life Assurance Society of the United States, John Hancock Mutual Life Insurance Company, Connecticut General Life Insurance Company and Aetna Life & Casualty. These five companies provide insurance and annuity contracts, pension funding arrangements, and investment management, administrative and other services for numerous employee benefit plans throughout the United States.

In this statement, we will focus on four issues or particularly troublesome problem areas relating to ERISA and S. 209 that are greatest concern to the companies. There are, of course, additional problems and questions under ERISA in which we are interested and, in this regard, we strongly support and endorse the tesimony on S. 209 that has been submitted to this Subcommittee by the American Council of Life Insurance.

Briefly, our comments are as follows:

(1) *Insurance Company General Account Assets.* We strongly support the purpose of section 141 of S. 209, which is designed to make clear that when an insurance company issues a contract to a plan, the contract, rather than the insurance company's general account assets, constitutes the "plan asset" for purposes of ERISA. However, modifications are needed in section 141 to ensure that this purpose is clearly reflected in the language of the bill.

(2) *Prohibited Transactions.* The prohibited transaction provisions of ERISA should be amended to enable responsible professional asset managers to make investments on behalf of plans without undue impediments. Such an amendment should:

(a) Substitute for the "prior restraint" prohibitions for party in interest transactions engaged in on behalf of plans by *qualified* professional asset managers a more balanced system of safeguards;

(b) Simplify the procedures for accounting for employer securities and real property in the case of pooled investment funds; and

(c) Retain the "prior restraint" prohibitions against self-dealing, conflicts of interest, etc., but require the Labor Department to adopt procedures for expeditious processing of exemption requests submitted by qualified professional asset managers.

(3) *Joint and Survivor Annuities.* The joint and survivor annuity provisions of S. 209 improve current law as applied to defined contribution plans. We believe, however, that the benefits, if any, to participants of the proposal to expand joint and survivor annuity coverage do not justify the substantial costs and administrative burdens that would be imposed on plans, and we therefore oppose its adoption. We also propose that the provision of S. 209 applicable to plans that provide annuities as the normal form of benefit be amended to eliminate the notice and election requirements if such plans automatically provide a death benefit at least equal in value to the survivor benefit provided by ERISA.

(4) *Small Employer Plans.* The following three changes in S. 209 are proposed to foster the growth of plans among small employers:

(a) *Target Benefit Plans.* The benefit limitation provisions of section 415 of the Internal Revenue Code should be modified to apply the defined benefit plan annual benefit limitations to target benefit plans.

(b) *Special Master Plans.* The special master and prototype plan provisions of section 301 of S. 209 should be modified to make this program more attractive to employers and financial institutions by further reducing administrative costs and burdens for these plans and by clarifying the duties of financial institutions under these plans.

(c) *Insurance Salesmen.* The ERISA definition of "fiduciary" should be modified to make clear that an insurance salesman's normal sales activities do not make him a plan fiduciary.

These comments and recommendations are discussed below in further detail.

Insurance company general account assets

Section 141 of S. 209 would amend section 401(b)(2) of ERISA to make clear that where an insurance company issues a contract to a plan and allocates amounts received under the contract to the company's general account, the contract, rather than the assets of the general account, will be considered to be the "plan assets" to which ERISA's fiduciary responsibility provisions are applicable. As Senator Williams indicated in his statement introducing S. 209, this amendment is designed to "codify exactly" the Labor Department's position on this question, which is embodied in ERISA IB 75-2.

We believe this is the correct interpretation of ERISA. If it were interpreted otherwise, it is possible that the management of general account assets would be subjected to a host of restrictions that were never intended to be applied in such cases. For example, the ERISA prohibited transaction restrictions generally prohibit all transactions with employers and various other categories of persons who are directly or indirectly related to a plan, even if the transaction is prudent and on arm's-length terms. Many life insurance companies issue general account contracts in connection with the employee benefit plans of thousands of employers. The same insurance companies engage in billions of dollars of financial activity throughout the United States, including lending money or leasing facilities to thousands of businesses. Obviously, there are many overlaps between businesses in their capacities as employer/customers and in their capacities as investment sources If the prohibited transaction rules of ERISA were to be applicable to transactions with all of these companies and their affiliates (and the multitude of service providers who may be parties in interest of insured plans, and their affiliates), the investment and marketing activities of life insurance companies would be at least severely curtailed and, at worst, brought to a complete halt. The disruptive impact would adversely affect not only life insurance companies, employers, plans, participants and beneficiaries generally, but also the economy of the United States which relies heavily on the investment of life insurance company assets for financing and capital formation.

Accordingly, we strongly support the enactment of section 141. We urge, however, that modifications be made in the language of section 141 to eliminate any possibility that insurance company general account assets could under any circumstances be deemed to be "plan assets". We cannot over-emphasize the importance of such a clarification. If the issuance of even a single contract based on an insurance company's general account were to result in general account assets being plan assets, then conceivably every one of hundreds or thousands of transactions, involving all of the assets of such general account and, therefore, literally billions of dollars of financial activity, would have to be individually scrutinized in terms of whether the transaction complies with the technical requirements of ERISA. Such a result will be severely disruptive of the vital investment activities of insurance companies.

In order to eliminate this possibility, we recommend that section 141, as set forth below, be modified by the addition of the commas in the second and third lines and the removal of the bracketed language.

"In the case of a plan which is funded in whole or in part by a contract, or policy of insurance, issued by an insurer, the assets of the plan shall include such contracts or policy but shall not[, solely by reason of the issuance of such contract or policy,] include the assets of the insurer issuing the contract or policy except to the extent that such assets are maintained by the insurer in one or more separate accounts and do not constitute surplus in any such account. For purposes of this paragraph, the term 'insurer' means an insurance company, insurance service, or insurance organization, qualified to conduct business in a State."

These modifications remove any implication that there may possibly be some general account contracts issued by insurance companies that might cause the assets of the general account to be deemed to be plan assets.

Prohibited transactions

As applied to institutional fiduciaries such as life insurance companies and banks, the prohibited transaction provision of ERISA present a classical case of statutory overkill resulting in government over-regulation

In the absence of an exemption, literally thousands of desirable financial transactions in which insurance companies engage on behalf of employee benefit plans would be prohibited transactions under ERISA These would include routine loans, leases, and purchases of stocks and bonds in the ordinary course of business.

We are familiar with many actual cases where plans have been deprived of good investments or services because of these rules, or where parties have inadvertently engaged in perfectly proper, but nevertheless prohibited, transactions. For example:

A commingled account maintained for pension plans by Prudential was unable to make a loan to a quality borrower because that borrower feared that its relations with Taft-Hartley plans would ultimately make the loan a prohibited transaction

Prudential has also had to forego purchasing high quality commercial paper issued by GMAC for its pooled account because the National Automobile Dealers Association pension trust is one of the participants in the account.

The subsidiary of one insurance company issued its commercial paper to a bank trustee who, it was later learned, was purchasing the obligation on behalf of a plan that had placed other unrelated assets with the insurance company. Thus, a prohibited transaction occurred.

To deal with these types of problems, the statute provides an administrative exemption procedure During the initial years following the enactment of ERISA, it was generally agreed that the procedure worked very poorly, when it worked at all. For example, a major class exemption that involved insurance company separate accouts took over four years to process. Recently, we have seen some improvement in the administration of the procedure. Certainly, it is clear to us that the Department of Labor is making genuine, good faith efforts to make the program work. Moreover, we believe that Department officials are not unsympathetic to many of our problems

Nevertheless, we currently have on file three applications whose pendency can be measured in years. Additionally, notwithstanding that five years have expired since the enactment of ERISA, regulations have never been issued construing many of the key statutory prohibited transaction and exemption provisions.

More importantly, the current procedure for granting exemptions for routine individual investment transactions entered into by institutional fiduciaries is inadequate to deal with these transactions because of the time delays and costs inherent in the exemption process. Even where an exemption application is processed expeditiously (i e., within 60 to 90 days), the delays are too long because decisions on most investment transactions must normally be made within a much shorter period of time, and frequently within only a few hours or days. Needless to say, the process of identifying potentially prohibited transactions, applying for an exemption and subsequently policing the transactions to determine compliance with the exemption is an expensive one, and these costs are ultimately passed on to participating plans.

Class exemptions that are currently available have not eliminated these problems. For example, the insurance company pooled separate account exemption (PTE 78-19) requires insurance companies to go through complex analytical procedures in connection with almost all separate account investments in order to determine whether, and under what conditions, the exemption is available for the transaction involved. These procedures have proved to be much more costly and burdensome to apply than had been expected and have already resulted in troublesome delays and confusion.

There have been a number of occasions in which investments have been lost—primarily loans—where the borrower was in a position to readily place the loan and the prospect of delays and uncertainties resulting from an "ERISA search" was sufficient to deter the lender or the borrower from using separate account facilities.

Also, while the companies have been working with ERISA's prohibited transaction provisions for nearly five years, and have identified many of the major areas of concern, we continue to identify new problems on a regular basis. Thus, we are currently working on several new individual and class exemption requests.

To deal with these problems, we propose that amendments be made to ERISA that would reduce substantially these problems in the case of qualified professional fiduciaries without sacrificing any essential safeguards for plans whose assets are being managed. Specifically, the amendments we propose would incorporate the following principal features:

1. Qualified professional asset managers would not be required to obtain exemptions from the Department of Labor to engage in party in interest transactions. However, exemptions would still be required for transactions prohibited by section 406(b) of ERISA.

2. The current requirement to obtain an exemption would be removed only in the case of a "qualified professional asset manager." To be a qualified professional asset manager, a person would have to meet the following requirements:

(a) Be a bank, insurance company or registered investment adviser; and

(b) Satisfy Department of Labor standards relating to financial responsibility. In this regard, standards already used in DOL Reg. § 2550.404b-1(a)(2)(i) would be appropriate.

3. If a determination is made on the record that there has been a pattern of abuse, the Department of Labor could reinstate the party in interest prohibitions with respect to an individual or class of professional asset managers or with respect to an individual or class of transactions, or it could impose more rigorous financial responsibility safeguards.

4. All party in interest transactions would continue to have to be on arm's-length terms. Moreover, the burden of proof of establishing compliance with this requirement would be on the professional asset manager in any proceeding where compliance is in issue.

5. Where exemption applications are still required, the Department would be required by statute to process expeditiously applications by qualified professional asset managers. While certain standards might be suggested by Committee Report, the proposal does not contemplate the imposition of statutory specified mandatory time requirements.

6. A special rule would be provided to lessen the problems of accounting for employer securities and real property in pooled investment funds maintained by insurance companies and banks which would permit such funds to invest up to 10 percent of their assets in employer securities or real property.

Joint and survivor annuity requirements

Section 127 of S. 209 would significantly modify and expand the joint and survivor annuity requirements applicable to plans under current law.

Under current law, all plans that have annuity options must provide participants with the option to obtain survivor coverage after such participants reach early retirement age under the plan, or, if later, age 55. Prior to retirement, such coverage need be provided only if the participant affirmatively elects such coverage. Upon retirement, current law requires that all plans with annuity options must pay benefits in the form of a joint and surivivor annuity unless the participant elects otherwise. Complex notice and election provisions are also applicable to plans to which the joint and surivivor annuity requirements apply.

Section 127 of S. 209 would make the following significant changes in current law:

(1) Plans that do not provide an annuity as the normal form of benefit would be required to provide the value of a participant's vested benefits to the surviving spouse if the participant dies at any time after achieving 10 years of vesting service. Thus, defined contribution plans, such as profit sharing and thrift plans, would no longer be required, as they are under current Treasury regulations, either to provide automatically for a joint and survivior annuity as the normal form of benefit under the plan, and hence subject themselves to burdensome notice and election requirements, or, on the other hand, to eliminate annuity options from the plan altogether.

(2) Plans that provide an annuity as a normal form of benefit would be required to provide a survivor benefit in the form of an annuity to the surviving spouses of a participant who dies anytime after attaining 10 years of vesting service unless the participant affirmatively elects to the contrary. Payment of the survivor annuity may begin no earlier than the date on which the participant would have reached the earliest retirement age under the plan.

S. 109 would make the above changes in current law effective for active participants, and vested participants who have terminated from service, for all plan years beginning on or after the date that is one year after the proposed changes are enacted into law.

We strongly support the provisions of S. 209 that would eliminate needless and costly burdens that have discouraged the inclusion of annuity options in defined contribution plans. On the other hand, we believe that expanding the scopé of the current joint and survivor requirements to all participants with 10 years of vesting service is not in the best interests of plan participants and hence should not be adopted. We also urge that the joint and survivor annuity rules applicable to plans that provide annuities as the normal form of benefit be amended to eliminate the notice and election requirements for pre-retirement survivor annuities if such plans automatically provide a death benefit that is at least the actuarial equivalent of the survivor benefits required under ERISA. Finally, we urge the adoption of certain changes of a more technical nature, which are described below.

Defined Contribution Plans: In contrast to defined benefit plans, the basic form of benefit under many forms of defined contribution plans has historically been lump-sum distributions, although these plans typically provide for benefits under other options, including life annuity options. As interpreted by Treasury regulations, ERISA currently requires defined contribution plans that provide an annuity option to be restructured to make a joint and survivor annuity the basic or normal form of benefit under the plan. These plans are also subjected to the burdensome joint and survivor annuity notification and election procedures, even though most participants choose to receive their benefits in the lump-sum form. Many plan sponsors have responded to these administrative problems by eliminating life annuity options from their plans. In short, plan sponsors generally do not believe they can justify the costs of complying with the joint and survivor annuity administrative rules if the vast majority of plan participants are electing to receive their benefits in the lump-sum form. Of course, this also means that those participants for whom an annuity option, including a joint and survivor annuity option, is appropriate no longer have that option, a result totally contrary to the purpose of the joint and survivor annuity rules

S. 209 would address this problem by providing that plans need not be restructured to make a joint and survivor annuity the normal form of benefit under the plan. It also eliminates the application of unnecessary and costly notice and election requirements for such plans. We strongly support these provisions and urge that they be adopted.

Expansion of Survivor Coverage: We oppose the proposal to expand survivor coverage to all participants with at least 10 years of vesting service because believe the costs and additional burdens imposed by such a change far outweigh the additional benefits, if any, that would be provided.

We question, first of all, whether the additional requirements imposed under S. 209 will result in a net increase in benefits to the survivors of plan participants. Many employers now provide for survivor protection through means other than their retirement plans, *e.g.*, in the form of group life insurance. Mandating additional death benefits under the retirement plan may only cause a shift in the same amount of benefit from one form to another.

Also, the amount of the death benefit that could be provided when a participant dies at, *e.g.*, age 35, would be very small in most cases. Such a participant's accrued benefit would not be substantial at early ages and the survivor benefit, after actuarial reductions, would be smaller still. The American Council of Life Insurance estimates, for example, that for each dollar of accrued benefit, the survivor benefit would only be in the range of 15 to 20 cents.

While the benefits of the S. 209 proposal are likely to be small, the additional costs and burdens that would be imposed on plans would be significant. Additional notification requirements would be imposed. Contact with the surviving spouses would have to be maintained over substantially longer periods of time. The complexity of actuarial computations would increase significantly. The burdens and administrative costs created by expanding joint and survivor coverage would be, we submit, far out of proportion to any benefits resulting therefrom.

Automatic Survivor Coverage: Under current law and under S. 209, defined benefit plans are required to provide participants prior to retirement with the right to obtain survivor coverage after attaining a certain age or status under the plan. Plans are not required to subsidize such coverage, however. Thus, if a participant decides to bear the cost of this pre-retirement survivor protection, he or she must elect to receive it under complex procedures specified in regulations. However, some defined benefit plans, many of which are funded with insurance contracts, automatically provide a death benefit that, although different in form from a qualified joint and survivor annuity, equals or exceeds the minimum requirements of both ERISA and those that would be imposed under S. 209. Because these plans and designed to provide a pre-retirement death benefit automatically, the survivor annuity rules, including the notice and election requirements, are an unnecessary burden for these plans and, consequently, they should be eliminated.

Other Suggestions: We urge that the provisions of S. 209 be modified to make it clear that (1) a participant in a plan described in proposed section 205(c) may designate a beneficiary other than his or her spouse for the death benefit provided under the plan, and (2) consistent with the approach taken under current law, any new provisions adopted should apply only to persons who are active participants on or after the provisions become effective. With regard to beneficiary designations, the law should recognize the legitimate right of a participant for reasons of estate planning or otherwise to designate a beneficiary other than his or her spouse. We also believe that the applicability of any new provisions should be mandatory only with respect to active participants in plans after the effective date of section 127 in order to avoid imposing undue notification burdens on plans with respect to terminated participants. Such a limitation will also avoid unwanted reductions in the retirement benefits of terminated participants who, because of the inability of their employer to locate them, are unaware of their right to elect out of survivor coverage.

Small employers

One of the principal purposes of S. 209 is to encourage increased coverage under private pension plans for American workers. S. 209 attempts to accomplish this purpose by making plans more attractive for employers, particularly small employers, through reduced administrative costs and burdens, tax credits and a new special master and prototype plan program.

We strongly support the objectives of S. 209 to stimulate the growth of private pension plans among small employers. However, be believe that additional steps can and should be taken to achieve this objective. Also, modifications must be made in the special master and prototype plan provisions in order to ensure that this program will be attractive to employers and financial institutions.

Our proposals in this regard are as follows:

(a) Target Benefit Plans

Various studies have shown that approximately 50 percent of the labor force in the United States is not covered by any private retirement plan. A large number of these workers are employed by small, closely-held employers for whom the current retirement plan options hold little attraction. Defined contribution plans, such as profit-sharing plans, are frequently not attractive because the limits on permissible annual contributions to these plans for each employee (the lesser of 25 percent of compensation or $32,700) are not sufficient for older employees, often including shareholder-employees, to provide for an adequate retirement income in a newly established plan.

While defined benefit plans do not suffer from this problem, they can be unattractive for small employers because of the high administrative costs and burdens associated with such plans, such as the need to obtain acturial certifications, and because they are subject to the termination insurance provisions of ERISA, including contingent employer liability.

Target benefit plans could be a very attractive alternative for small employers. Like defined benefit plans, these plans let employers fund a reasonable retirement income, compared with active years' earnings, for such employee, young or old. In both kinds of plans, the employer contributes a much higher percentage of pay for older workers than for younger ones. This is as it should be since the older worker has a much shorter time in which to have his retirement income bought for him.

Although target benefit plans are established to provide a targeted benefit, they also provide for individual accounts for each employee, with actual benefits under the plan varying with actual investment experience. Target benefit plans are also not subject to the ERISA actuarial certification requirements or the plan termination insurance provisions. Thus, administrative costs and potentially severe liabilties for employers that are normally associated with defined benefit plans are reduced under these plans. Also, the target benefit under these plans, while not promised as under a defined benefit plan, nevertheless provides a useful guideline as to what each employee's retirement income is likely to be. In addition, unlike defined benefit plans, target benefit plans provide that favorable investment experience in excess of that which was assumed will serve to increase retirement benefits for employees rather than reducing employer contributions to the plan. All of these features are particularly attractive to small employers and beneficial to their employees.

However, these plans lose their attraction for small employers because they are subject to the Internal Revenue Code limitations on annual contributions applicable to defined contribution plans (i.e., the lesser of 25 percent of annual compensation or approximately $32,700). These limits frequently do not permit the accumulation of a sufficient fund to provide an adequate retirement income for older employees.

If, however, the defined benefit plan annual benefit limitations (i.e., the lesser of 100 percent of average final three years' compensation or approximately $98,100) were instead applicable to target benefit plans, these plans could provide adequately for the retirement needs of both young and old employees on a non-discriminatory basis, and would, therefore, be much more attractive to small employers. In this regard, Prudential has surveyed a random sample of target benefit plans with respect to which Prudential has issued contracts. In 29 percent of these plans, the largest contribution is at or near the maximum of 25 percent of compensation. However, because of the contribution limits, most of these plans can only provide a target retirement income of less than 40 percent of final pay, and in some cases, less than 25 percent of final pay. Thus, a participant's target retirement income under these plans is required to be held to a ralatively low percentage of pay, situation which is particularly troubling in times of rampant inflation.

Accordingly, we believe that a change in section 415 of the Code to apply the defined benefit plan annual benefit limitations (instead of the defined contribution plan annual contributions limitations) to target benefit plans would be an important step in fostering the growth of new plans among small employers.

Special master plans

Section 301 of S. 209 contains a new special master and prototype plan program that is intended to reduce administrative burdens and shift them to financial institutions thereby encouraging small employers to take advantage of this program to establish a plan. We believe that this is a worthwhile objective and, in fact, insurance companies have for many years successfully sponsored a variety of master and prototype plans.

Nevertheless, section 301 raises numerous problems that we believe will discourage employers and financial institutions from participating in the special master plan program. For example, as proposed these plans would shift almost all fiduciary responsibilities and liabilities, as well as the title "plan administrator", to the financial institution sponsoring the master plan. Such a shifting of responsibilities and functions would subject financial institutions to liability for matters which are not in most cases within their control (such as the employer's selection of the financial institution's special master plan, the distribution of disclosure materials to employees, etc.). Also, financial institutions would become subject to ERISA financial penalties for unintentional errors in any disclosure materials they prepare under this program.

In addition, section 301 does not go far enough in reducing paperwork burdens. For example, the volume of information required in the annual report for these plans, could be substantially reduced. Also, section 301 would not eliminate the need for employers to seek advance determination letters even though this procedure in the context of master and prototype plans is largely unnecessary.

Since many of the most costly administrative burdens imposed by ERISA relate to defined benefit plans, the special master plan program should also permit the adoption of a special master simplified defined benefit plan (as an alternative to a more standard special master defined benefit plan). Such a plan should be patterned on the insurance contract plans already permitted by section 412(i) of the Code, with, among other things, fixed actuarial assumptions and a full funding requirement under the level annual premium funding method. Funding of these plans might be restricted to fully guaranteed insurance company accounts, or bank certificates of deposit, Treasury bills or similar fixed-income obligations. In the presence of these requirements, it should be possible to eliminate costly actuarial reports and certifications and coverage under the termination insurance provisions of Title IV of ERISA.

We believe that these changes are essential for the success of the special master plan program.

Insurance salesmen

Insurance agents and brokers have been a major factor in the growth of employee benefit plans in the United States. Through their sales efforts, they actively encourage employers to establish pension and welfare plans. For many plans, particularly small plans that they have helped to establish, insurance agents and brokers also provide valuable technical services in plan management and administration, thereby reducing the costs and burdens of maintaining a plan for many employers.

Although the agent's or broker's function is principally that of a salesman, the Labor Department has indicated that, under certain unspecified facts and circumstances, agents and brokers may be fiduciaries under ERISA by reason of providing "investment advice" to plans when making a normal sales presentation. Conceivably, this would subject agents and brokers to all of the fiduciary responsibility requirements of ERISA, even though these requirements were not meant to be applied to salesmen.

For example, ERISA requires fiduciaries to discharge their duties "solely in the interest of participants and beneficiaries." Although in making a sales presentation an agent or broker takes into account the needs of plan participants and beneficiaries, by the nature of the transaction he must consider many other factors as well. These include the financial burden the employer is able to assume, the type of benefits the employer wishes to provide, and the extent to which the employer can handle the day-to-day administration of a plan.

In addition, because it is unclear under what circumstances an insurance agent or broker might become a plan fiduciary by reason of making a sales presentation to a plan, many agents and brokers, including those who would clearly not the fiduciaries under any reasonable interpretation of ERISA, feel compelled to comply with all of the conditions and requirements of Prohibited Transaction Exemption 77-9 in connection with the sale of insurance products to plans. PTE 77-9 permits, among other things, insurance salesmen who are fiduciaries to receive their normal commissions on the sale of insurance products to plans. Failure to comply with PTE 77-9 exposes the salesman to potential liability and excise taxes for a violation of the prohibited transaction rules. The requirements of PTE 77-9 are, however, extremely burdensome. Among other things, salesmen are required to provide plan fiduciaries with complex written disclosures and to make difficult legal judgments with respect to affiliations with plan fiduciaries and others. These burdens tend to induce agents and brokers to avoid the employee benefits field.

Insurance companies are also exposed to unnecessary risks and burdens under the current situation because a failure to comply with PTE 77-9 might lead to rescission of contracts issued to plans. As a result, many insurance companies feel obligated to enforce agent and broker compliance with PTE 77-9, which is enormously burdensome from an administrative and paperwork standpoint. Ultimately, the cost of this compliance effort is borne by plans. Further, in those situations where it is unclear whether an agent or broker is actually a "fiduciary," some companies, acting conservatively, require compliance, and some do not. This creates unfair competitive problems between companies since most agents and brokers would prefer to sell products for companies which impose the fewest administrative burdens. These competitive problems are inappropriate since they are not based on substantive differences between insurance products, but on different perspectives on the need to comply with ambiguous government regulations.

In order to eliminate these problems, we urge that the ERISA definition of "fiduciary" be amended so that an insurance salesman's normal sales activities will not be considered to be "investment advice" of a type that would make the salesman a plan fiduciary.

The concept of "investment advice" normally involves the impartial rendering of recommendations on investments to a client on a regular or continuous basis. Such advice is commonly furnished pursuant to a formal written agreement. The investment adviser is generally expected to render disinterested advice for a fixed fee payable directly by the client that is not dependent on whether any particular investment is made. The relationship is normally considered to be one of strict trust and confidence involving a clear identity of interest between the adviser and the client.

The normal insurance sales presentation generally does not involve a written agreement for the rendering of disinterested advice on the investment or disposition of plan assets. Rather, it is generally understood that the salesman's goal is to sell a product and that he will be compensated only if he is successful in doing so. As a result, dealings between a plan sponsor and an insurance agent or broker are generally on a much more arm's-length basis than the close relationship of investment adviser and client. The ERISA definition of "fiduciary" should take these differences into account by excluding the normal sales activities of an insurance salesmen from the concept of "investment advice."

In this regard, it should also be noted that the National Association of Insurance Commissioners has adopted a model statute designed to preclude, among other things, unfair and deceptive acts and practices in the sale of insurance products. This statute, which has been adopted in some form by all 50 states and the District of Columbia, prohibits insurance salesmen from making misrepresentations with respect to various key elements of insurance products. Violations of this statute can result in substantial monetary penalties and license revocation. Thus, there already exists at the state level substantial regulation of the activities of insurance salesmen which renders largely duplicative and unnecessary additional regulation under the fiduciary responsibility provisions of ERISA.

We would be glad to assist the Subcommittee and its staff in the development of this legislation and the recommendations set forth in this statement.

Senator MATSUNAGA. Our next panel of witnesses consists of Mr. Robert C. Gilkey, deputy director, Department of Labor and Industrial Relations of the State of Hawaii; Mr. Orlando Watanabe, administrator, disability compensation division, Department of Labor and Industrial Relations of the State of Hawaii; and Ms. Carol Yamamoto, deputy attorney general, State of Hawaii.

They have traveled 5,000 miles just to be here today. I am truly happy to have this opportunity to chair the hearing while these three distinguished citizens of Hawaii testify.

You may proceed.

STATEMENT OF ROBERT C. GILKEY, DEPUTY DIRECTOR, DEPARTMENT OF LABOR AND INDUSTRIAL RELATIONS, STATE OF HAWAII, ACCOMPANIED BY ORLANDO WATANABE, ADMINISTRATOR, DISABILITY COMPENSATION, AND CAROL YAMAMOTO, DEPUTY ATTORNEY GENERAL

Mr. GILKEY. Thank you, Senator.

It is true that we have, indeed, come a long way, but this legislation is important to us, and we are very grateful to have this opportunity to testify on S. 209, the ERISA Improvements Act of 1979, with particular reference to section 155.

As you will recall, in August of 1978, we testified along with Mr. A. Van Horn Diamond, who at that time was the executive secretary of the Hawaii Central Labor Council of the AFL-CIO, before a joint hearing of this subcommittee, and the Labor Subcommittee of the Committee on Labor and Human Resources regarding S. 1383 which you and Senator Inouye introduced on behalf of the State of Hawaii. We like to think that our testimony helped to persuade Senators Williams and Javits to introduce S. 209 in January of this year, with Section 155, providing for an exemption of the Hawaii Prepaid Health Care Act, included in the bill.

We were pleased that both you and Senator Inouye testified last February in support of section 155 in hearings before the Committee on Labor and Human Resources. We were also pleased to learn that Hon. Ray Marshall, Secretary of Labor, presented supportive testimony for section 155 during those hearings.

We are here today to add our support in urging the expeditious passage of section 155 of S. 209 by the Finance Committee in order to clarify our belief that State-mandated comprehensive health insurance plans are not intended to be preempted by ERISA. At stake is Hawaii's unique and innovative plan for providing health insurance coverage for vitually all workers and many of their dependents at a cost which experience has shown to be affordable for both employees and employers, and which involves only minimal administrative costs on the part of government.

Clearly, it is a plan that works very well. While universal comprehensive basic health insurance coverage continues to be a subject of debate on the national level, Hawaii comes very close to having it right now. A recently completed federally funded study has concluded that the insurance plans required by the Hawaii Prepared Health Care Act when combined with medicare, medicaid and individual plans cover approximately 98 percent of the civilian population of the State. In fact, Hawaii's law reflects many of the principle features currently under discussion for the establishment of a comprehensive national health insurance program which is focused on requiring employers to provide basic coverage that meets established standards.

According to the Federal study the key to its low cost is the highly competitive nature of the health insurance industry in Hawaii. Our major insurance providers are constantly reviewing health care utilization for excessive services and changes. As a result, recent statistics show that Hawaii's inpatient hospital admission rate per 1,000 persons was 111.8 versus 159.9 for the country as a whole. Hawaii also has a low 3.1 hospital bed supply per 1,000 persons versus the national average of 4.5 beds.

The Hawaii Prepaid Health Care Act, a summary of which is provided for your information, and attached to our testimony today, has as its purpose a two-fold objective: First, to provide basic comprehensive health insurance for workers who were previously unprotected; second, to mandate a reasonably adequate level of basic benefit coverage for those whose existing plans provided insufficient benefits.

The means by which these objectives were accomplished are really quite simple. First, all employers are required to provide prepaid health care coverage to their employees, and to pay at least one half of the premium cost. The coverage may be from an insurance carrier, a health care contractor or provider, an approved self-insurance plan, or a collectively bargained plan. Workers may be required to pay up to one half the cost of premiums, but in no event more than 1.5 percent of their wages.

Second, the law mandates that the benefits provided must be equal to or better than those provided under the health care provider or insurance carrier plan having the most subscribers in the State and must, as a minimum, include benefits for outpatient care, 120 days per year of hospital care, medical fees for home, office, and hospital visits, laboratory services, maternity care and substance abuse treatment.

Perhaps the most important effect of the enactment of this law has been to mandate adequate, affordable coverage for the workers at the bottom of the wage scale, particularly those who are without union representation. Prior to its passage, these workers were typically either not covered at all, offered inferior coverage, or offered coverage at rates beyond their means.

Now, a full time, 40-hour-per-week worker earning the minimum wage of $2.90 per hour, receives good basic health insurance coverage at a cost to him or her which by law cannot exceed $1.74 per week, or about $90 per year. A 20-hour-a-week worker, therefore, would only pay about $45 per year.

It is the fate of these workers and their families that is our deepest concern, should the Hawaii Prepaid Health Act be ruled to come under the preemption clause of ERISA. It is they who are most vulnerable to rising medical costs, and who are least able to afford the insurance protection. It was this concern for Hawaii's working poor, the gap group that earns too much to qualify for welfare, but not enough to afford individually purchased medical care, that led to the passage of our law.

Senator, Ms. Yamamoto, who is, incidentally, one of the attorneys assigned to the case of *Standard Oil* v. *Agsalud* now pending in the Ninth Circuit Court of Appeals, will now describe the history of our law.

Senator MATSUNAGA. We will be happy to hear from you, Ms. Yamamoto.

STATEMENT OF CAROL YAMAMOTO, DEPUTY ATTORNEY GENERAL, STATE OF HAWAII

Ms. YAMAMOTO. Senator Matsunaga, thank you for permitting the State of Hawaii to present testimony today on behalf of a law to which many individuals and organizations have devoted years of work and inspiration.

The origin of the Hawaii Prepaid Health Care Act began with a long-felt belief that a means should be found for providing adequate, affordable health care for all residents of the State. The specific genesis of this law can be found in a short paragraph in a 1967 Hawaii State appropriations act, which requested studies of legislative proposals for an increased minimum wage, temporary disability insurance, and prepaid health insurance.

In 1971 the study "Prepaid Health Care in Hawaii," by Prof. Stefan A. Riesenfeld, was published by the Hawaii State Legislative Reference Bureau, and a bill designed to implement the study's recommendations was introduced. It was then and still is a unique, pioneering piece of legislation. Like most such legislation, it was vigorously opposed by those who supported the status quo for both philosophical and economic reasons.

The bill did not pass that year, or in 1972, or 1973. However, in 1974, compelled by rising medical costs, and the lack of substantial progress in Congress toward the enactment of a national health insurance program, the State bill was passed and signed into law as act 210 of 1974, which became chapter 393 of the Hawaii Revised Statutes, effective June 12, 1974.

It is crucial to the understanding of the present preemption situation to realize that it was during the same 3-year period, 1971 to 1974, that Congress was working on the legislation which eventually became ERISA. Because ERISA and the Prepaid Health Care Act were developed and enacted simultaneously, neither took the provisions of the other into consideration. It is respectfully submitted that had the Hawaii Prepaid Health Care Act become law in 1971, 1972, or even 1973, Congress would have definitely included language, such as we now seek, or would have provided by some other means to clearly indicate that ERISA was not intended to preempt such a Government-mandated comprehensive health insurance plan.

It would be strange, indeed, had Congress really intended to nullify a law which has favorably impressed many health insurance and health care experts with its success.

For instance, in its report entitled "Outreach Report on National Health Insurance, October 1977," HEW Region IX noted that the Hawaii law has created in general a population that is far more conversant and knowledgeable in matters related to health insurance than populations in other parts of the region. "People talk more easily about alternatives and options," it continued, "and they have a better feel for what national health insurance could or could not do."

The report concluded, "Their collective understanding of Federal, State, and private roles in the formulation of health insurance policy would be valuable" in assessing administrative proposals.

Another confirmation of the value of Hawaii's successful experiment with prepaid health care insurance comes from the study alluded to earlier by Mr. Gilkey, which was conducted by the Martin E. Segal Co. of New York under Federal contract No. 299-77-0014.

The study, entitled "Universal Health Insurance in Hawaii, October 1978," developed criteria for the evaluation of Hawaii's law as a prototype for national health insurance. These criteria included coverage, benefits, equity of financing, equity to providers, incentives for efficiency, acceptability, adaptability, efficiency of administration, and quality controls.

The study found that: "In terms of these criteria, Hawaii ranks quite high. It is clear that Hawaii has accomplished in large measure what is being sought for the rest of the country."

Even Judge Charles B. Renfrew, who ruled against the State in *Standard Oil* v. *Agsalud,* noted that:

> The workers whom ERISA was primarily intended to protect may be better off with the State health insurance laws than without them, and the efforts of States like Hawaii to insure that their citizens have low-cost comprehensive health insurance may be significantly impaired by ERISA's preemption of health insurance laws.

He then cited Justice Brandeis' famous comment:

> It is one of the happy incidents of the Federal system that a single courageous State may, if its citizens choose, serve as a laboratory, or try novel social and economic experiments without risk to the rest of the country.

This is, indeed, what Hawaii has done with respect to prepaid health care. It therefore cannot be believed that in acting to reform the mismanagement and abuse of pension systems, Congress intended to eliminate this most successful "novel social and economic experiment."

I thank you for your time and attention. The balance of the testimony will be given by Mr. Gilkey.

Mr. GILKEY. Senator, It is clear that the Hawaii Prepaid Health Care Act is presently under attack because it succeeded only too well. The act has required certain employers to provide more benefits—benefits which the people of Hawaii, through their legislators, have deemed essential—than these companies are willing to provide on their own.

Having been defeated in the legislative arena, these employers now seek to have the courts frustrate the will of the citizens of Hawaii and they seek your assistance in doing so. Their case rests on a single issue: Does ERISA prevent the State of Hawaii from enforcing its prepaid health care act by preempting the field of health insurance legislation for the Federal Government?

There is nothing in the legislative history of ERISA to suggest such an intent, but a Federal court ruling now on appeal holds that such a preemption was accomplished by inadvertance if not by intention.

When ERISA was enacted, there was no apparent need to specifically exclude State-mandated comprehensive health insurance laws from its broad preemption—there were no such laws known to be in existence. Almost simultaneously, however, such a law did come into being. Now, some form of specific exclusion is both necessary and appropriate.

Tens of thousands of Hawaii's people are now covered by adequate health insurance as a direct result of the Hawaii Prepaid Health Care Act. It would be a bitter irony if ERISA, a landmark in the struggle to protect the continued well-being and security of millions of employees and their dependents, were to be used to blunt another milestone in this same struggle.

The battle in the courts has just begun. While we are confident of a final ruling in our favor, the road to that ruling may consume many years and many thousands of taxpayers' dollars to reach a conclusion that, with your help, can be reached in just a few weeks by adopting section 155 of S. 209, or in some other way clarifying the treatment of State-mandated comprehensive health insurance laws under ERISA.

It is important both to the workers of Hawaii and to the Nation that this important innovation in basic health care protection not be allowed to die. I respectfully urge your favorable consideration of section 155 of S. 209 or some suitable alternative.

Senator, Ms. Yamamoto, and Mr. Watanabe, who is the administrator of our Prepaid Health Care Act in Hawaii, will assist me in answering your questions.

Senator MATSUNAGA. Thank you very much, Mr. Gilkey, and Ms. Yamamoto. I think that you have presented an excellent case for the retention of Hawaii's prepaid health care law.

The relationship of the Hawaii Prepaid Health Care Act to ERISA is something which many do not fully understand. For that reason, will you state for the record, what that relationship is, and whether or not there is in fact a conflict between the Federal and Hawaii laws.

Ms. YAMAMOTO. Senator Matsunaga, there is no conflict between ERISA and the Hawaii Prepaid Health Care Act. ERISA itself contains no substantive provisions for welfare plans. ERISA is clearly not a national health care program, and with respect to welfare plans it simply provides protection to persons who have participated in employer plans through reporting, disclosure, and fiduciary requirements.

Admittedly, the Hawaii Prepaid Health Care Act is not a regulatory statute. It does not regulate employee benefits in the same way as ERISA does. It merely prescribes provision of health care benefits for plans mandated by the State. The reports that are required under the Hawaii law in no way conflict with those provisions that ERISA requires.

Senator, there is no conflict between the two.

Senator MATSUNAGA. One of my principal concerns, as is yours I am sure, is that by preempting the Hawaii health care law, Congress would be eliminating one of the most successful laws ever passed by any State in the Nation in the history of social welfare. As a matter of fact several of the major national health insurance proposals now pending before the Congress are modeled after the Hawaii law.

Consequently I am fearful of a serious gap ocurring in health insurance protection, which now covers 98 percent of Hawaii's population, if Congress should not pass a legislative exemption for the plan. Would you care to comment on that?

Mr. WATANABE. Senator, the Hawaii prepaid health care law guarantees health care protection for all qualified employees; that is, employees who work at least 20 hours a week and have 4 continuous weeks of employment.

The Hawaii law is primarily directed at the health care contractor and the employer doing business in Hawaii, rather than plan administrators. The Hawaii law does not regulate employee benefit plans. Rather, mandates employers to provide health insurance to their employees, which is guaranteed by law.

In the case where an employer neglects to provide the coverage, the regular employee is guaranted coverage which is paid from a specifically designated special premium supplementation fund established in the Treasury of the State of Hawaii. This fund would, in effect, pay for the employee's benefits, and collect from the employer whatever costs in benefits the fund has paid out.

The State attorney general has informed me that the Prepaid Health Care Act is a Government insurance program, in which by statute, the health insurance coverage is guaranteed.

That, hopefully, answers your question.

Senator MATSUNAGA. Thank you, Mr. Watanabe.

Yesterday, representatives of multiemployer plans argued against an ERISA exemption for State health insurance laws, such as the Hawaii Prepaid Health Care Act, on the basis that it would greatly increase the administrative costs for each multistate employer.

However, there are currently four major Federal labor laws concerning minimum wage, workplace safety standards, worker's compensation, and unemployment compensation, which as you know permit considerable State discretion in the administration of these laws. Varying State laws and regulations on these federally mandated programs have not appeared to affect multistate employers unduly.

Since its implementation, has the Hawaii Prepaid Health Care Act unduly impacted multistate employers doing business in Hawaii?

Mr. GILKEY. I don't believe that our prepaid health care law has had any undue impact. For example, you referred, to four Federal labor laws. Our State Department of Labor administers State laws in all four of those areas, which are applicable to multistate employers. In Mr. Watanabe's division, in addition to the prepaid health care law, he has the responsibility for worker's compensation, to which you referred, and for our temporary disability insurance law. Those State laws are also applicable to multistate employers.

Obviously, there would be some additional administrative costs, but we don't believe that they would have the kind of impact that would warrant retaining the preemption.

Senator MATSUNAGA. Aside from the Standard Oil Company of California suit, have you received any major complaints from the multistate employers in Hawaii with regard to complying with the requirements of the Prepaid Health Care Act?

Mr. GILKEY. Other than that, we have had no significant complaints.

Senator MATSUNAGA. None at all, just Standard Oil?

Mr. GILKEY. Yes.

Senator MATSUNAGA. What has been done to resolve the problems of the multistate employers if any, in complying with the Hawaii Prepaid Health Care Act?

Mr. GILKEY. I think we really have not had anything too significant, but certainly we do try to work with them to facilitate any problems that might arise.

Senator MATSUNAGA. Do you anticipate any problems for multistate employers in the future because of the continuance of the act?

Mr. GILKEY. No; I think that if section 155, or some suitable alternative is enacted, we will not have any significant problems. Of course, if we do not receive the exemption, we will continue to have court suits and other legal problems such as we have now with Standard Oil Company of California.

However, with the exemption that we are hoping to receive, we don't anticipate any significant problems.

Senator MATSUNAGA. In expressing opposition to the proposed Hawaii-ERISA exemption, multistate employers have contended that the total dollar value of the required minimum benefits under the Hawaii Prepaid Health Care Act is less than that contained in many health insurance plans currently offered by certain large multistate employers. What is your comment on this?

Mr. GILKEY. It may be true in a few cases, Senator. I think, basically, our act is geared toward the kind of community health care and health insurance standards that we have in Hawaii, rather than perhaps to other standards that may exist in mainland States. So, while it is true that the minimum statutory requirements under our act may be less than the benefits offered by some multistate employers, when one recognizes the purpose of our act, it becomes clear that we are really focusing on the problems which we see as most important and applicable to our community.

For example, as we mentioned earlier in the testimony, in Hawaii we provide much more on outpatient care than is provided in many other areas of the country. We have statistics that clearly show how this has significantly reduced overall health care costs without any adverse effects on the overall quality of patient care.

Senator MATSUNAGA. What is your position on the Department of Labor's recommendation that the Hawaii Prepaid Health Care Act be exempted from ERISA on a temporary, experimental basis only?

Mr. GILKEY. We are opposed to that position. Of course, something is better than nothing. At the same time, however, we feel that we have a good act, the success of which has been more than adequately demonstrated. Therefore, we certainly would like to have a complete exemption.

There would be continuing problems such as we have now, if we were exempted only on an experimental basis. We would definitely favor the complete exemption.

Senator MATSUNAGA. Assuming the worst for the record, that section 155 of S. 209 is not passed by Congress, and assuming further that the U.S. district court decision in *Standard Oil Company of California* v. *Agsalud* is affirmed by the Ninth Circuit Court, is there anything that the State of Hawaii could do to save the coverage currently afforded to Hawaii employees of multistate employers under the Prepaid Health Care Act?

Mr. GILKEY. What we could do in a situation like that would be to enact by State legislation some other form of a mandated health insurance program, which would eliminate those existing multistate plans with respect to our local employees who run into these ERISA preemption problems.

What we could do is to establish a State health insurance fund, which would be supported as our act is now by employer/employee contributions, and empower the State fund to arrange mandated benefits with contractors who would be chosen by employee elections.

This arrangement would essentially provide the same benefits and advantages that are now provided through our Prepaid Health Care Act, except that the multistate employers would then lose the possibility of providing coverage for their entire work force by a carrier of their own choice, such as they can do now.

We believe that this alternative would lead to greater inconvenience for these employers, and would also significantly increase their administrative problems and costs. For that reason, we definitely believe that the proposed amendment in section 155 is preferable and is really in greater harmony with the overall purpose of the proposed ERISA legislation.

Senator MATSUNAGA. Thank you very much.

Because of the great success of Hawaii's plan, I understand the State of California has adopted its own mandated health plan. Consequently, the Committee on Labor and Human Resources significantly broadened the exemption for Hawaii in section 155 of S. 209 to include any other mandated State health plan which meets the approval of the Secretary. Multi-State employers and labor unions have expressed serious concern over Congressional approval of such a broad exemption.

However, I understand that organized labor would not object to a legislative exemption for Hawaii only. The multistate employers, I am told, will not concede to any exemption. The Department of Labor speaks of a temporary, experimental exemption, using Hawaii as the model.

If it becomes necessary, would ou have any objections to Congress exempting only Hawaii?

Mr. GILKEY. Of course, we would not, Senator. That is obviously our primary concern in coming here to testify. We think that we have a good law, and other States could benefit from the experience we have. But, certainly, our main objective is to insure that the law that we now have on the books is exempted and preserved in its present form.

Senator MATSUNAGA. Thank you very much.

In closing, I would like to quote the late President John F. Kennedy when he made his first major civil rights address. He prefaced his speech before the U.S. Conference of Mayors in Hawaii by saying that he had selected Hawaii as his platform for his first major civil rights address because, "Hawaii is what the United States is striving to be."

In the areas of civil rights, worker's compensation, unemployment compensation, and other laws pertaining to the working man and woman, particularly to those workers at the lower rung of the economic ladder, Hawaii has led the Nation. With regard to the establishment of a comprehensive, employer-based health insurance program Hawaii is once again setting an example for the rest of the Nation to follow.

I congratulate you three for representing your State so ably here this afternoon. Your testimony will be instrumental in conclusively documenting the background of this ERISA preemption problem for Hawaii.

Mr. GILKEY. Senator, I remember that you were in our State legislature when many of those progressive labor and civil rights amendments and laws were enacted.

Senator MATSUNAGA. Thank you very much.

Mr. GILKEY. Thank you.

Ms. YAMAMOTO. Thank you.

Mr. WATANABE. Thank you.

[The prepared statement of Mr. Gilkey follows. Oral testimony is continued on p. 544.]

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December 5, 1979

To: The Honorable Lloyd Bentsen, Chairman
Private Pension Plans and Employer Fringe
Benefits Subcommittee of the Committee on
Finance

From: Robert C. Gilkey, Deputy Director
Department of Labor and Industrial Relations
State of Hawaii

Re: S. 209

Senator Bentsen and Members of the Committee, thank you for the opportunity to present this testimony concerning Senate Bill 209; I hope you will find it cogent and persuasive. In August 1978, we testified with Mr. A. Van Horn Diamond, Executive Secretary of the Hawaii Central Labor Council, AFL-CIO, before this Honorable Committee and the Labor Subcommittee of the Committee on Human Resources on S. 1383. We like to think that our testimonies helped to persuade Senators Williams and Javits to introduce S. 209 in January of this year, specifically Section 155.

We were pleased to learn both Senators Inouye and Matsunaga testified on February 6, 1979 in support of Section 155 before the Committee on Human Resources. We were delighted that the Honorable Ray Marshall, Secretary of Labor, also presented supportive testimony.

We are here today to add our support in urging the passage of Section 155 of S. 209 in order to clarify that state-mandated comprehensive health insurance plans are not intended to be preempted by ERISA. At stake is Hawaii's unique and innovative plan for providing health care insurance coverage for virtually all workers and many of their dependents at a cost which experience has shown to be affordable for both employees and employers, and which involves only minimal administrative costs on the part of government.

It is a plan that works. While universal health insurance continues to be a subject for debate on the national level, Hawaii comes very close to having it right now. A recent federally-funded study[1/] concludes that the insurance plans required by the Hawaii Prepaid Health Care Act combine with Medicare, Medicaid and individual plans cover up to 98 percent of the civilian population of the State. In fact, Hawaii's law reflects the principle features currently favored for National Health Insurance which is to require employers to provide coverage meeting established standards.

A key to low cost, according to the study is the competitive nature of health insurance in Hawaii. Our major providers constantly review health care utilization. Statistics show that Hawaii's hospital admission per 1,000 person was 111.8 versus 159.9 for the country as a whole. Hawaii does have a low 3.1 hospital bed supply versus the national average of 4.5 beds.

The Hawaii Prepaid Health Care Act, a summary of which is provided for your information, has as its purpose a two-fold objective. First, to provide health care insurance for workers who were previously unprotected and, second, to mandate a reasonably adequate level of coverage for those whose existing plans provided insufficient benefits.

The means by which these objectives were accomplished are simple. First, all employers are required to provide prepaid health care coverage to their employees and to pay at least one-half the premium cost. The coverage may be from an insurance carrier, a health care contractor or provider, an approved self-insurance plan, or a collectively-bargained plan. Workers may be required to pay no more than half the cost of premiums, but in no event more than 1.5% of their wages.

Second, the law mandates that the benefits provided must be equal to, or better than, those provided under the health care provider or insurance carrier plan having the most subscribers in the state and must, as a minimum, include benefits for outpatient care; 120 days per year of hospital care; medical fees for home, office or hospital visits; laboratory services; maternity care and substance abuse treatment.

1/ Universal Health Insurance in Hawaii, Martin E. Segal Co., Federal Contract No. 299-77-0014

Perhaps the most important effect of the enactment of this law has been to mandate adequate, affordable coverage for the workers at the bottom of the wage scale, particularly those without union representation. Prior to its passage, such workers were typically either not covered at all, offered inferior coverage, or offered coverage at rates beyond their means. Now, a full-time, 40-hour-per-week worker earning the minimum wage of $2.90 per hour receives good coverage at a cost to him or her that, by law, cannot exceed $1.74 per week, or about $90.00 per year. A 20-hour-per-week employee, therefore, would only pay about $45.00 per year.

It is the fate of these workers and their families that is our deepest concern should the Hawaii Prepaid Health Care Act be ruled to come under the preemption clause of ERISA. It is they who are most vulnerable to rising medical costs and who are least able to afford insurance protection. It was this concern for the working poor--the gap group that earns too much to qualify for welfare but not enough to afford medical care--that led to the passage of our law, as will now be described by Miss Carol Yamamoto, Deputy Attorney General, State of Hawaii. Miss Yamamoto is one of the attorneys assigned to the Standard Oil case now pending in the Ninth Circuit Court of Appeals.

Miss Carol Yamamoto
Deputy Attorney General
State of Hawaii

Thank you for permitting the State to present testimony on behalf of a law for which many individuals and organizations have devoted years of work and inspiration. The origin of the Hawaii Prepaid Health Care Act began with a long-felt belief that a means should be found for providing adequate, affordable health care for all, but the specific genesis of the law may be found in a short paragraph in a 1967 appropriations act which requested studies of, and if appropriate, legislative proposals for, increased minimum wages, temporary disability insurance, and prepaid health care insurance. In 1971, the study, Prepaid Health Care in Hawaii, by Professor Stefan A. Riesenfeld, was published by the State Legislative Reference Bureau and a bill was introduced designed to implement the study's recommendations. It was, and is, a unique and pioneering piece of legislation and, like most such legislation, was vigorously opposed by those who supported the status quo for both philosophical and economic reasons.

The bill did not pass that year, nor in 1972 and in 1973. In 1974, however, impelled by rising medical costs and the lack of substantial progress toward national health insurance, the bill was passed and signed into law as Act 210 of 1974, and became Chapter 393 of the Hawaii Revised Statutes, effective June 12, 1974.

It is crucial to the understanding of the present situation to realize that it was during the same three-year period, 1971 to 1974, that Congress was working on the legislation that eventually became ERISA. Because ERISA and the Prepaid Health Care Act were developed and enacted simultaneously, neither took the provisions of the other into consideration, and it is respectfully submitted that had the Hawaii act become law in 1971, 1972 or even 1973, Congress would have included language such as we now seek or would have provided by some other means that ERISA was not intended to preempt such government-mandated comprehensive health insurance plans.

It would be strange, indeed, had Congress really intended to nullify a law which has favorably impressed many knowledgeable experts with its success. HEW Region IX, for instance, in its report entitled <u>Outreach Report on National Health Insurance</u> (October 1977), noted that the law "has created, in general, a population that is far more conversant and knowledgeable in matters related to health insurance than populations in other parts of the region." "People...talk more easily about alternatives and options," it continued, "[and] they [have] a better feel for what National Health Insurance could or could not do." The report concluded, "...their collective understanding of a Federal, State and private role in the formulation of health insurance policy would be valuable" in assessing administration proposals.

Another confirmation of the value of Hawaii's successful experiment with prepaid health care insurance comes from the study alluded to earlier by Mr. Gilkey, which was conducted by the Martin E. Segal Company under Federal Contract No. 299-77-0014. The study, entitled <u>Universal Health Insurance in Hawaii</u>, developed criteria for the evaluation of Hawaii's law as a prototype for national health care insurance. These included coverage, benefits, equity of financing, equity to providers, incentives to efficiency, acceptability, adaptability, efficiency of administration, and quality controls. The study found that "In terms of these criteria, Hawaii ranks quite high. [I]t is clear that Hawaii has accomplished in large measure what is being sought for the rest of the country."

Even Judge Renfrew who ruled against the State in Standard Oil v. Agsalud noted that, "The workers whom ERISA was primarily intended to protect may be better off with state health insurance laws than without them, and the efforts of states like Hawaii to ensure that their citizens have low-cost comprehensive health insurance may be significantly impaired by ERISA's preemption of health insurance laws." He then cited Justice Brandeis' famous comment, "It is one of the happy incidents of the federal system that a single courageous State, may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."

This is, indeed, what Hawaii has done with respect to prepaid health care, and it cannot be believed that Congress, in acting to reform the mismanagement and abuse of pension systems, intended to wipe out this most successful "novel social and economic experiment."

I thank you for your time and attention. The balance of the testimony will be given by Mr. Gilkey.

Robert C. Gilkey

Members of the Committee, my summation will be brief. The Hawaii Health Care Act is under attack because it has succeeded only too well. It has required certain employers to provide more benefits--benefits which the people of Hawaii, through their legislators, have deemed essential--than these companies are willing to provide on their own. Having been defeated in the legislative arena, these employers now seek to have the courts frustrate the will of the people and they seek your assistance in doing so. Their case rests on a single issue: Does ERISA prevent the State of Hawaii from enforcing its Prepaid Health Care Act by preempting the field of health insurance legislation for the federal government? There is nothing in the legislative history of ERISA to suggest such an intent, but a court ruling now on appeal holds that such a preemption was accomplished by inadvertance if not by intention. When ERISA was enacted, there was no apparent need to specifically exclude state-mandated comprehensive health insurance laws from its broad preemption--there were no such laws in existence. Almost simultaneously, however, such a law did come into being, and now some form of specific exclusion is both necessary and appropriate.

Tens of thousands of Hawaii's people are now covered by adequate health insurance as a direct result of the Hawaii Prepaid Health Care Act. It would be a bitter irony if ERISA, a landmark in the struggle to protect the "continued wellbeing and security of millions of employees and their dependents,"2/ were to be used to blunt another milestone in the same struggle.

The battle in the courts has just begun, and while we are confident of a final ruling in our favor, the road to that ruling may consume many years and many thousands of taxpayer's dollars to reach a conclusion that, with your help, can be reached in just a few weeks and at almost no cost by adopting Section 155 of S. 209 or in some other way clarifying the status of state-mandated comprehensive health insurance laws with respect to ERISA.

It is important both to the workers of Hawaii and to the nation that this important innovation in health care protection is not allowed to die and I respectfully urge your favorable consideration of Section 155 of S. 209 or some suitable alternative.

I will be happy to answer any questions you may have. Assisting me will be Mr. Orlando Watanabe, Administrator of our Disability Compensation Division--and, I might add, the codefendent in Standard Oil v. Agsalud--and Miss Yamamoto.

Attachment

2/ ERISA, Section 2(a).

HAWAII PREPAID HEALTH CARE LAW

CONCEPT

Mandates subject employers to provide health care coverage to employees who meet eligibility requirements. While it should not interfere with protection provided pursuant to collective bargaining agreements, or lessen protection provided by employer sponsored plans which are equivalent or more favorable to employees, it affords protection to workers who do not have, or have inadequate coverage against the high cost of medical care.

COVERAGE

Unless an employee claims authorized exemption, subject employer must provide prepaid health care coverage at the earliest enrollment date after an employee completes four consecutive weeks of 20 hours each and earns 86.67 times the State's minimum hourly wage. (86.67 x $2.65 = $230 per month)

BENEFIT STRUCTURE

Hawaii's health care plan provides for:

Hospital Benefits:

Out-patient care, in-patient care for at least 120 days in each calendar year covering room accommodations, special diets, general nursing services, drugs, dressing, oxygen, antibiotics and blood transfusion services. Outpatient care for use of outpatient hospital which also provides for surgical procedures and medical care of an emergency nature.

Surgical Benefits:

Surgical services performed by a licensed physician; reasonable after-care visits; services of anesthesiologist.

Medical Benefits:

Necessary home, office and hospital visits by a licensed physician; intensive medical care while hospitalized; medical consultations while confined; diagnostic laboratory services; x-ray films; radio-therapeutic services.

Maternity Benefits:

If employee has been covered by prepaid health care plan for nine consecutive months prior to delivery.

Substance Abuse Benefits:

In-patient benefits for detoxification and acute care shall be limited in the case of alcohol abuse to three admissions per calendar year, not to exceed seven days per admission and shall be limited in the case of other substance abuse to three admissions per calendar year, not to exceed twenty-one days per admission.

FINANCING

Employee may be required to contribute one-half the cost of premium, or 1.5 percent of his monthly wage, whichever is less. Employer pays the balance.

If employer's plan does not provide health care benefits equal to, or medically reasonably substitutable for, the benefits provided by prepaid health care plans which have the largest number of subscribers in the State, the plan shall be in compliance only if the employer contributes at least half the employee and dependents cost.

COST CONTROL - REIMBURSEMENT OF PROVIDERS

In accordance with Prepaid Health Care contract.

QUALITY CONTROL

None - except as provided by federal and miscellaneous State laws and control exercised by Health Care Contractors.

HEALTH DELIVERY AND RESOURCES

Depends on contents of health care plan: Kaiser type - emphasis on prevention of illness and early detection of disease. HMSA and Insurance Companies - generally reimbursement for illness and sickness which have occurred.

ADMINISTRATION

Disability Compensation Division oversees program - ensures that employer's plan meet standards prescribed by law.

Senator MATSUNAGA. Our next panel of witnesses consists of a representative of the Chamber of Commerce of the United States, Mr. David Kempken; Mr. John G. Mutschler of Mutschler Associates; a representative of the United Automobile Workers, Mr. Robert Kryvicky; and a representative of the American Bankers Association, Mr. Michael P. Moran.

I see others who have joined the panel. Would you please identify yourself, for the record?

Mr. KEMPKEN. Yes, Senator, I am David Kempken of Bethlehem Steel Corp., representing the chamber, and with me is Russell Guy, also of Bethlehem Steel, representing the chamber.

Senator MATSUNAGA. Thank you.

Now, you may proceed in whichever order you wish. You have a total of 20 minutes.

STATEMENT OF DAVID KEMPKEN, MANAGER OF EMPLOYEE BENEFITS PROGRAMS, BETHLEHEM STEEL CORP., REPRESENTING THE U.S. CHAMBER OF COMMERCE, ACCOMPANIED BY M. RUSSELL GUY, ASSISTANT MANAGER, SAFETY AND WORKERS' COMPENSATION DIVISION

Mr. KEMPKEN. Thank you, Senator.

Good afternoon. I am David Kempken, manager of employee benefits for Bethlehem Steel Corp. I appear on behalf of the national chamber and its 80,000-plus members. I ask that the chamber's statement be accepted for the record.

Senator MATSUNAGA. Without objection, it will appear in the record.

Mr. KEMPKEN. Rather than summarize the principal points of the chamber's statement, I would like to focus on one provision of S.209 which we consider to be of extreme importance. That provision is the portion of section 126 prohibiting the reduction of vested retirement pension benefits by workers' compensation payments. Without doubt, the prohibition of the reduction of workers' compensation payments would result in a proliferation of workers's compensation claims, whether justifiable or not.

If workers were permitted to claim injury and collect workers' compensation plus receive a full company pension, the earnings replacement level would be so high that a person would have lost his incentive to work. Such excessive benefits would most certainly lead to abuse.

The permitting of workers' compensation offsets has been taken into account in designing pension plans, and there is no reason now to prohibit the elimination of potentially a very costly duplication of benefits.

Duplication or pyramiding of collateral benefits such as pension, workers' compensation, and social security has been a concern of industry. The combination of all these benefits enables a worker to retire at levels approaching 150 percent of preretirement earnings, virtually all tax free, all except 50 percent of social security paid by the employer.

One only has to look at the black lung program, with the Federal Employee Compensation Act program, to appreciate the magnitude of the problem of pyramiding benefits. The incentive to remain gainfully employed or return to work following injury is lost.

In a similar situation, Congress has evidenced concern against pyramiding benefits by providing that social security disability benefits must be offset by workers' compensation benefits, to the extent that the combined Social Security and workers' compensation exceeds 80 percent of the employee's previous monthly average earnings. Congress has also just directed States to reduce unemployment compensation benefits in cases where the recipient is also receiving a pension.

The same reasons which compelled Congress to prevent overlap or duplication of social security and workers' compensation payments has influenced employers, unilaterally or through collective bargaining with unions, to prevent identical overlap or duplication of benefits under the private pension plans and workers' compensation.

Wage loss protection is designed to provide the worker with a portion of wages lost due either to a physical disability, economic unemployment, or old age. The cause of the wage loss should dictate the protection provided. Consequently, if a worker undergoes a period of wage loss due to more than one condition, it is not proper that the worker receive benefits for all such conditions, and thereby recover more than the actual wage loss.

Once it is recognized that workers' compensation is one unit in an overall system of wage loss protection, rather than something resembling a common law injury recovery program, it follows that duplication of benefits from different parts of the system should not be allowed.

For these reasons, we strongly oppose the portion of Section 126 prohibiting the reduction of vested retirement pension benefits by workers' compensation payments, and we urge the committee to strike those provisions from S. 209.

Thank you, Senator.

Senator MATSUNAGA. Thank you.

[The prepared statement of Mr. Kempken follows. Oral testimony is continued on p. 557.]

STATEMENT
on
THE ERISA* IMPROVEMENTS ACT OF 1979 (S.209)
and
THE ERISA SIMPLIFICATION ACT OF 1979 (S.1089)
before the
SUBCOMMITTEE ON PRIVATE PENSIONS & EMPLOYEE BENEFITS
of the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
David W. Kempken
December 5, 1979

Good afternoon, I am David W. Kempken, Manager of Employee Benefits Programs, Bethlehem Steel Corporation. I am also a member of the National Chamber's Committee on Employee Benefits, and as such, appear here this afternoon on behalf of the 90,000 plus members of the Chamber of Commerce of the United States.

Because our nation's retirement income systems are financed largely by employer contributions to social security, private pensions, profit sharing and welfare plans, the business community has a vital stake in the statutory treatment of employee benefits. Business is genuinely concerned about the adequacy of the retirement incomes of their employees. Every effort is made to maximize the benefit payout for every dollar invested by business in their private pensions. A major drawback of the current statutory treatment of pensions is the complicated and costly regulations to which they are subject.

Of the legislation before this subcommittee, we are primarily concerned with the ERISA Imrpovements Act of 1979 (a bill we generally oppose) and the ERISA Simplification Act of 1979 (a bill we generally support). As for the remaining legislation (S.511, S.989, S.1090 et al., S.1240 and S.1258), we do not offer our views since we have not as yet adopted policy bearing on them.

PRIVATE PENSIONS: A NATIONAL CONCERN

The National Chamber's policy goal is to assure that private sector retirement savings efforts -- by employers, employees and self-employed individuals -- play a substantial role in meeting the needs of the nation's elderly. To the extent that government policies, laws and regulations help achieve this goal, our problems with the adequacy and the affordability of retirement programs are diminished.

* Employee Retirement Income Security Act

We urge this committee to create a statutory environment that is attractive for retirement savings. That requires a streamlined administration of ERISA with a minimum of paperwork and compliance cost, and tax policies that make retirement savings an attractive investment alternative, but with appropriate safeguards to assure tax fairness and protect against undue revenue losses.

Today's statutory system tends to make such an environment just a dream. Only two-thirds of our workforce over age 25 is covered by private pensions and many plans are being terminated because of excessive cost and/or the complexities of complying with the myriad laws and regulations. Tax in entives for those without pension coverage or for those with only minimum protection either do not exist or have been woefully diminished by inflation.

For four years, ERISA has been the nation's primary statute governing private pension programs. It seems appropriate that we evaluate how well it is meeting the objectives of extending the benefits of private pensions to a larger group of Americans.

As we move to cope with the financial burdens imposed by the aging of America's population, we see the need to give high priority to legislation dealing with that issue. First and foremost, we need a coherent national policy that reflects our future needs. We hope such a policy will emanate from the President's Pension Policy Commission.

Meanwhile Congress needs to enact statutes that (1) encourage the growth of pensions and (2) help keep a rein on their costs. As we discuss below, some aspects of S.209 and S.1089 strive to achieve these objectives. To the extent they do so, these features should be approved but not at the price of accepting other counter-productive changes.

S.209-THE ERISA IMPROVEMENTS ACT OF 1979

The "ERISA Improvements Act of 1979" contains amendments to the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1954 which, in the view of a majority of the members of the Senate Labor and Human Resources Committee, are necessary and desirable in the light of four years experience since ERISA was enacted. We respectfully disagree. Despite its title, we must, and the members of the Committee on Finance should, oppose this bill because it falls far short of what is required to improve the statutory treatment of private pensions and employee benefits.

Much of S.209 resembles S.3017 on which we presented recommendations to Congress last year. While several significant changes and improvements have been made, those recommendations largely have gone unheeded.

1. Employee Benefits Commission

We are disappointed to find again the provisions to establish an Employee Benefits Commission to replace the joint jurisdiction now exercised by the Departments of Labor and Treasury. Without question the administrative provisions of ERISA requiring action by both the Treasury and Labor Departments and in some cases, the Pension Benefit Guarantee Corporation (PBGC), have resulted in bureaucratic confusion, unnecessary delays, complex requirements and justifiable criticism. Nonetheless, these agencies under the direction of the President's Reorganization Plan No. 4 are making a good faith effort to resolve these problems. We do not think that changing horses in midstream makes sense. We would prefer that the unfinished job of issuing ERISA regulations, interpretations and exemptions be completed before making dramatic regulatory shifts. Staying with the current arrangement as revised by the Reorganization Plan No. 4 seems to be the more prudent course at this time.

Admittedly, the current division of regulatory authority among the Departments of Labor and Treasury and the Pension Benefit Guarantee Corporation seemingly balkanizes the administration of ERISA; however, we have refrained from supporting efforts to consolidate the administration into a single agency for a variety of reasons which we believe make good sense.

We are reluctant to move to a new administrative arrangement until there has been a thorough review of the benefits and drawbacks of such a move. A beginning step in that analysis is mandated by Reorganization Plan No. 4 whereby a comprehensive analysis of alternative regulatory schemes is to be completed by January 31, 1980.

Many of the problems of poor coordination of administration and policy-making that existed in the early years of ERISA have been overcome. Indeed, we suspect that some of these difficulties would have surfaced even with a single agency. Moreover, Reorganization Plan No. 4 has addressed the most troublesome problems of the dual agency system. While it remains to be seen whether the plan will prove effective, we would prefer to give it an opportunity to succeed rather than subject the pension community and welfare plan sponsors to an unsettling transfer to a single agency.

2. Minimum Standards

We are also disappointed to see once again the minimum standard features to which we objected last year. For the most part they are identical or substantially similar to last year's bill. The minimum standards continue to be premised on the mistaken perception of a pension or welfare plan as nothing more than wages foregone, thereby entitling employees to all benefits as a matter of right, rather than their having to meet certain basic requirements before becoming entitled to the benefit. 1/

Extending this approach to employee benefits to all statutory benefit programs would negate all of the pre-conditions to benefit entitlement that have been the hallmark of employee benefits and by which employers have responsibly designed their employee benefit programs. Thus unemployment compensation recipients would no longer need to be actively seeking work or, for that matter, even be unemployed to receive benefits. A job-injury would no longer be a requisite for workers' compensation. Death would not be required for purposes of life-insurance benefits.

Equally objectionable is the prospect that these minimum standards will just add more "levers and buttons" for the federal government to pull and push as it impairs the ability of employers and employees to design employee benefit arrangements that meet their needs. Moreover, it adds to the cost of employee benefits resulting, perhaps, in pricing these benefits beyond the reach of many employers, especially small ones, and employees.

(a) Disability and Workers Compensation Offsets.

Section 126 would preclude a reduction in a disability benefit payable under a welfare plan when the beneficiary receives a cost-of-living adjustment in his or her disability benefits paid under the social security disability insurance program. It also would preclude a reduction in the benefit if the beneficiary subsequently becomes entitled to workers' compensation.

When an employer establishes a plan, he sets an income replacement rate that provides an adequate level of income in light of the tax-free nature of the benefit, the absence of work-related expenses, the availability of other disability income sources, and the desire to maintain an incentive for return to work. Section 126 destroys the rationality of these calculations.

1/ For an excellent discussion of this premise see, Logue, Dennis E., Legislative Influence on Corporate Pension Plans, American Enterprise Institute, Washington, D.C. 1979.

A simple example illustrates the point. An employer establishes a pension plan providing 2/3 of wages at retirement. An employee earning $300 per week retires and qualifies for a benefit of $200 per week. The employee then files a successful workers' compensation claim which grants him 2/3 of wages ($200) for life. Under present law, most pension plans become secondary to the workers' compensation benefit and the disabled employee receives only workers' compensation. Under S.209, this employee would receive $400 per week for life.

Without question, this results in a windfall for the employee. Also it raises substantially the cost of both public disability benefits and private pensions. Since private pension benefits are voluntarily offered by employers, there is the very real prospect that these plans will gradually disappear, placing the entire burden on already overloaded public disability and pension programs.

I cannot imagine the sponsors intending this result. Deletion of Section 126 is appropriate.

(b) Survivor Annuities

Section 127 presents a similar problem. It requires pension plans offering an annuity form of payment to preserve this annuity for a survivor of a vested plan participant who dies before the starting date of the annuity.

We recognize that the social purpose of this provision is to protect a surviving spouse and to acknowledge that an employee has earned a benefit entitlement. But, it is a cost and administrative burden that adds little to existing protections. Indeed, it could operate against the best interests of plans and participants. Here's why.

A deferred vested pension annuity is designed to be a form of retirement income, not life insurance. Extending the joint and survivor annuity guarantee to all survivors of plan participants with 10 or more years of service transforms the pension promise into a form of life insurance. We understand that this benefit extension will raise annual pension costs by 5 percent or so. It will be financed in two ways. First, the survivor benefit is reduced to recognize the additional years of protection. Second, the employer pays the added costs by reducing benefit protections elsewhere (primarily the pension benefit and/or life insurance). The net result is that the surviving spouse will receive very little additional protection. Balanced against this marginal protection is the considerable administrative complexity and cost upon the plan sponsor.

For employees, there is an added complexity in understanding and exercising this option. It becomes even more complicated and confusing in cases involving terminated vested participants who are no longer in the employ of the plan sponsor. For employer sponsors there arises a new problem of choosing between proper beneficiaries in cases where there is more than one alleged surviving spouse.

Employer experience with employee benefits has shown clearly the wisdom of designing a specific benefit for a specific risk (e.g. life insurance and death). When attempts are made, as in S. 209, to transform a single risk benefit plan into a multi-risk benefit, the result is an inefficient and ineffective means for meeting the needs of employees.

For these reasons, Section 127 should be struck from S.209.

3. Extending Pension Coverage

One of our priorities for pension legislation is to extend the coverage and protection provided by pension plans to more workers and their dependents. As mentioned previously, it is estimated that currently about two-thirds of our work force (over age 25) enjoys these benefits. The nation would be well served if coverage could be extended to the other third.

S.209 provides a number of incentives designed to stimulate the growth and improvement of pension plans.

(a) Tax Incentives

To promote the establishment of pension plans by small employers, S.209 provides a tax credit to employers over and above the allowable deduction for employer contributions. The credit would be based on a percentage of those contributions and would be phased downward over a period of five years.

The use of tax credits in this manner raises important tax questions which we are presently reviewing. For example: where is the equity for employers who have long financed excellent pension plans? Why is size a relevant consideration? How successful will these incentives prove to be? Can they be administered by tax authorities? What are the revenue implications?

Admittedly, current incentives are not sufficient to cover the gaps in pension coverages, but the proposed incentives must be studied carefully before adoption.

(b) Master and Prototype Plans

In addition to tax incentives, S.209 would establish a mechanism for special master plans which would provide sound retirement income programs without the paperwork and other burdens associated with maintaining a pension plan. As we stated last year, this provision may prove to be an attractive addition to the tax code as it applies to pensions. Nonetheless, as we have found with the Simplified Pension the lack of flexibility to design plan features to meet the specific needs of a specific employee group may prove to be a stronger disincentive than athe administrative savings might prove to be an incentive. Chart 1 illustrates this consideration as it compares the retirement savings options under current law.

(c) Deductible Contributions

S.209 also attempts to eliminate a patently discriminatory feature of our tax laws whereby some taxpayers may exclude their retirement savings from their current taxable income while others may not.

Our tax laws for a great number of years have sought to encourage pensions. In 1962, Congress expanded this policy by establishing favorable tax treatment for the retirement savings of the self-employed. In 1974 Congress encouraged the retirement savings of those employees who were not participants in a qualified pension plan. Since Congress has seen the wisdom of permitting some individuals to set aside funds from his current income and defer its taxation until retirement, elementary fairness requires that all employed taxpaying individuals be afforded this opportunity. In testimony presented to this Subcommittee on April 3, 1979, we indicated our support for this feature but noted we preferred the changes advocated by S.557 because of its higher limits and relative simplicity. We take this opportunity to renew our support for S.557 and urge its enactment.

We would also support legislation increasing the $1,500 annual limit on contributions to Individual Retirement Accounts (IRA's) and the $7500 annual limit for Keough plans. Adding a cost-of-living adjustment in order to maintain an appropriate tax deferral level for these retirement plans would also be helpful.

4. Preemption

S.209 contains new exceptions to the broad federal preemption feature of ERISA. Specifically, it would weaken the preemptive reach of ERISA over state laws as they relate to (1) health care and (2) domestic relations. While we recognize the legitimate interests of a state in the health and welfare of its citizenry, we fear that in the absence of broad and effective federal preemption of state laws in the area of employee benefits, compliance with a multitude of state statutes will destroy the attraction of employee benefits for employers. Consequently, we urge this subcommittee in the strongest terms to retain a broad preemption of state law within ERISA.

While such a preemption is essential to a sound national policy for retirement and employee benefits, it is not impossible to make reasonable provisions for accommodating the interests of the States in the welfare of their citizenry. Section 206 of S.209 is a case in point. This section, as introduced, would seemingly allow an exemption for state domestic relations decrees from the ERISA preemption. This would be acceptable if it is clear that the exemption from ERISA's general prohibitation against assignments and alienations applies only to those state court orders which do not require the plan to alter the provisions of the plan.

On the other hand, we do not view Section 155(2) of ERISA as a reasonable exception to the broad preemption policy. That section would allow States to mandate or regulate health care employee benefits. It does so on the simple premise that, since the Federal government has not yet chosen to require employers to provide health benefits, States ought not to be prevented from doing so.

We respectfully disagree and suggest that this exception will ultimately destroy ERISA's preemption authority. Without preemption, multi-state employers will be unable to maintain uniform and equitable benefit plans. Without preemption employers will be unable to avoid increases in the complexity and costs of administering their plans on a state by state basis.

5. Anti-Fraud Remedies And Securities Law

We support Section 154(a) which amends ERISA to clarify that the anti-fraud provisions of federal securities laws do not apply prospectively to the relationship of plan sponsor and participant. The effect of this section is to codify the decision of the Supreme Court in Daniel v. Teamsters for both contributory and non-contributory pension and welfare plans. We applaud this addition since securities laws clearly should not cover employee benefits.

However, S.209 goes beyond this by attempting to introduce the anti-fraud requirements of the federal securities laws to ERISA. This Section 154 (b)would prohibit misrepresentation while Sections 153 (2) and (5) would authorize remedies for participants who allege that they were victimized by such misrepresentation. We are concerned because it is not advisable to attemp to legislate in this area without a full appreciation of the extent of misrepresentation that exists, or of the damages being caused, if any, and of the impact that such rules might have on employee benefits. Moreover, the existing ERISA disclosure and fiducairy requirements are adequate safeguards for benefit plan participants. Further, the application of anti-fraud rules to ERISA will only complicate an already difficult system imposed on employee benefit plan providers and administrators.

S.1089 - THE ERISA SIMPLIFICATION ACT OF 1979

The ERISA Simplification Act consists of five provisions, four of which are designed to achieve paperwork reduction. The fifth provision would revise ERISA's enforcement procedures by empowering the Treasury Department's Internal Revenue Service (IRS) to enforce its ERISA rules through civil actions for equitable relief, in much the same way as the Labor Department now enforces its rules. The Chamber generally supports enactment of those features of S.1089 primarily designed to achieve paperwork reduction (Sections 2 through 5).

We oppose the provision to grant civil enforcement authority to the IRS for purposes of carrying out its responsibilities under ERISA and the Internal Revenue Code. Such authority would represent a fundamental and very important enlargement of IRS enforcement authority. IRS has structured its audit and enforcement procedures to settle or litigate matters in specialized tax proceedings. It has neither the staff nor the expertise to engage in civil enforcement litigation.

This proposal would duplicate authority presently vested by ERISA in the Department of Labor. We see no advantage to such duplication. We urge deletion of this provision.

CONCLUSION

The Chamber is concerned about the adequacy of existing national policies and laws designed to foster retirement savings. The disappointingly large number of plan terminations and widespread complaints about the burdens and costs of ERISA compliance indicate that urgent attention is warranted.

Our policy goal is to assure that private retirement savings efforts -- by employers, employees and individuals -- play a substantial role in meeting the needs of the nation's elderly. To the extent that government policies, laws and regulations help achieve this goal, our problems with the adequacy and the affordability of public programs are diminished.

Thus, we urge the Congress to create a statutory environment that is attractive to retirement savings. We look for streamlined administration with a minimum of paper work and compliance cost. We also look for tax policies that make retirement savings an attractive inventment alternative but with appropriate safeguards to assure tax fairness and protect against undue revenue losses. Generally, S.209 does not meet these objectives whereas S.1089 (with the exception of Section 6) is a progressive step in that direction.

CHART 1 - COMPARISON OF RETIREMENT OPTIONS

	Simplified IRA	Self-Employed Keough	Profit Sharing Money Purchase Pension* ESOP	Defined Benefit Pension
Eligibility	Age 25, 3 of last 5 years of service.	3 years of service.	Age 25, 1 year of service.	Age 25, 1 year of service.
Contributions	Lesser of 15% or 7,500 (Special makeup for employee of up to 1,500) $1,750 with spouse.	Lesser of 15% or 7,500.	Lesser of 15% or 32,700. 2 plans or Money Purchase Plan - 25% or 32,700.	Amount necessary to provide annuity at retirement equal to 100% of last 3 yrs. comp. maximum 98,100
Voluntary Contributions by Employees	None.	10% of comp. max. of $2,500 for 10% owners.	10% compensation	10% compensation
Vesting	100% Upon Contribution.	100% Upon Contribution.	New Plans	
			0 - 4 years	None
			4 - 5 years	40%
			5 - 6 years	45%
			6 - 7 years	50%
			7 - 8 years	60%
			8 - 9 years	70%
			9 - 10 years	80%
			10 - 11 years	90%
			11 or more years	100%
Distribution	Not before 59 1/2 or disability - over lifetime beginning at 70 1/2.	Not before 59 1/2 or disability - over lifetime beginning at 70 1/2 only if 10% or greater owner.	Separation from service, retirement or disability.	Separation from service, retirement or disability.
Income Tax	Ordinary Income.	Pre-74 Capital Gain Post-73 Ordinary Income Subject to 10 year averaging.	Pre-74 Capital Gain Post-73 Ordinary Income Subject to 10 year averaging.	Pre-74 Capital Gain Post-73 Ordinary Income, Subject to 10 year averaging.
Estate Tax Exclusion	Installments 36 months or longer.	2 taxable years - 2 to 13 months.	2 taxable years - 2 to 13 months.	2 taxable years - 2 to 13 months.

SOURCE: J.McKENDRY, Landman, Hathaway, Latimer, Clink & Robb, Muskegon, Michigan

Senator MATSUNAGA. Next?

STATEMENT OF JOHN G. MUTSCHLER, PRESIDENT, JOHN G. MUTSCHLER ASSOCIATES, INC.

Mr. MUTSCHLER. Mr. Senator, I have submitted a written summary of my testimony. Rather than reading it verbatim, I would rather talk to you directly and follow closely the summary.

Senator MATSUNAGA. In these proceedings, the written statements will appear in the record as though delivered in full.

Mr. MUTSCHLER. My firm presently administers approximately 400 pension plans, covering approximately 4,000 employees. The assets of these plans are approximately $100 million. I estimate that annual contributions to these plans are about $9 to $10 million, with earnings of about $8 million.

My clients are mostly small businessmen, located in the Midwest and Far West, ranging from one and two-men family firms, to one large company with approximately 1,000 employees.

My entire career, since leaving military service in 1955, has been devoted to the designing and administering of pension and profit-sharing plans. Each year, I meet with about 2,000 employees participating in these plans. I see their satisfaction when they are told that their company has made the maximum contributions possible for example in a profit-sharing plan 15 percent of compensation, or when they see increases in their benefits in their defined benefits plans.

Some of my plans invested substantially in stocks. In 1966, and again in 1969 and 1970, and 1973 and 1974, there were substantial losses in many of these funds, and of course the employees were disappointed in those years.

I basically support the principle of ERISA to protect employees, increase coverage, accelerate vesting, the requirement of explaining to employees their benefits in layman's language, and of course to protect trust funds from unscrupulous people.

However, I have found that there have been some unforeseen, seriously negative effects resulting from the prohibited transactions sections of ERISA which I do not believe were intended by the Congress.

Prior to ERISA, a great many of my clients borrowed funds from their trust fund. They provided adequate security, and paid the going rate of interest. These loans created capital which accelerated the rate of the companies' growth, created jobs, encouraged the companies to make maximum contributions to the plans, and provided a secure and high trust earnings. These trust earnings and contributions resulted in greater benefits for participants, for the employees in the plan.

A successful business needs capital to grow. Capital can be obtained from the sale of stock, which in most cases is impractical for small companies, or from retained earnings, or from borrowed funds. It costs approximately $50,000 to create a new job. I have seen clients, who had 3 or 4 employees, when I set up their plans grow to 50 or 60 employees today. I have seen larger companies, with 30 or 40 employees when the plans were set up, which now have several hundred employees.

After ERISA, which prohibits loans by trusts to the companies establishing them, some of my clients have regrettably terminated their plans. Many of my clients have been forced to reduce contributions. Also, earnings of the trust funds have declined. The growth of many of these clients has also slowed, resulting in fewer jobs.

As a practical matter after ERISA, trustees are limited in investing in the stock market, the bond market, investment departments of banks or insurance companies. For various reasons the stock market today is about the same as it was in 1964, 15 years ago, if not even a little lower. Insurance company returns have been based primarily on long term interest rates, which also have been disappointing to many of my clients.

Thus the termination of plans, reduction in contributions, reduction in trust earnings have substantially reduced potential benefits for employees. For an example, if contributions averaging $1,500 a year for an employee from age 25 to 40, are reduced to $1,000, and at the same time earnings are reduced from 8 percent to 5 percent, the reduction in benefits for that employee at retirement is approximately $282,000, a substantial amount of money.

Also I consider as a very serious problem the fact that the formation of new plans by small businesses except for professional corporations has decreased substantially. This is a serious problem because their employees will not have an opportunity to enjoy generous retirement benefits in addition to social security.

Another serious problem created by ERISA is the channeling of capital from small businesses in my area, in the Midwest and the Far West, to financial centers outside their local areas. I have over 100 trust funds in North Dakota, South Dakota, Wyoming, Montana, Oregon, and Washington, but I can find only one company located in North Dakota that is listed on the New York Stock Exchange or the American Stock Exchange, or the National Over-the-Counter. There are three such companies in South Dakota, one in Wyoming, and two in Montana. Furthermore, I know of only one trustee in my plans that has invested in a listed company located in his area.

Trustees of these plans do not vest their funds in the area, but invest in listed stocks and rated bonds in financial centers located in other States. This is also true in Wisconsin and in Minnesota, although there are a much larger number of listed companies in those areas.

This capital is needed in those local areas for capital formation and the creation of jobs. I realize that ERISA provides procedures for applying for exemptions, from the prohibition, but these transaction procedures are much too time consuming and costly for my small sections clients. To date, none of my clients, not a one, has authorized me to request an exemption, when I have advised them that the cost would probably be in the area of $450 to as much as $1,000 if a conference was needed in Washington. This discourages them. This cost would be in addition to their normal administrative and actuarial fees.

We have prepared an amendment to ERISA which would correct these unintentional problems, promote the formation of new plans, maximize contributions, and increase trust earnings, while at the same time protecting the interests of employees as provided by ERISA.

I personally feel that a well secured loan provides safety, probably more safety for employees than listed stocks, which as we have seen go up and then down.

I understand that ERISA prohibited transactions provisions were taken from the law dealing with private foundations. As I understand charitable foundations, they are usually established by a substantial grant of money, and the trustees invest these funds, distribute the earnings as required by the terms of the trust. Private foundations do not generally depend on further grants by the grantor. Whereas in pension and profit-sharing plans, the future of the trust, the growth of the trust, depends on substantial and recurring contributions by the creator of the trust, the employer.

I feel that because the beneficiaries in the trust depend on recurring contributions, and on a successful and profitable company to make contributions, the trustee should be able to loan funds when adequately secured, at a current rate of interest to the creator of the trust, as long as the employees are adequately protected.

Mr. Senator, I wish to thank you for this opportunity to testify, and I would welcome any opportunity to be of assistance in this area.

Senator MATSUNAGA. Thank you.

[The prepared statement of Mr. Mutschler follows. Oral testimony is continued on p. 592.]

SUMMARY OF TESTIMONY OF JOHN G. MUTSCHLER, PRESIDENT OF
JOHN G. MUTSCHLER AND ASSOCIATES, INC.
BEFORE THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS AND
EMPLOYEE FRINGE BENEFITS
OF THE
FINANCE COMMITTEE OF THE
UNITED STATES SENATE

Mr. Chairman and members of the Subcommittee, my firm presently administers approximately 400 Pension Plans covering over 4000 employees. These plans currently have assets exceeding $100,000,000. My clients are small and medium-sized businesses located in the mid-west and far west ranging from one and two men firms to one company with over 1000 employees. My entire career since leaving the service in 1955 has been devoted to administering Pension Plans. I work directly with the individual companies. I hold meetings with over 2000 employees each year concerning their pension and profit sharing benefits. I see their satisfaction when they see that the Company has made the maximum contribution (15% in a profit sharing plan) and when the trust earned 8% or 10% or more. I see their disappointment when a trust loses 5 or 10% because of stock market or bond fluctuations.

I support the basic principle of ERISA to protect employees, increase coverage, accelerate vesting, require communication, in simplified language, of the terms of the plan and to protect employee funds from unscrupulous people.

I find that there have been some unforeseen negative affects in the Investment and Prohibited Transaction area of ERISA that I do not believe was intended by Congress. Prior to ERISA, a great many of my clients borrowed funds from their pension and profit sharing plans, they put up more than adequate security, they generally paid more than the going rate of interest. These borrowed funds accelerated their growth, created new jobs, encouraged my clients to make maximum contributions and provided high earnings for the trust which greatly increased retirement benefits and job security for employees. A successful business needs capital to grow, either through the sale of stock, retained earnings, or borrowed funds. It costs approximately $50,000 to create a new job. I saw Companies grow from 3 - 4 employees to 50-60 employees and other Companies grow from 30-40 to several hundred employees. After ERISA, which prohibited loans from qualified trust to the Companies creating the trust, a few clients terminated their plans, many clients reduced contributions, trust earnings were reduced, and the growth of many clients were reduced, thereby decreasing the creation of new jobs. Trustees were limited to investing principally through Mutual Funds, the Stock Market, Bank Trust Departments, and Insurance Companies. For a variety of reasons, the Stock Market today is about the same level as 15 years ago and since Insurance Company returns are generally tied to the long-term mortgage market, yields have been disappointing. The termination of plans, reduced contributions, and trust earnings have obviously reduced employee benefits. As an example, if an employee's average annual contributions from age 25 to 65 are reduced from $1,500 to $1,000 and earnings fall from 8% to 5% annually, his total benefit would be $282,000 less. Also, it is my personal experience that the formation of new plans by small businesses other than professional people has been drastically reduced. This too is tragic because their employees have lost the opportunity of having a generous retirement income in addition to Social Security.

Even more tragic is the channeling of capital created by small businesses in the Midwest to financial centers outside of the local areas. I have over 100 trusts in North Dakota, South Dakota, Wyoming, and Montana, but I can find only one Company listed on the New York Stock Exchange, American Stock Exchange, and National Over the Counter market located in North Dakota, three in South Dakota, one in Wyoming, and two in Montana. Furthermore, I know of only one trustee willing to invest in even these few local companies. Overwhelmingly, trustees of these plans do not invest in companies where they are located, but invest in Stocks and A-rated bonds of Companies located in other states. This is also true in Wisconsin and Minnesota, although each state has more listed Companies.

Mr. Chairman, this capital is needed in these local areas for capital formation and the creation of jobs. I realize that ERISA provides procedures for "exemptions" permitting loans from trusts to their Creator, but such procedures are too costly for small businesses. To date, not one of my Clients has requested that my firm process a request for approval of a loan after I estimated our fees would not be less than $450 and could be as high as $1,000 if a conference in Washington was required. This cost would be in addition to their normal administrative and actuarial fees.

We have prepared an amendment to ERISA which would correct these unintentional problems, promote formation of new plans, maximum contributions, increase trust earnings, help create new jobs through company expansion, and maintain, if not increase, the protection and safety of employees benefits provided by ERISA.

I understand that the ERISA provisions relating to Prohibited transactions was taken from Charitable Foundation laws. Generally, a Foundation is established by a grant or gift of a substantial amount and the trustees must invest the funds and carry out the purposes of the Foundation. They do not generally depend on further gifts from the creator of the Foundation. In a Pension or Profit Sharing Trust, the trustees depend on substantial and recurring contributions from the Creator of the Trust. I feel that because the beneficiaries and the trust depend on a successful and profitable Company to make contributions, the Trustees should be able to loan funds, with adequate security and the going rate of interest to the Creator of the Trust as long as the employees are adequately protected.

Mr. Chairman and members of the Subcommittee, I want to thank you for this opportunity to testify and I would welcome an opportunity to be of further assistance.

TESTIMONY OF

JOHN G. MUTSCHLER

PRESIDENT OF

JOHN G. MUTSCHLER AND ASSOCIATES, INC.

BEFORE

THE SUBCOMMITTEE ON PRIVATE PENSION
PLANS AND EMPLOYEE FRINGE BENEFITS

OF THE

FINANCE COMMITTEE OF THE
UNITED STATES SENATE

Accompanied by:

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DECEMBER 5, 1979

STATEMENT OF JOHN G. MUTSCHLER, PRESIDENT OF JOHN G. MUTSCHLER AND ASSOCIATES, INC.

I. INTRODUCTION

Mr. Chairman, and other members of the Subcommittee on Private Pension Plans and Employee Fringe Benefits, I wish to thank you for this opportunity to testify today. I am accompanied by Richard Fay of the law firm of Reed Smith Shaw & McClay who assisted me in the preparation of this testimony.

You and the other members of the Senate Finance Committee are to be congratulated for your continuing interest in the employee benefit area and your attempts to improve the Employee Retirement Income Security Act of 1974 ("ERISA"). In these two days of hearings, you have heard some excellent testimony on S. 1089, the ERISA Simplification Act of 1979, introduced by Chairman Bentsen and S. 209, the ERISA Improvements Act of 1979 introduced by Senators Williams and Javits. The Subcommittee is also considering several other related legislative proposals. I concur with much of the testimony you have heard on these bills, but the purpose of my testimony today is to propose an additional revision to and, I believe, significant improvement in ERISA. This proposal is based on my 24 years of experience in administering qualified plans.

John G. Mutschler and Associates, Inc. ("Company") currently administer approximately 400 qualified plans. Basically, our clients are smaller, privately-owned businesses located in Minnesota, Wisconsin, Iowa, North and South Dakota, Wyoming, Montana, Washington, and Oregon. Of the 400 plans we administer, approximately 250 are defined contribution plans and 150 are defined benefit plans. Of the 400 plans we administer, approximately 250 excess of $100,000,000, and annual contributions to the plans are estimated to exceed $9,000,000. These plans cover approximately 4,000 employees, the average equity of each employee is more than $21,000, and the average annual contribution for each covered employee is about $2,200. Since ERISA, the average annual earnings from investment of our employee plan trust funds has been approximately 3% for plans which invested primarily in the stock market, and approximately 8 1/2% for our other plans.

Our experience has been primarily with closely-held, smaller privately-owned corporations that would be categorized as "small businesses". These smaller corporations typically are owned by fewer than five stockholders, and often the ownership is confined to members of one family. It is my understanding that 97% of all businesses are "small business", very much like our clients. In addition, the latest statistics which I have read show that 93% of all retirement plans involve employees of small privately-owned businesses.

II. INVESTMENT EXPERIENCE PRIOR TO ERISA

Prior to ERISA, transactions involving pension and profit sharing trust funds were subject to Section 503(b) of the 1954 Internal Revenue Code. This section, which was consistent with the general common law of trusts, limited transactions between employers and their employee trusts to those commonly characterized as "arms length transactions". Under this law, loans of employee trust funds had to be adequately secured and had to earn a reasonable rate of interest. Our records indicate that of the companies whose employee plans we administer, prior to ERISA, that 102 borrowed funds from their plans, 16 leased equipment from their plans, 12 leased real estate, and 18 engaged in other types of "arms length transactions" such as selling third party notes, etc. All of these employee plans had above average earnings records.

In fact, our records show that the best returns on investments were realized by those plans which loaned part of their funds to employers. In general, companies borrowing money from plans have been willing to pay as high or higher interest rates than the rates charged by local lending institutions. The actual interest rates on such loans have been from 8% to as high as 15% per year. As a result, plans which loaned funds to the company realized average overall annual earnings of from 7% to 12%. Plans which purchased equipment and leased it to the employer company realized returns from such investments of 12% to 22% before taxes on "unrelated income". Over the same period, plans which invested only in the stock market realized an average annual return of less than 3% and in some years, such as 1970, 1973, and 1974, recorded very substantial losses. The disappointing rate of return on stock market investments were consistent with the generally poor performance of the market during the last decade as illustrated by the Dow Jones Industrial Average, which first reached 800 in 1964 and is still fluctuating between 800 and 860 in 1979, fifteen years later.

Because ERISA no longer permits loans to an employer even with adequate security and a reasonable rate of interest, a number of my clients have had to reduce their profit sharing contributions from a previous level of 15% of compensation to 10% or lower. I estimate that already over 1,000 employees have been affected by these reductions. Additional clients are seriously considering reductions in their annual contributions.

Based on average yearly income of 8% on pre-ERISA annual contribution of $1500 and 5% on post-ERISA annual contribution of $1,000 (my experience has shown the 3% disparity to be accurate) and compounding the contribution and income therein over a 40 year period the loss to the employee in benefits amounts to approximately $282,000. These figures do not, of course, reflect the losses in potential benefits resulting from terminations of plan or from the unwillingness of employers to establish new plans under present conditions.

In summary, based on my experience, one of the unfortunate and undoubtedly unintended consequences of ERISA, most particularly the prohibited transaction sections, has been to reduce substantially the rate of return of investments of qualified plans of smaller employers, and reduced in many cases employers' contribution to such plans. Less investment return and less employer contribution result in less overall benefits for the employees participating in the plans.

The prohibited transaction section as presently constituted not only have a detrimental effect on qualified plans themselves, but on the communities where they are located. In practice, there is a prohibition against investment by small plans in their communities.

Because of the prohibited transactions sections, trustees of small plans are limited to investing principally in mutual funds, stock market, bank trust departments and insurance companies. Investment managers are unwilling because of the restrictions of ERISA and other applicable laws to invest in local companies. I administer over 100 plans of employers located in North Dakota and South Dakota, Wyoming and Montana, but I know of only one company located in North Dakota listed on either the New York Stock Exchange, the American Stock Exchange, or the National Over the Counter Market. There are three such companies in South Dakota; one in Wyoming; and two in Montana. In my experience I know of only one trustee who was willing to invest even in these listed local companies.

56-943 O - 80 - pt.2 - 6

Overwhelmingly, investment managers of qualified plans located in these states invested in stocks and A-rated bonds of companies located in other states. This is also true for Wisconsin and Minnesota, although these states have more listed companies. ERISA has accelerated the channeling of capital created by small businesses in the Midwest and the West to financial centers outside of these areas. This capital is needed in these local areas for expansion and the creation of jobs.

III. EXPERIENCE UNDER ERISA

After more than five years of ERISA, I believe that we now have enough experience to revise ERISA to prevent these undesirable consequences without jeopardizing the interest of participants. As you know, the Department of Labor ("DOL") has the authority to grant administrative exemptions from the prohibited transaction sections of ERISA. In the last five years, they have proposed or granted several exemptions for loans to employers. This administrative exemption procedure, however, is as a practical matter not feasiable for small plans. It is much too costly and time consuming for small plans to use. Based on my experience, I can assure the Subcommittee the administrative exemption procedure is just not available to small plans.

What is needed is a specific statutory standard permitting loans in a way that is protective of participants' interest. A review of the administrative exemption already proposed or granted demonstrates how this can be done. Attached to my testimony as Appendix A is a brief description of the various administrative exemptions dealing with loans.

IV. PROPOSAL

I believe, and the exemptions set forth in Appendix A demonstrate that in many instances a loan from a plan to the employer is in the best interest of the plan and its participants and beneficiaries, the local community and can be done in a way protective of the rights of the plan's participants. Loans subject to the following conditions would achieve these goals.

Amount -- No more than 50% of total plan assets at any one time may be committed to loans to the employer or other person or entity who are parties in interest in respect to that plan.

Interest -- The interest rate must be equal to or greater than the prime rate in effect at the time of the loan.

Security -- The plan must receive a perfected security interest in collateral valued at 125% or more of the amount of the loan. In addition, a party other than the borrower must guarantee repayment of the loan. At the time of the loan, such guarantor must have net assets sufficient to repay the loan. The employer must insure the collateral during the entire term of the loan, and must assign the proceeds of such insurance to the plan. All security interests and guarantees must be duly recorded or filed in accordance with applicable state law.

In the alternative, if the plan receives a perfected security interest in collateral valued at 200% or more of the amount of the loan, then no guarantee will be required.

Duration -- The loan must be for a term of no more than 5 years. The loan must provide for quarterly payments of interest, commencing not later than three months from the date of the loan.

Reporting -- Plans using the proposed statutory exemption would be required to indicate in the annual report sent to the DOL and the Internal Revenue Service (Form 5500) that they have an outstanding loan.

I strongly recommend that ERISA be amended to allow loans from a plan to the employer if the loan meets the foregoing criteria. It should be clearly understood that the proposed amendment would merely refine the present prohibited transaction sections of ERISA and would in no way lessen the fiduciary standards established by ERISA. Even with a statutory exemption for loans, plan fiduciaries in deciding whether to make a loan to an employer would be fully subject to the exclusive benefit and other fiduciary standards of Section 404 of ERISA.

Finally, it should be understood that there is nothing sacrosanct about the specific language of the present prohibited transaction sections of ERISA. These sections were essentially taken by the drafters of ERISA from the prohibited transaction sections of the Internal Revenue Code dealing with private foundations. There is really very little similarity between qualified plans and private foundations. Firstly, qualified plans are much more numerous and involve millions of more individuals than private foundations. Secondly, generally, a private foundation is established by the grant of a single sum and does not depend on further gifts from the creator of the foundation. A pension or profit sharing trust however depend not only on substantial and recurring contributions from the creator but also on his continued existence. There is obviously a much more dependent relationship between a qualified plan and its sponsor than a private foundation.

V. CONCLUSION

The proposed amendment to ERISA permitting loans to employers subject to specific conditions is desirable because

(1) smaller plans would be able to make totally secure investments which would guarantee a greater rate of return on investment than presently available;

(2) the loan would be subject to the exclusive benefit and other requirements of the fiduciary standard of ERISA and the protection of participants' interest presently provided by ERISA would not be lessened or placed in jeopardy;

(3) smaller plans would be able to make loans without incurring the transitional cost associated with other forms of investments;

(4) smaller plans would be able to make loans without incurring the prohibitive cost and lengthy delays inherently a part of any administrative exemption procedure;

(5) it would stop to some extent the channeling of capital created by small businesses located in the Midwest and South to financial centers and large corporations located outside of their areas; and

(6) it would promote the formation of new plans, and create an incentive for employers to make maximum contributions to plans.

Mr. Chairman and members of the Subcommittee, I hope that my testimony has convinced you that amending ERISA to provide loans to employers is desirable and in the best interest of plan participants. I wish to thank you for the opportunity to testify and I would welcome an opportunity to be of further assistance.

APPENDIX A: EXEMPTION DEALING WITH LOANS

1. Prohibited Transaction Exemption No. 79-39 For A Transaction Involving The Everybody's Inc., Employee Profit Sharing Plan And Trust[1/]

Transaction -- Loan from Trust to Employer, Everybody's Inc.

Amount -- $40,000, or approximately 40% of plan assets.

Interest -- 14%, a rate 1% to 2% higher than a bank would charge for such a loan and much higher than the 7-1/2% the Trust previously had been receiving on its assets, which were invested in government obligations.

Security -- Equipment which at all times during the loan would be worth over twice the outstanding balance of the loan. The equipment was easily resaleable and would be fully insured. Plus personal guarantees by the owners. In addition, the Employer was financially sound.

Duration -- 5 years.

Other Factors -- Trust expects to receive further annual contributions of $12,500 to $15,000 and payments of plan benefits during the term of the loan are expected to be negligible.

1/ Signed July 20, 1979 (PH Pension Reporter ¶110,253). The proposed exemption, which contains significant information not contained in the final exemption, was published at 43 Fed. Reg. 61061 (PH Pension Reporter ¶110,160).

2. Prohibited Transaction Exemption No. 79-3 2/
For a Transaction Involving The Majestic
Paint Centers, Inc. Employees' Retirement
Trust and The Yenkin Majestic Employees'
Retirement Plan

Transaction -- Loans from the Plans to the Yenkin Majestic Paint Corporation and the Majestic Paint Centers, Inc. (Yenkin/Majestic) for the purchase of trucking equipment and latex emulsion equipment.

Amount -- $220,000, or less than 21 percent of the Plans' total assets.

Interest -- No less than 1/2 to 1% higher than the rate a bank would charge for loans on similar equipment.

Security -- Collateral interest in the equipment purchased, which would be insured and would at all times have a value in excess of 150% of the outstanding loan balance. Security agreements and UCC financing statements would be executed and promptly filed. Yenkin/Majestic would maintain insurance on the collateral. Plus guarantees of three major shareholders.

Duration -- Three years, a shorter term than the 4 years allowed by area banks on similar loans.

Other Factors -- 1. Historically it had been an established practice for the Plans to enter into equipment purchase loans with Yenkin/Majestic. The loans generally provided greater returns

2/ Signed January 31, 1979 (PH Pension Reporter ¶110,178). The proposed exemption was published at 43 Fed. Reg. 56306.

to the Plans than the return available from alternative investment opportunities, and there had been no defaults on losses.

2. Prior to making a trucking loan, the Plan's trustees would obtain a statement from a local bank stating that the bank was willing to finance the particular item of equipment, and setting forth the terms of such financing.

3. Prohibited Transaction Exemption No. 78-13[3/] For A Transaction Involving The Ragnar Benson Profit Sharing Plan and Trust

Transaction -- Loan from the Trust to the Woodlane Corporation, a real estate holding company which was partially owned by Ragnar Benson. The loan would be part of $6.3 million borrowed by Woodlane to finance a building constructed by Ragnar Benson for Woodlane. The balance of the $6.3 million would be obtained from banks and other institutional lenders on terms no more favorable to those lenders than the terms available to the plan. At the time the exemption was approved, 13 banks had provided the full $6.3 million, subject to the condition that in the event the plan decided to participate in the mortgage loan, each existing participant would reduce its participation on a pro rata basis. At least one bank which had no banking relationship with Ragnar Benson or its principals had furnished $1 million.

Amount -- $1 million, which, in combination with a previous loan from the Trust to Woodlane, totaled less than 25% of the Trust's $6.5 million total assets. The DOL rejected a proposal to increase the loan from $1 million to $4 million, an increase which DOL believed would have raised questions about the proper diversification of plan investments in compliance with §404(a)(1)(C) of ERISA. In rejecting the proposed increase to $4 million, DOL also noted that none of the banks which participated in the financing had furnished more than $1 million.

3/ Signed September 20, 1978 (PH Pension Reporter ¶110,143, CCH Pension Reporter ¶22,660). The proposed exemption was published at 42 Fed. Reg. 956 (PH Pension Reporter ¶135,230).

Interest -- 9 1/2%, equal to the rate on the bank loans.

Security --

1. Mortgage on the building. Even in the event of a distress sale, the value of the mortgaged property would be sufficient to provide adequate security on the loans.

2. Assignment of the lease of the building and all rents to the lenders. The rent due under the lease would be sufficient to repay the loans. In addition, the lease was noncancellable during the term of the loans.

3. Guarantees to the Trust from Ragnar Benson and from one of its owners. The net worth of Ragnar Benson was $6.5 million, and the net worth of the owner was $1 million.

Duration -- 15 years, which would coincide with the term of the noncancellable lease.

4. Prohibited Transaction Exemption No. 79-37 for 4/ Transaction Involving the Padilla & Speer, Inc., Retirement Plan and Trust and Profit Sharing Plan and Trust. 5/

Transaction -- Loans to the Employer, Padilla and Speer, Inc., from the Pension Plan and Profit Sharing Plan.

Amount -- Originally $16,000 from the Pension Plan and $8,000 from the Profit Sharing Plan. As of June 1, 1975, the principal unpaid balance due was $11,185 to the Pension Plan and $5,570 to the Profit Sharing Plan, or approximately 12% of the total assets of the Pension Plan and 11% of the total assets of the Profit Sharing Plan.

Interest -- 3 1/2% over the prime rate, or identical to the rate being quoted by an independent bank on a loan with similar terms which was replaced by the subject loans.

Security -- Identical to security required by independent bank on loan replaced by subject loans. Collaterally secured by a

4/ Signed July 13, 1979 (PH Pension Reporter ¶110,251). The proposed exemption was published at 44 Fed. Reg. 32309.

5/ Prohibited Transaction Exemptions Nos. 79-37, 79-40, 79-45, and 79-52 apply to transactions which were entered into before the effective date of ERISA but after July 1, 1974, the date specified in the transition rules contained in sections 414 and 2003 of ERISA. In each case the applicant represented that the transaction was entered into without prior knowledge that the transaction would become prohibited on January 1, 1975, and further that as soon as the applicant realized that the loan would become a prohibited transaction, the applicant submitted a good faith request for an exemption instead of terminating the loan transaction.

pledge of all accounts receivable and contract rights of the Employer, which, as of the date of the loans, had a value of approximately $124,627, five times the amount of the loan. Parties executed written security agreements and appropriate financing statements, and financing statements were recorded.

Duration -- 30 months.

Other factors -- All payments to the Plans were made in accordance with the loan agreement, and the loans were completely repaid. See also footnote 5, *supra*.

5. Prohibited Transaction Exemption No. 79-40[6/] for a Transaction Involving the Cochran Electric Co., Inc., Profit Sharing Trust

Transaction -- Loan from the Trust to the Employer, Cochran Electric Co., Inc. for the purchase of construction equipment.

Amount -- $3,700 compared to $430,688 net assets of Trust.

Interest -- 10 1/2%, the prevailing bank rate for similar transactions at the time of the transaction.

Security -- Equipment purchased with loan, valued at $4,400, served as collateral. Loan agreement recorded.

Duration -- 24 months.

Other Factors -- All payments were made in a timely fashion and the loan was repaid in full. Also, prior to the effective date of the Act, the Employer regularly borrowed funds from the Trust on similar terms. See also footnote 5, *supra.*

6/ Signed July 27, 1979 (PH Pension Reporter ¶110,255). The proposed exemption was published at 44 Fed. Reg. 34655.

6. Prohibited Transaction Exemption No. 79-45[7/] for a Transaction Involving the Profit Sharing Plan of Allied Investment Credit Corp.

Transaction -- Loan from the Plan to the Employer, Allied Investment Credit Corp.

Amount -- $24,852.21, or approximately 25 percent of the Plan's assets. In combination with two loans made in 1973, the total principal amount was $68,985.75, or approximately 70 percent of the Plan's assets.

Interest -- 10%, approximately 2% higher than the Employer would have paid to borrow from a bank.

Security -- Assignment of nine notes, together with security agreements and real estate mortgages, which the Employer had received from its debtors. The balances due on the notes totaled $100,357, and the security for the notes was appraised at $356,500. Also personal guarantees of the Employer's major shareholders.

Duration -- 4 1/2 years.

Other Factors -- The loan was repaid in full. Also, the employer has been engaged in business for over 20 years and has always made a profit. See also footnote 5, *supra.*

7/ Signed August 27, 1979 (PH Pension Reporter ¶110,266). The proposed exemption was published at 44 Fed. Reg. 34657.

7. **Prohibited Transaction Exemption No. 79-52[8/] for Transactions Involving the Profit Sharing Plan for Employees of Stone, Marriccini & Patterson**

Transaction -- Refinancing of Second Note on real property. Second Note is between Plan and the Partnership, which is comprised of certain shareholders of the Employer, other employees of the Employer, and, in some cases, their spouses.

Amount -- Refinanced Second Note was for $175,000. At the time of the Notice of Proposed Exemption, the outstanding balance on the Refinanced Second Note represented less than 8% of the assets of the Trust.

Interest -- 10%, the maximum permitted under California usury laws at the time the loan agreement was negotiated.

Security -- Second deed of trust on the Property, which was valued at approximately 250% of the amount of all unpaid debt on the First Note and the Refinanced Second Note as of June 20, 1977. Plus assignment of rents on the building located on the Property, the principal tenant of which is the Employer. The assignment allows the Plan to collect rents should any default in payment occur. The monthly rents paid by the lessees of the building are approximately twice the amount needed to service the monthly payments on the First and Refinanced Second Notes.

Duration -- 8 years. Same maturity date as original Second Note.

Other Factors -- See footnote 5, *supra*.

8/ Signed September 21, 1979 (PH Pension Reporter ¶110,285). The proposed exemption was published at 44 Fed. Reg. 39627.

8. Proposed Prohibited Transaction Exemption for Transaction Involving Victoria Machine Works, Inc. Thrift Retirement Trust Plan (Application No. D-1383) 9/

Transaction -- Loan from Plan to Borrower, a 28.5% shareholder of the Employer and a Trustee of the Plan, for purchase of tape lathe machine (the Equipment), which Borrower will lease to Employer.

Amount -- $223,335, approximately 20.5% of the Plan's total assets.

Interest -- 1/2% greater than the interest rate currently charged by a local bank to its major corporate customers, but in no event less than 12%. Present return on plan assets was between 7% and 8%.

Security -- First lien money purchase mortgage on the equipment, which is not expected to decrease appreciably in market value over the term of the loan. Plus a first lien mortgage on a mill purchased at a cost of $256,250 in July 1977, which had appreciated in value since then due to substantial improvements. Perfected security interests would be filed, and Employer will fully insure collateral. Value of collateral would at all times during the term of the loan be at least 200% of the outstanding loan balance.

9/ Signed September 12, 1979 (PH Pension Reporter ¶110,284).

Duration -- 5 years.

Other Factors -- Borrower had obtained a commitment letter from the bank stating that the bank would provide financing for the purchase of the equipment at 11 1/2% interest with a five-year payback. The bank's terms were approximately the same as the proposed loan from the Plan, except that the bank would charge a lower interest rate and not require collateral other than the equipment purchased.

9. Proposed Exemption for Certain Transactions Involving the United Precision Machine and Engineering Company Profit Sharing Plan (Application No. D-1061)10/

Transaction -- Loan from the Plan to the Employer, United Precision Machine and Engineering Company.

Amount -- $120,000, which, in conjunction with prior transactions with the Employer, represents approximately 19.1% of the Plan's assets.

Interest -- 14 1/2%, or 1% greater than the rate at which a local bank has represented that it would lend an equal amount of money to the Employer on identical terms.

Security -- Perfected security interest in equipment (two lathes, a milling machine and a tracer) owned by the Employer, with an appraised value of more than twice the amount of the loan. Demand for the equipment is high and therefore the market is good. The market value of the collateral will at all times be kept to at least twice the outstanding loan balance due at any time. Thus, in the event the value of the present collateral falls below the above ratio, additional collateral will be offered as security. The Employer will maintain adequate insurance against loss on the equipment during the period the loan is outstanding.

10/ Signed November 6, 1979. Published in the Federal Register on November 16, 1979, 44 F.R. 66106.

<u>Duration</u> -- 4 years.

<u>Other Factors</u> --

1. A local bank has represented that it would lend $120,000 to the Employer, secured by machinery, for a term of four years at 13 1/2% interest, provided the value of the collateral is at least twice the amount of the loan.

2. The loan will be administered by an independent custodial manager.

10. Temporary Prohibited Transaction Class Exemption No. 79-9 11/ to Permit Plans to Purchase Customer Notes from Employers Maintaining the Plans.

Transactions to which the exemption applies. Subject to certain conditions which protect the interests of plan participants and beneficiaries, the exemption permits an employee benefit plan to purchase certain notes from an employer whose employees are covered by the plan if the employers received such notes from its customers in the ordinary course of business and the notes are collateralized by security agreements on the property purchased by the customers. The exemption does not apply to the purchase of notes secured by leases, intangible personal property, real property, mortgage contracts, construction notes, etc.

Rationale -- In proposing the exemption, DOL observed that historically the purchase of such notes has been an established business practice in many industries; that plans which have invested in such notes have experienced very low default rates and rarely, if ever, experienced a loss, because the employer or the principals of the employer, or both, have guaranteed payment of principal and interest; that notes of similar quality have been sold to unrelated financial institutions on the same terms, and the notes, as well as the underlying collateral, have been readily marketable; and that the notes generally have provided greater returns to the plans than the return that has been available from alternative investment opportunities.

11/ Signed March 16, 1979 (PH Pension Reporter ¶110,191). The proposed exemption was published at 42 Fed. Reg. 55321.

<u>Limitation on Amounts</u> -- No more than 50% of plan assets may be invested in customer notes of the employer, and no more than 10% of plan assets may be invested in the notes of any one customer.

<u>Required Terms</u> -- Any sale of customer notes to a plan must be on terms at least as favorable to the plan as an arm's length transaction with an unrelated third party would be.

<u>Required Security</u> --

1. The note must be secured by a perfected security interest in the property purchased by the obligor on the note so that if the security is foreclosed upon, or otherwise disposed of, in default of repayment of the loan, the value and liquidity of the security is such that it may reasonably be anticipated that loss of principal or interest will not result.

2. Insurance against loss or damage to the collateral must be provided by the obligor, and the proceeds from such insurance assigned to the plan.

3. The employer must guarantee repayment of the note.

<u>Limitation on Duration</u> -- The term of the note must not exceed a specified number of months, depending on the nature of the collateral, as follows:

1. 60 months where the note is secured by heavy equipment.

2. 48 months where the note is secured by passenger automobiles and light-duty highway motor vehicles.

3. 36 months where the note is secured by other tangible personal property.

Senator MATSUNAGA. Next?

STATEMENT OF ROBERT KRYVICKY, ACTUARIAL CONSULTANT, SOCIAL SECURITY DEPARTMENT, UNITED AUTOMOBILE, AEROSPACE, & AGRICULTURAL WORKERS OF AMERICA

Mr. KRYVICKY. Good afternoon. My name is Robert Kryvicky. I am an actuarial consultant for the Social Security Department of the UAW.

I would like to confine myself today to a summary of our testimony with regard to four bills: S. 1089, S. 209, S. 1240, and S. 1958.

On the bill S. 1089, the UAW commends the author for the careful attention that he has paid in this bill toward lightening the load of administrative on employee benefit plans. This UAW supports this bill's efforts to reduce the administrative load on the employee benefit plans.

On the bill S. 209, we are fully in accord with the basic objectives of the authors of the ERISA Improvements Act of 1979.

With regard to the various sections of the bill—First with regard to reporting and disclosure, we support the elimination of the summary annual report because of the confusion it brings as well as the disinterest the confusion produces among plan participants. Employee organizations representing plan participants should receive, however, a complete copy of the annual report.

With regard to the reciprocity agreement, the UAW supports the reciprocity agreements referred to in the bill. The study, however, on portability and reciprocity referred in ERISA should be undertaken. The objective of the study should be whether such arrangements can be made across the private pension system in a rational manner, without discouraging the development of new plans.

With regard to survivor protection, we feel that there are many arguments against the bill's extension of the ERISA survivor benefits.

First, because the benefit would be provided on a "no cost" basis, severe reductions would prevent many workers from electing the option.

Second, reductions would reduce the survivor's actual benefit to a miniscule amount.

Third, the current trend we see of employers subsidizing the cost of the current ERISA survivor benefit might be reversed due to the high cost of the added protection.

Fourth, the existence of such a provision might hinder the development of what we consider to be the more important life insurance programs.

We would consider an alternative would be to mandate the elimination of the actuarial reduction for the current ERISA survivor benefit.

With regard to funding, the bill's provisions would require for cost purposes immediate recognition of pension increases bargained over the term of the agreements in steps. The UAW opposes this concept.

With regard to administration, enforcement and adjustment in applicable law, the UAW would be interested in the results of the study regarding cost of living in private pensions. On another issue, we feel that the present fiduciary provisions of section 404 of

ERISA should suffice in preventing willful misrepresentation by fiduciaries to employees who are not yet plan participants.

With regard to special master and prototype plans, the UAW supports the creation of such plans, especially in the defined benefit area.

With regard to the Employee Benefits Commission, the UAW supports the creation of a new Commission, provided the Pension Benefit Guaranty Corporation would retain considerable autonomy.

On the bill S. 1240, the consideration of this bill by the committee gives the UAW the opportunity to reaffirm its commitment to the concept of employees stockownership plans. From our perspective, such plans are viewed as only one part of the total class of employee benefits, which provide for income security at retirement or disability.

Such stockownership plans cannot and should not be viewed as replacement for sound pension, disability, life, sickness, accident and health insurance programs. Only after such programs are established and well developed, can consideration be given to stockownership arrangements.

The authors of the bill are to be commended, both on their steady commitment to an expansion of stockownership plans and on their farsightedness in this area from which the commitment is derived.

Finally, on bill S. 1968, no sweeping changes are needed in this area. Present law, together with Labor Department discretion in this area, provide flexibility and protect against abuse.

Thank you very much.

[The prepared statement of Mr. Kryvicky follows:]

SUMMARY OF TESTIMONY BY ROBERT KRYVICKY

S. 1089

The UAW supports this bill's effort to reduce the administrative load on employee benefit plans.

S. 209

The UAW supports the general ideas in the bill.

Reporting and disclosure

Elimination of the Summary Annual Report is supported because of the confusion it brings as well as the disinterest the confusion produces. Employee organizations representing plan participants should receive a complete copy of the Annual Report.

Reciprocity agreements

The UAW supports such arrangements. The study on portability and reciprocity referred to in ERISA should be undertaken. The objective of the study should be whether such arrangements can be made across the private pension system in a rational manner, without discouraging the development of new plans.

Survivor protection

There are many arguments against the bill's extension of the ERISA survivor benefit:

Because the benefit would be provided on a "no cost" basis, severe reductions would prevent many workers from electing the option.

Reductions would reduce the survivor's actual benefit to a miniscule amount.

The current trend of employers subsidizing the cost of the current ERISA survivor benefit might be reversed due to the high cost of the added protection.

Existence of such a provision might hinder development of more important life insurance programs.

An alternative would be to mandate the elimination of the actuarial reduction for the current ERISA survivor benefit.

Funding

The bill's provisions would require for cost purposes immediate recognition of pension increases bargained over the term of agreements in steps. The UAW opposes this concept.

Administration, enforcement and adjustment in applicable law

The UAW would be interested in the results of the study regarding cost-of-living in private pensions. The present fiduciary provisions of Section 404 of ERISA should suffice in preventing willful misrepresentation by fiduciaries to employees who are not yet plan participants.

Special master and prototype plans

The UAW supports the creation of such plans.

Employee Benefits Commission

The UAW supports the new Commission, provided the Pension Benefit Guaranty Corporation would retain considerable autonomy.

S. 1240

The UAW reaffirms its commitment to stock ownership plans. Such plans should only be viewed as one part of a total class of employee benefits which provide income security at retirement or disability.

S. 1958

No sweeping changes in this area are needed. Present law, together with Labor Department discretion in this area, provide flexibility and protect against abuse.

Testimony by Robert Kryvicky, Actuarial Consultant, Social Security Department, International Union, UAW

Mr. Chairman, members of the Subcommittee on Private Pension Plans and Employee Fringe Benefits, My name is Robert Kryvicky, I am an Actuarial Consultant for the Social Security Department of the International Union, UAW. We appreciate this opportunity to testify on behalf of the 1.8 million active and retired workers we represent.

The bills before this Committee are of great importance to the UAW. If enacted, they will directly alter the pension environment in this country. As a labor organization which has a current universe of over 2000 single employer defined benefit pension plans and 10 multiemployer defined benefit plans to which nearly 300 employers contribute, we obviously have a strong interest in any legislation which would affect pension plans in general, and defined benefit plans in particular. Furthermore, our general and direct concern in this area is for the financial security of our members in retirement. Thus, any legislation which is even remotely connected with retirement security is of the utmost importance to the UAW.

We would like to confine our remarks today to four bills: S. 1089, introduced by Senator Bentsen; S. 209, introduced by Senators Javits and Williams; S. 1240, introduced by Senators Long and Gravel; and S. 1958 introduced by Senator Matsunaga.

WITH REGARD TO S. 1089

The UAW commends the Chairman for the careful attention that he has paid in his bill toward lightening the load of administration on employee benefit plans. We endorse the concept of simplified administration, especially as it relates to our smaller employers. We feel that the bill addresses precisely those areas where relief can be granted without compromising full, adequate and meaningful disclosure both to the government agencies empowered with policing the employee benefit area, and to the participants of the plans.

WITH REGARD TO S. 209

For more than a decade before the passage of ERISA, the UAW labored for pension reform legislation. The UAW believes that ERISA is the most important piece of social legislation to have been enacted since the passage of the Social

Security Act of 1935. We are fully in accord with the basic objectives of the authors of the ERISA Improvements Act of 1979.

ERISA created a number of problems for pension plan administrators, but the UAW opposed proposals to amend the law soon after its passage because we believed that most of the problems could then be solved by regulations, as in fact they were. However, some problems are not amenable to any solution under the present legal framework and we now believe that new legislation is required to remedy some of the problems created by the law.

Because of the detail and complexity involved, I'll confine my remarks to only certain rejected sections of the bill.

Title I, Subtitle B—Part 1—Reporting and disclosure

The UAW is in agreement with the general intent of the proposed changes in the area of reporting and disclosure. We perceive these amendments as an attempt to make the requirements for administrators reasonable without removing participants' rights to information which they can understand and in which they are interested.

One of the proposals which we have carefully reviewed is the elimination of the requirement that a plan administrator distribute a copy of the Summary Annual Report to participants. We have observed that as a result of this distribution, some of our members have become fearful about the solvency of their plans. Often they cannot understand the terminology of the reports or the significance of such items as a very large "unfunded past service liability." Even where there has not been this reaction, the lack of understanding by participants has led to disinterest; they simply discard the Summary Annual Reports.

Participants, however, do have a need for meaningful information about the financial operations of their plans. To get this information, they presently turn to their unions who often do not have in their possession the documents necessary to provide accurate advice. Therefore, we would recommend that the law require that the employee organizations representing plan partiicpants receive the full copy of the Annual Report, including the supporting actuarial and financial reports.

Title J, Subtitle B—Part 2—Minimum standards—Reciprocity agreements

The UAW is in full agreement with any legislation which would allow workers covered by collectively bargained plans to transfer their pension credits to different collectively bargained plans. We would urge that the portability feasibility study that is referred to in ERISA Section 513 be undertaken. The objective of such a study should be whether portability and reciprocity are concepts that can be implemented throughout the private pension system in a rational manner without discouraging the formation of new plans.

Survivor protection

We commend the Committee for its concern over the plight of surviving spouses of workers who participate in pension plans. The UAW has long recognized this problem and has taken steps to solve it such as providing adequate levels of monthly income under a life insurance program.

The proposed extension of the joint and survivor benefit would be provided at full cost to the employee, i.e. there would be no subsidy from the plan. The severe reductions in the employee's potential pension benefit necessary to provide the additional surviving spouse benefit at no expense to the plan would be such that only a handful of employees would avail themselves of their right to elect the benefit. Moreover, it should also be borne in mind that, with few exceptions, the option would provide a minuscule benefit for surviving spouses. The provision of this new benefit, acclaimed by those who fought for it, would raise high expectations of income protection, which in most cases would turn out to be an illusion.

ERISA provides a limited version of what is proposed in S. 209; an employee eligible for early retirement now has the option of electing a surviving spouse benefit that would be payable upon his death prior to the actual retirement date.

When this provision first became effective in 1976, workers who elected the option faced substantial benefit reductions upon retirement. Since then, plan sponsors have balanced the expenses of administering the elective provision against recouping the costs from the participants and we have seen a trend towards providing the benefit on a "free" basis.

If the proposed extension of the surviving spouse benefit to all vested employees is implemented, the additional cost would no longer be insignificant. As a result, plan participants and their surviving spouses may stand to lose any present element of subsidy.

We also fear that the existence of such a benefit may hinder the establishment or improvement of life insuranced programs, either in the form of lump sums or as periodic payments to the surviving spouse. Finally, mandating such a benefit which presents serious technical and administrative problems might precipitate the termination of a number of pension plans and create additional obstacles in the establishment of new plans, a matter which is of concern to the Committee as demonstrated by the proposal on tax credits.

Therefore, we urge the Committee to weigh the arguments carefully and to consider alternative proposals. For example, we would suggest that the Committee study the possibility of mandating elimination of the actuarial reductions for the preretirement surviving spouse benefit.

Title I, Subtitle B—Part 3—Funding

The UAW has traditionally bargained pension increases on a step basis over the term of the contract (usually three years). This approach has been met with wide acceptance on the part of both our membership and the employers with whom we bargain. Before ERISA was passed, provisions of the Internal Revenue Code allowed plan sponsors to recognize the cost of such bargained increases gradually by requiring only the increases which occurred in the plan year in question to be taken into account when determining the costs for that plan year. After ERISA was passed, the IRS reaffirmed its earlier position in a Revenue Ruling 77-2.

Although we understand the problems involved with shortfall situations and the need to correct them, the UAW is concerned that the provisions of Section 131 of the bill would undermine our traditional practice by requiring that plan sponsors take into account all future pension increases when determining costs for a plan year even if the increases aren't scheduled until later plan years. Thus, for example, increases occurring in the third year of a new agreement would have to be recognized for funding purposes in the first year of the agreement.

From the UAW's standpoint, such a provision would drastically restrict the types of pension improvements that our membership could bargain by front-loading the contract's cost. Instead of spreading the cost over the contract term, the cost would be compressed into the first year. From the employer's standpoint, in times of high inflationary expectations the effect would be building tomorrow's potential inflation into today's product cost—a move which simply does not make sense.

Title I, Subtitle B—Part 5—Administration, enforcement and adjustments in applicable law

The UAW shares the concern of this Committee that the disastrous levels of inflation which we have seen in the last few years, and anticipate for the future, cause a serious problem for retirees who have to manage on fixed incomes. We are disturbed over the erosion of our member's pensions through the insidious effects of inflation. We will have to redouble our efforts to restore the purchasing power which has been lost through inflation. The many employers who are able to do so should meet their responsibility to former employees by providing cost-of-living increases.

We would view with interest the results of the study proposed in S. 209.

On another issue, S.209 builds on the Supreme Court's Daniel decision by providing that the securities laws will not apply to those employee benefit plans covered by ERISA. The UAW agrees with the extension of the protections afforded by ERISA to employees who are not yet plan participants, but who could make an employment decision on the basis of willful misrepresentation by a fiduciary of the plan.

However, we do not believe that it is necessary to create a new tort in the proposed Section 515(a) of ERISA. We think that the provision presently found in Section 404 outlining fiduciary duties should suffice, provided more individuals or organizations charged with responsibilities for administering plans are deemed "fiduciaries" by the Labor Department.

Title III—Special master and prototype plans

Small employers have been deterred from instituting new pension plans by the ongoing burden of administration added to high start-up costs.

The UAW believes that by providing economical vehicles such as master and prototype plans, S. 209 will foster the creation of new pension plans in the United States. The special emphasis should be on the creation of new defined benefit plans.

For a number of years now, the UAW has seen the operational advantages of a type of master plan. Since 1965, the National Industrial Group Pension Plan (NIGPP), a simple basic plan, has been available to small groups of employees. While it was already popular before 1974, we have seen increased interest and a spurt in the number of units participating in the plan since ERISA became effective. This is due to the fact that NIOPP eliminates much of the administrative burden of plan sponsors and also provides sharing of initial costs as well as actuarial, legal and accounting expenses.

Title IV—Employee Benefits Commission

The existence of dual jurisdiction over employee benefit plans by the Treasury and Labor Departments—not to mention the Pension Benefit Guaranty Corporation—has created confusion and a number of problems for employers and plan administrators. It also causes delays in decisions affecting plan participants. Interim reorganization measures have been adopted by the Treasury and Labor Dapartments, but these measures were intended to be temporary. In fact, no permanent solution that would be satisfactory to all parties can be worked out under the present statute. This is why we favor the creation, as proposed in S. 209, of an Employee Benefits Commission which would be responsible for the administration of ERISA. We trust that, under the proposed system, the Pension Benefit Guaranty Corporation would retain considerable autonomy. The establishment of the proposed Employee Benefits Commission would ease the compliance by plan administrators with the various requirements of ERISA; it would expedite the issuance of regulations; it would help to dissipate the confusion that is inevitably created when three government agencies regulate the same sector. In general, we believe that the Employee Benefits Commission would be more beneficial for plan participants and their beneficiaries than the present arrangement. It would make for a more efficient private pension system.

WITH REGARD TO S. 1240

The consideration of this bill by the Committee gives the UAW the opportunity to reaffirm its commitment to the concept of employee stock ownership plans. From our perspective, such plans are viewed as only one part of a total class of employee benefits which provide for income security at retirement or disability. Such stock ownership plans cannot and should not be viewed as replacements for sound pension, disability, life, sickness, accident and health insurance programs. Only after such programs are in place can consideration be given to stock ownership arrangements. We have no specific comments with regard to the bill, but rather a general approval of the ideas involved.

As the members of this Committee may know, as a part of the recent Automobile Agreements, the UAW successfully negotiated TRASOP's. Stock ownership for workers is viewed by the UAW as desirable in that it eliminates one more double standard between hourly and salaried workers. Admittedly, the TRASOP's recently negotiated represent a very modest first step toward an eventual expansion of the idea. But, much of the reason why the first step has been so modest is that the existing provisions of law governing such stock ownership plans are equally modest.

Howerver, the subject bill would change this situation by creating an environment in which such plans could prosper and grow. The authors of the bill are to be commended both on their steady commitment to an expansion of stock ownership plans and on their farsightedness in this area from which the commitment is derived.

WITH REGARD TO S. 1958

The UAW feels that there is no sweeping change needed in the area of facilitating investment by employee pension benefit plans in qualifying employer real property. We feel that the present provisions of law as well as the ability of the Labor Department to exempt certain transactions in real property from the law are sufficiently broad to permit flexibility but, at the same time, prevent abuse.

STATEMENT OF CHARLES MORAN, SENIOR VICE PRESIDENT, MANUFACTURERS HANOVER TRUST CO., CHAIRMAN, EMPLOYEES TRUSTS DIVISION, AMERICAN BANKERS ASSOCIATION

Mr. MORAN. I am Charles Moran, senior vice president of Manufacturers Hanover Trust Co. I appear here today as chairman of the Employees Trusts Committee of the Trust Division of the American Bankers Association.

I would like to address the major points in my written statement, and I ask that the complete statement be made a part of the record.

Senator MATSUNAGA. Your statement will appear in full in the record.

Mr. MORAN. We support the general thrust of the provisions of S. 1089, intended to simplify compliance by employee benefit plans with various reporting and disclosure requirements of ERISA. However, we believe that the whole statute is much too specific on what is required, and we feel that the statutory specifics currently in sections 103 and 104 should be eliminated, and that the Secretary of Labor should determine what report and disclosure details are necessary. We hope that in its consideration of S. 1089 and S. 209, the subcommittee will undertake a broader review of this matter. We also have reservations regarding section 6 of S. 1089, which are explained in our written statement.

As fiduciaries and investment managers, ABA member banks feel their greatest problem with ERISA is the prohibited transaction provisions. Prior to the passage of ERISA, we expressed concern about the breadth of application of these provisions. We recommended that the law should prohibit only those transactions entered into for less than adequate consideration where a plan's assets are being sold, leased, or otherwise transferred, and from transactions entered into for more than adequate consideration, when assets or services are being acquired.

Regrettably, our concerns have proven correct. The significant impact of the enacted provisions on traditional fiduciary practices can only be understood when the almost limitless definition of party in interest is considered. It is almost impossible to track all of the possible parties in interests. The vast majority of prohibited transactions would not only be innocently entered into, but would also be in the plan participants best interest.

We were told at the time that the prohibited transaction provisions were formulated that the exemption procedure would be significantly liberal, so as to alleviate any unnecessary severity of the provisions. We have found the exemption procedures totally unworkable.

My written statement discusses the four class exemption applications we have submitted, the first of which was filed in December 1976. None of these applications has been resolved into a final exemption. The Department of Labor last summer did publish two proposed exemptions based on two of our applications, but we find both of these fall short in dealing with the practical world in which we, as fiduciaries, must function. It is not known when the Department will take final action on any of these applications.

The Senate Labor Committee added to S. 209 a provision to require the Labor Department to report to Congress when action on an exemption application is delayed. We feel that this is not an adequate solution to the prohibited transaction problem. We urge this subcommittee to examine the merits of substituting an "arm's length standard" to the current prohibited transaction provisions. In this regard, the American Bankers Association strongly supports the thrust of the testimony of Mr. Theodore Groom before you today.

Regarding the special master and prototype plans in S. 209, I might make the observation that in order to successfully implement that program, it is our opinion that some of the securities problems would have to be resolved in order to encourage financial institutions to sponsor such special master plans.

There are other provisions in S. 209 which require comment. We are troubled by the uncertainty likely to be created by the proposed misrepresentation standard. This provision provides unnecessary and duplicative standards. We are also concerned about the current definition of "fiduciary". It should be clarified to indicate that individuals acting on behalf of corporate fiduciaries are not themselves fiduciaries. We feel that the ambiguous language in section 405 of ERISA should be rewritten, more accurately assigning liabilities, making clear that the cotrustee liability only applies when trustees are acting in concert over the same trust asseets. Finally, we feel that the proposed definition of "knowledge" for purposes of determining liability of an institutional fiduciary for a breach of fiduciary responsibility by a cofiduciary must be limited to knowledge actually communicated.

Thank you very much, Senator.

Senator MATSUNAGA. That completes the panel's presentation. There is one question I have. You spoke of a combination of the workers' compensation and social security benefits at times exceeding the actual wages. How many actual cases have there been?

Mr. GUY. Senator, I cannot give you the exact number of cases. When you consider the maximum workers' compensation benefit that is available for total disability in the States today and under the Federal program, in combination with the social security benefits, and then in concert with the pension benefits, we are talking about benefits available in excess of 125 to 130 percent. Most of that money is tax free, all of it but 50 percent of the social security, and all of it is paid for by the employer.

Senator MATSUNAGA. Thank you.

[The prepared statement of Mr. Moran follows. Oral testimony is continued on p. 621.]

SUMMARY

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS OF THE
SENATE FINANCE COMMITTEE
ON THE
ERISA SIMPLIFICATION AND ERISA IMPROVEMENTS ACTS OF 1979
(S.1089 and S.209)

December 5, 1979

1. Reporting and Disclosure - The ABA supports the general thrust of the provisions of S. 1089 intended to simplify compliance by employee benefit plans with various reporting and disclosure requirements of ERISA. However, we believe the whole statute is much too specific on what is required, and we hope in its consideration of S. 1089 and S. 209, the Committee will undertake a broader review.

2. Prohibited Transactions - As fiduciaries and investment managers, ABA member banks feel their greatest problem with ERISA is the prohibited transaction provisions. We continue to advocate replacing these provisions with an "arms length standard" which would prohibit only those transactions entered into for less than adequate consideration when a plan's assets are being disposed of and those transactions entered into for more than adequate consideration when assets are being acquired. We have found the exemption procedure of ERISA totally unworkable as exemplified by the lack of resolution of the four class exemption applications we have submitted, the first of which was filed in December 1976. The provision added to S. 209 by the Senate Labor Committee to require the Labor Department to report to Congress when action on an exemption application is delayed is not an adequate solution to the prohibited transaction problem.

3. Special Master and Prototype Plans and the Securities Laws - The special master and prototype plan concept may allow a breakthrough in extending pension plan coverage of employees of small employers if costs can be minimized under a responsible, effective regulatory scheme. In order for smaller financial institutions to sponsor such plans for smaller businesses in their communities, it will be an economic necessity that the employer contributions be collectively invested. The SEC has taken the position that neither Keoghs nor IRAs are exempt from the registration requirements of the securities laws. The cost of registration would be prohibited to most if not all of the financial institutions interested in sponsoring the proposed special master plan. S. 209 as introduced would have cured many of the securities law problems for special master plans and other pension plans. If such relief from SEC regulation is granted, no additional duplicative regulatory authority is needed by the Labor Department, since bank trustees of collective investment funds are subject now to the fiduciary

standards of ERISA and federal and state banking laws and regulations.

4. Daniel Issue - We are troubled by the uncertainty likely to be created by the proposed misrepresentation standard in S. 209. Our concern goes not only to the vagueness of the standard but also to the lack of specificity in identifying those subject to the standard and those intended to be protected by the standard.

5. Other Provision - The ABA also expresses concern about the current definition of "fiduciary," the ambiguous language in ERISA on the liability created by actions of co-trustees, and the definition of "knowledge" for purpose of determining liability of an institutional fiduciary for a breach of fiduciary responsibility by a co-fiduciary.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS OF THE
SENATE FINANCE COMMITTEE
ON THE
ERISA SIMPLIFICATION AND ERISA IMPROVEMENTS ACTS OF 1979
(S.1089 AND S.209)

December 5, 1979

Mr. Chairman and members of the Subcommittee, I am Charles A. Moran, senior vice president of Manufacturers Hanover Trust Company, and Chairman of the Employees Trusts Committee of the Trust Division of the American Bankers Association. I appear on behalf of the ABA, an association composed of over 90 percent of the nation's more than 14,000 full service banks. Approximately 4,000 of our members have fiduciary powers and most of these serve as trustees, investment managers, or in some other fiduciary capacity with respect to employee benefit plans. The American Bankers Association is committed to efforts to insure the strength, integrity, and further expansion of private plans covered by the Employee Retirement Income Security Act. On the whole ERISA has proven to be a workable and salutary law, but some of its provisions have placed conflicting, duplicative, and unnecessarily burdensome requirements on plans and those involved in providing services to plans. We are pleased that the Senate Finance Committee is holding these hearings on S.1089, "ERISA Simplification Act of 1979", and S.209, "ERISA Improvements Act of 1979", in order to explore what changes should be made in ERISA.

Our testimony today will cover a number of matters not directly involving the Internal Revenue Code. We believe, however, that all these matters are critical to sound changes in ERISA to promote the expansion of the pension system and improve its functioning.

Reporting and Disclosure

We support the general thrust of sections 2 through 5 of S.1089, provisions which are intended to simplify compliance by employee benefit plans with various reporting and disclosure requirements of ERISA. Consolidation of forms and of filing dates should be encouraged wherever feasible. We support the elimination of the summary annual report but suggest alternative means of communication other than posting be allowed if they result in the necessary information being adequately disseminated to the workforce. We also support additional assistance to smaller businessmen by the regulatory agencies on how to cope with ERISA requirements which should aid them in keeping down the expense of trying to comply with the complex (and changing) recordkeeping provisions. Regarding individual retirement accounts, the Internal Revenue Service already publishes Publication 590, "Tax Information on Individual Retirement Savings Programs." What is needed is periodic publication (perhaps in a question and answer format which the Service has already utilized for IRA information) of the interpretations of the IRA law contained in individual opinion letters. In addition better assistance is needed from the Service in answering questions on IRAs from individuals and those such as banks offering IRA accounts. Section 4009 of ERISA currently gives the Pension Benefit Guaranty Corporation responsibility to provide individuals with advice and assistance on whether to establish an IRA, but since the tax consequences of whether and how to establish an IRA are a primary consideration, the Service should logically have this responsibility.

We hope that as part of this Subcommittee's study of S.1089 and S.209 further consideration will be given to a more comprehensive change in the reporting and disclosure provisions. We feel the whole approach taken in ERISA on reporting and disclosure is fundamentally wrong. The statute is much too specific in how, what, when and where information on a pension plan must be reported. We urge the Subcommittee to review whether the reporting requirements really need to be elaborately spelled out in the statute. We favor eliminating the statutory specifics currently found in Sections 103 and 104 and augmenting the authority of the Labor Secretary to require employee benefit plans to file such reports as he determines necessary to carry out the policy of ERISA, and to furnish or make available to participants and beneficiaries for inspection copies or summaries of the reports. At the same time the regulators should be given a strong Congressional directive to devise a system to simplify and ease the reporting burden.

In the five years since the enactment of ERISA we have experienced continued delays in receiving reporting forms and regulations. We recommend that Congress incorporate a provision into S.1089 or S.209 that any revised reporting form and its accompanying regulations must be issued in final form 180 days before the beginning of the plan year for which the form is to be used. Otherwise, the sponsor can use the prior form to fulfill agency reporting requirements. We believe that such a recommendation will relieve some of the burden of the reporting changes and aid in compliance.

We hope the Subcommittee will also review our comments on reporting and disclosure of August 17, 1978 on S.3017, the predecessor bill to S.209. There we discuss some specific changes needed in section 103 if

Congress does not repeal all the statutory specifics of that section. In particular, we feel Section 103(a)(3) on public accountant opinions needs revision as proposed by Section 116 of S.209. Section 103(a)(3)(C) should state that a public accountant <u>shall</u> rely on a bank's statement of assets. Our August 1978 statement also discussed the unnecessary annual reporting burden being placed on master trusts. In the year and a half since we testified on master trust reporting problems, the agencies have not resolved the matter. The agencies apparently feel there should be an allocation of assets and reportable transactions of the master trust among participating plans. There is no legal or accounting basis for such an interpretation. The asset of each participating plan is a beneficial interest in the master trust, not an interest in each security held in the master trust. This Subcommittee might want to examine further how master trust reporting is being handled as an example of an unresolved ERISA reporting problem.

<u>Prohibited Transactions</u>

As fiduciaries and investment managers our member banks have found that their overriding problem under ERISA is its prohibited transaction provisions. These provisions found in almost identical form in both the labor law and Internal Revenue Code sections of ERISA are prophylactic in nature, prohibiting transactions or dealings between a plan and "parties of interest." The Code provision imposes excise taxes for such transactions even if they are entered into without knowledge. These provisions are a clear case of regulatory overkill.

Section 406(a) of ERISA and Section 4975 of the Internal Revenue Code prohibit all transactions between a plan and a party in interest, such as sales or exchanges of property, lending of money, furnishing of goods or services and the transfer to or use by a party in interest of any of the plan assets. Prior to the passage of ERISA, we expressed concern about the breadth of the application of these prohibited transaction provisions. We recommended that the law should prohibit only those transactions entered into for less than adequate consideration when a plan's assets are being sold, leased or otherwise transferred and those transactions entered into for more than adequate consideration when assets or services are being acquired. Regrettably, our concerns have proven correct.

The significant impact of the enacted provisions on traditional fiduciary practices can only be understood when the almost limitless definition of party in interest is considered. We are aware that S.209 includes some redefinition of party in interest. We feel that the deletion of "employee" from Section 3(14)(H) will be helpful. However, the limited changes in the definition of party in interest will not solve our basic problems. The number and variety of possible transactions that would still be prohibited by the statute are enormous, and the vast majority of such transactions would not only be innocently entered into but would also be in the plan participant's best interests. For example, investments in private placements are a nightmare under existing rules. Where there are significant borrowings by U.S. companies involving major financial institutions serving a great number of large employee benefit accounts, the opportunity for interrelationships of interests are endless. Review of these potential relationships is expensive, time-consuming and not cost effective. Frequently the result is to abort participation by fiduciaries in first class credits.

We were told at the time the prohibited transaction provisions were formulated that the exemption procedure would be significantly liberal so as to alleviate any unnecessary severity of these provisions. We have found the exemption procedure totally unworkable. Implementation of Reorganization Plan No. 4 of 1978 which placed sole responsibility for exemptions in the Labor Department has not made any substantial difference from our view point. The ABA has spent a great deal of time considering if the prohibited transaction provisions and the party in interest definition can be changed to minimize their deleterious effects on the efficient operation of ERISA and we have found no real solutions. We have concluded that the extensive listing of flat prohibitions in the statute is just an unsatisfactory way to achieve the protection for participants which is the fundamental goal of ERISA. Although the Labor Department has indicated that it is making good progress on exemption applications, only a small number of substantive class exemptions have been granted, with the broker-dealer exemption being the most notable one. The bulk of exemptions granted have been individual exemptions which do not have widespread application. Our own experience with the Labor Department on four exemption applications that the ABA has filed indicates the practical impossibility of trying to obtain class exemptions for legitimate fiduciary activities which will benfit plan beneficiaries.

Our first application was filed in December 1976 requesting issuance of a class exemption from prohibited transactions with respect to certain acquisitions of short-term obligations of banking organizations. The purpose of the application is to eliminate possible violations of the prohibited transaction rules of ERISA where more than one bank has been named as trustee or investment manager of a single employee benefit plan with each bank responsible for the investment and administration of its own portion. The possible violation arises when one bank invests cash in the short-term obligations of another bank serving as trustee or investment manager for another portion of assets of the same plan. Both banks are acting totally independent of the other and, in fact, they probably do not even know of the other's role as a fiduciary of the plan.

In January 1977 we filed our second application for exemption. This application requested a class exemption from prohibited transactions for purchases of securities in the public marketplace by employee benefit plans where proceeds of the sale are used by the issuers of the securities directly or indirectly to retire or reduce indebtedness to banks which are parties in interest or disqualified persons with respect to the employee benefit plans.

Our third application was filed in May 1977. It requested a class exemption from prohibited transactions for collective investment funds maintained by banks for the investment of assets of employee benefit plans. This exemption application should be unnecessary because the proper interpretation of the statutory language and the legislative history of ERISA is that a plan participating in a collective investment fund holds a beneficial interest in the fund itself, not a share of each of the underlying assets of the fund. Unfortunately, since the regulators do not find this specific language in the statute, the only way for fiduciaries to adequately guard against liability is to seek an exemption. A more desirable and direct approach to resolve this problem would be to have language added to ERISA to make clear that the assets of a collective investment fund are not assets of a plan which holds participations or interests in the collective investment fund. ERISA contains such a provision for mutual funds and similar treatment of banks is clearly justified. We recommend the following language be added to the "ERISA Improvements Acts":

"Section 401(b) of the Employee Retirement Income Security Act of 1974 is amended by adding the following new paragraph:

'In the case of a plan which invests in interests in (i) a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or Federal agency, or (ii) a pooled investment fund of an insurance company qualified to do business in a State, the assets of such plan shall be deemed to include such interests but shall not, solely by reason of such investment, be deemed to include any assets of such common or collective trust fund or pooled investment fund.'"

We have seen little evidence of progress on our first exemption application. Regarding our second application, the Labor Department published a proposed exemption in July of this year with comments due by September 24. We filed lengthy comments and asked for a public hearing because we feel the proposed exemption is seriously inadequate. The hearing has not yet been scheduled. The application celebrates its third birthday next month. The subject matters of this application and our first application which was submitted three years ago this month are not all that complex. Our third application has received more attention as a result of the insurance companies' pooled separate account application filed in November 1974 and granted in December 1978, a mere 4 years later.

The Labor Department held a hearing yesterday on its proposed collective fund exemption which also was published in July. We find this proposed exemption even less adequate than its proposed exemption on the use of securities sales receipts to pay down bank debt in meeting the needs of the real world in which bank fiduciaries must function. When the Department will take final action on this application or either of the other two filed earlier is not ascertainable.

The Association filed its fourth application in March 1979. It seeks an exemption to lend plan securities under specific conditions to a broker-dealer who is a party in interest to the plan. Individual applications were submitted on the same issue in mid-1978 and the Labor Department has indicated it would handle all these as a class exemption. We have seen little evidence of progress in this issue either.

We urge the Subcommittee to consider legislation to change the basic concept of prohibited transactions as they relate to dealings with parties in interest. After five years of struggling with ERISA's prohibited transaction provisions, we feel more strongly than ever that the proper approach is that only those party in interest transactions entered into for less or more than adequate consideration should be prohibited. This standard coupled with the duty of undivided loyalty and the exclusive purpose test of Section 404 would be sufficient to obviate any need for the prohibitions enumerated in Section 406(a).

Based on our experience, no substantive protection would be lost to participants by this change. The breadth and force of the affirmative duties of undivided loyalty, exclusive purpose and prudence are more than sufficient to reach any conceivable misconduct by a fiduciary involving a party in interest relationship. It would appear that the enforcement efforts of the Department of Labor support this view. Our understanding is that in none of the fiduciary actions brought to date has it relied exclusively on the provisions of Section 406(a). It has in each case invoked the equitable doctrines in Section 404, and we might add, been very successful in securing the relief sought.

It is our firm conviction that Section 406(a) should be repealed, not only because the burdens it imposes are excessive in relation to the protection it offers participants, but also because it gives no substantive protections that they do not already enjoy under Section 404. There is no overt misconduct that the Congress would want to see banned under Section 406(a) which would be permitted under Section 404. Conversely, there are many beneficial transactions and relationships which have been unduly impeded by those prohibitions, to the detriment of participants and beneficiaries.

The Senate Labor and Human Resources Committee added to S.209 a provision which requires the Secretary of Labor to report to the labor Committees of Congress and the President any application which is pending final determination more than 180 days in the case of an individual exemption and 365 days in the case of a class exemption. The report is to describe the applicant, the transaction, the terms requested in the application and those proposed by the Department, the reasons for its continuing pendency and the identity of the official in the Department responsible for the application. While such a provision, is unique in administrative procedure, it might be of some help in expediting consideration of exemption applications. But more likely it would destroy the functioning of the administrative exemption procedure. Whichever it might do, it does not provide a workable solution to the problem. We believe the arms length transaction approach of adequate consideration is the only real answer. If there is concern about difficulties which might be encountered in proving a transaction was not arm's length, it might be appropriate to shift the burden of proof to the fiduciary to show that a challenged transaction was arm's length.

In connection with our consideration of the prohibited transaction problem the Association is renewing its consideration of the establishment of a single independent agency whether it be an adminsitrative agency or commission. It is doubtful that such an agency would do much, if anything, to cure the problems we have experienced in the exemption application procedure. We are looking, however, at the impact such an agency might have on the overall administration of ERISA, particularly in promoting the interest of pension plans as well as protecting the interests of participants and beneficiaries. Congress indicated in its committee reports on ERISA its concern that ordinary commercial transactions not be unncessarily impeded. This has not been the record of ERISA administration to date.

Special Master Plans

S.209 offers a potential major step forward to provide pension plans for employees of small employers. The special master and prototype plan concept may allow a breakthrough in extending pension plan coverage if costs can be minimized under a responsible, effective regulatory scheme. We believe it particularly important to attract smaller financial institutions to sponsor such plans for the smaller businesses in their communities. Because of the size of the employers that will participate in the special master plans, it will be an economic necessity that the contributions of individual employers to their pension trusts be collectively invested.

This raises securities law problems. S.209, as introduced, would have gone a long way toward solving these problems by allowing banks to collectively invest assets of all employee benefit plan trusts without the added burden of SEC regulation.

As we read the bill a special master or prototype plan would have to meet the requirements of Section 401 of the Internal Revenue Code, the requirements of new Section 601 of ERISA and the other requirements of ERISA to qualify. All small employers regardless of business organization would be able to adopt the plan. Considering the past and current attitude of the Securities and Exchange Commission relative to Keoghs and IRAs it seems doubtful that the current Federal securities laws exemption for single or collective trusts for pension plan assets would be considered applicable.

Under current law the assets of corporate plans may be collectively invested regardless of the size of the company without registration under Section 3(a)(2) of the Securities Act of 1933. Congress has not, however, exempted Keogh plan collective trusts from registration under the 1933 Act. Nevertheless, banks with very few exceptions have not registered their collective trusts for Keoghs but have relied upon the intrastate exemption of Section 3(a)(11) of the 1933 Act. This has resulted in some strange consequences. In multistate communities such as Washington, D.C., New York and Chicago, Keogh plan trusts have to be tailored carefully so that the interest in the plan of any participant who resides out-of-state is not invested in a collective trust fund. The interest of such a person may be invested in an interest bearing deposit account. Because of the intrastate restriction, plans that are collectively invested must be policed continually to ascertain when any participant moves out of the state so the participant's interest can be withdrawn from the collective trust and reinvested in a deposit account. These nonproductive costs are borne by the plan and the bank trustee but the really unfortunate aspect is that the participant loses his ability to have his pension account invested in a diversified, professionally managed portfolio.

Many smaller banks have considered collectively investing their Keogh plan trusts and their corporate pension trusts in one fund because they do not hold sufficient assets to maintain two separate collective trusts. However, they have decided against such action because according to SEC registration would be required to do this unless all corporate plans including all their participants reside in one state. The reason for this result is that the intrastate exemption requires all securities in the issue to meet the intrastate requirement.

When Congress created individual retirement accounts, it attempted to remove impediments to the collective investment of such accounts with Keogh plan assets and other 401 pension plan assets. The SEC, however, has taken the position that interests in collective trusts for IRAs are not exempt from the 1933 and 1934 Securities Acts and the trusts themselves are not exempt from the Investment Company Act. The reason for this is that the exemption provisions of these securities laws are couched in terms of trusts qualified under Section 401 of the Internal Revenue Code and IRA trusts qualify under Section 408. There is nothing in the legislative history as to why Congress utilized an entirely new section in authorizing an entirely new type account. It is sheer speculation to argue, as some do, it was to avoid the exemptive provisions of the securities laws. Nevertheless, the SEC has not allowed banks to invest IRAs collectively without registration and compliance with the 1940 Investment Company Act. As a consequence, banks do not invest IRA accounts in securities except for large rollover accounts where they can be managed economically on an individual basis.

The same problem exists under the securities laws where a smaller bank wishes to invest collectively assets it holds as trustee for personal trusts and assets it holds as trustee for pension trusts because it does not hold sufficient assets to establish two separate collective trusts. Presumably, the intrastate exemption would be available under the 1933 Act if all the accounts met the residency requirement or, maybe, even the exemptions for common trust funds and corporate pension trusts might be available. But according to the SEC such a collective trust could not find an exemption from the Investment Company Act because the pension trust exemption and the common trust fund exemption are found in different subsections of the Act and there is no intrastate exemption which might cover all the individual trusts. The common trust fund exemption alone is not available because the SEC holds that the trustee of a pension trust is not a trustee.

If the special master and prototype plan proposal is enacted without action being taken to deal with the securities laws, it appears that the same situation will exist as with IRA accounts. No current exemption from the three Federal securities laws would be available but collective investment would be essential to sponsoring such a plan. S.209 as introduced would have cured the problem for the special master plan trusts and further would have cured many of the other problems we have discussed relative to other types of pension plans.

It is long past time to straighten out the hodge-podge quilt work found in the application of our securities laws to collective investment of trusts. The securities laws, as construed by the SEC, contain exemptions under which personal trusts, corporate pension trusts and Keogh pension trusts can be collectively invested so long as assets from the different types of trusts are not combined in one fund. Thus smaller banks may often find that they are precluded from using a collective trust fund not because of a lack of an exemption for each type of trust they would like to invest collectively but because they do not have sufficient assets to establish a separate collective fund for each type of trusts--personal, corporate pension and Keogh.

We have argued here in detail the current securities law problems of collective investment of employee retirement plans and the need for legislative change because if banks are going to be able to actively participate under the special master and prototype plan program a change in the application of the securities law is essential.

As mentioned before, S.209, as did its predecessor, originally contained language which would have cured the securities law problem for banks offering special master and prototype plans. As introduced the bill would have provided that interest in collective trust funds for employee benefit plans are not securities for purposes of the registration and reporting requirements of the 1933 Securities Act and the 1943 Exchange Act and that the collective funds themselves are not investment companies under the 1940 Investment Company Act. After having provided for the removal of this unnecessary duplicative regulatory burden S.209 unlike S.3017 went on to provide for additional duplicative regulations by the Department of Labor not only for collective trust for employee benefit plans but for all trusts for these plans. The bill mandated the Secretary of Labor to issue within 12 months regulations for single and collective retirement trusts governing disclosure of material information, advertising and any other matter found necessary by the Secretary to protect plan participants and beneficiaries.

The Senate and Labor Human Resources Committee apparently felt unable to remove one set of regulations without imposing an alternative set of regulations because in its markup session when it deleted the Labor Department new regulatory authority over pension trusts maintained by banks it also deleted the provisions which would have taken collective trusts for pensions out from under the registration and reporting provisions of the securities laws and the regulatory provisions of the Investment Company Act.

We urge the Finance Committee to consider carefully the need to restore the provision of S.209 which removes the duplicative regulatory burden of the securities laws on collective trusts maintained by banks. In maintaining these trusts banks carry the full obligations and duties of trustees subject to the fiduciary standards of ERISA and federal and state banking law and regulation. Full disclosure of these trusts is required on a continuing basis and their operation is subject to periodic examination by Federal and state bank examiners who, according to the Comptroller of the Currency's examination manual, have a duty to protect trust beneficiaries as well as bank depositors. Despite the lack of SEC registration and regulation we know of no pension plan participant or sponsor who has come forward to complain to Congress or the Labor Department of injury or harm due to the failure of a bank trustee to disclose information or a bank's advertisement of trust services.

The complete removal of bank collective trusts from the regulation and reporting requirement of the 1933 and 1934 securities laws and the 1940 Investment Company Act will in no way jeopardize the protection of plan participants and beneficiaries.

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Finally, if maximum participation in the special master plan program is to be achieved among banks, they will need the ability to collectively invest in one fund all types of pension trusts, corporate, Keogh, IRA and special master plan, without the unneeded counterproductive burden of SEC registration. Thus, we urge the Committee to include in the exemption language not only employer and union sponsored IRAs but all IRAs.

Daniel Issue

In another, but related area of securities law application to pension plans, S.209 and the Senate Labor and Human Resources Committee took the same approach but rather than deleting the two provisions in markup the Committee kept both. S.209 provides that the interest of an employee benefit plan is not a security for the purposes of the antifraud provisions of the 1933 and 1934 Securities Acts and then the bill establishes its own new misrepresentation prohibition. We are troubled by the lack of certainty of this new standard. We are not before the Committee to defend misrepresentation, on the contrary we abhor the idea that any person in a position of responsibility might deliberatedly mislead an employee, participant, or beneficiary as to any right or interest he might have in a plan. We believe, however, that the existing provisions of ERISA currently prohibit bank fiduciaries from misrepresenting matters within their purview to employees, participants, and beneficiaries, plan sponsors, other fiduciaries, the plan administrators and the government. As we read this new section we must assume that the intention of S.209 is that persons other than fiduciaries would be subject to its requirement and possibly some new group not now protected by ERISA would come within the scope of its protections. Our concern goes to the lack of specificity in identifying those subject to the bar and those to be protected as well as the standard itself. We do not believe that the language in section 154 adding a new ERISA section 515 solves this problem. The breadth and vagueness of the provision, we fear, will lead to uncertainty and confusion until its meaning is developed through the years of case law. This confusion would be contrary to the goal of S.209.

Other Provisions in ERISA Needing Review

We continue to be concerned about the definition of "fiduciary" in Section 3(21) of ERISA. Fiduciary is defined in such broad terms that the definition could even include individual employees of a corporate trustee. Every corporation must act through individuals but these individuals do not act in their own right or on their own behalf. We urge the Congress to add the following language to the Section 3(21) definition of fiduciary: "(C) If a corporation or an employee organization is a fiduciary with respect to a plan, under subparagraph (A), a director or employee of such corporation or employee organization when acting in such capacity, shall not be a fiduciary with respect to such plan."

We are also concerned about the ambiguous language of Section 405(b) on the liability created for actions of co-fiduciaries. Section 405(b)(1)(A) requires a trustee "to use reasonable care to prevent a co-trustee from committing a breach." Traditionally, co-trustees exist only when the instrument creating the trust grants more than one trustee authority to act in concert over the same assets. A distinct situation exists where each of several trustees is given responsibilities over a different portfolio of assets, and in this situation these trustees have not been considered co-trustees under trust law. We feel Section 405 should be amended to more accurately assign liabilities, and the co-trustee liability of Section 405 should apply only where trustees are acting in concert over the same trust assets. We feel the language in S.209 proposing a new Section 405(e) needs to be rewritten. We support the aspect of the proposal that indicates in the case of an insitutional fiduciary, the term "knowledge" means knowledge actually communicated to the fiduciary's officer or employee who is authorized to carry out or who in fact carries out the fiduciary's responsibilities. However, we are concerned about the language regarding knowledge "which, in the normal course of business, should have been communicated." We feel this language should be deleted because it creates an impractical, confusing standard. If the co-fiduciary is going to be held liable for a breach under Section 405(a)(3), liability should be based on its actual knowledge of a breach. Without actual knowledge there is no way the institutional fiduciary can undertake reasonable efforts under the circumstances to remedy the breach as called for in Section 405(a)(3).

Section 6 of S.1089 would give the Secretary of the Treasury the same authority to bring a civil action to enforce minimum ERISA standards as the Secretary of Labor has under the current law. We agree the Service's power to disqualify plans is not always the most effective and fair means to enforce compliance because innocent plan participants and beneficiaries may suffer. However, we do question if the Service needs this authority since the civil enforcement authority vested in the Department of Labor would appear to be sufficient. If the Secretary of Treasury is granted this authority, the statute should make clear that similar facts and circumstances cannot result both in civil damages or a civil fine and an excise tax being imposed. Also, the law should provide that if the Secretary pursues compliance through civil remedies he cannot disqualify the plan.

We oppose Section 127 of S.209 on joint and survivor annuities. This section would require a plan with respect to a participant who under the plan is credited with at least 10 years of service for vesting purposes and who dies before the annuity starting date to provide a survivor's annuity for the participant's spouse to begin on the annuity starting date. We oppose this proposal based on its potential costs and the existence of more appropriate alternatives, such as group life insurance, to fill the financial needs of all classes of surviving dependents.

Section 152 of S.209 requires the Secretary of Labor to conduct a study on the impact of inflation on retirement benefits and the feasibility and ramifications of requiring employee benefit plans to provide cost-of-living adjustments in benefits paid. We believe the Secretary should study not only the impact of inflation on retirement benefits, but also its impact on the plans themselves, the plan trustees, and the employer's ability to fund retirement plans. The impact of inflation on all aspects of plan operation must be looked at in order to formulate any recommendation.

The subcommittee had intended to conclude these hearings at this hour.

However, we have other witnesses still to be heard. So, I would like now to call upon the next witness, Ms. Iris Mitgang of the National Women's Political Caucus.

STATEMENT OF IRIS MITGANG, NATIONAL WOMEN'S POLITICAL CAUCUS

Ms. MITGANG. Thank you, Senator.

I am here representing the Women's Political Caucus, a 45,000 member organization across the country.

As an individual, I practice law in the State of California, which is a community property State, which recognizes pensions as property under existing domestic law.

In conjunction with ERISA, and a variety of provisions related thereto, there have been some direct conflicts in dealing with the distribution of pensions to spouses, both divorced and widowed. I draw your particular attention to the problems of the nonassignment clause and preemption clause.

Because the area of domestic relations is changing as part of the reflections of the changes in men's and women's roles in our society across the country, two provisions that, although they are not community property provisions per se, they recognize the concept of equal division of property, I believe that in more and more States the concept of pensions as property will be recognized. As we have made those gains for women, I am hoping that as the Federal law is changing, it changes in a direction that allows that concept to be enforceable and recognized.

The antiasssignment provisions of ERISA do not allow the courts to retain jurisdiction to enforce court orders which recognize private pensions as property in those situations where there are concerns in terms of both distribution and of valuing those pensions as a lump sum as an award to one spouse or the other.

For a woman to have lived her life in the traditional mold as a homemaker and mother, who often has no income earnings or benefits of her own, because there has been extended litigation on that issue, it would be unfortunate if Federal law precluded the ability of that kind of distribution, and when the distribution is made, the actual enforcement of those judgments.

There are all kinds of ways to simplify, I think, under ERISA to allow the distribution of pensions, and to, in fact, recognize the concept of equal ownership of earnings and, therefore, the contributions to pension plans.

I believe ERISA allows anticipation. There is no antianticipation clause.

I have with me, which might be useful for the committee, a chart under the community property laws in California, of each of a variety of pension benefit plans, and how they are affected by a variety of Federal laws. We use them in our day-to-day work in California, because the area has become so technical and so complicated for a benefit that should be so simple, and a concept that should be so simple. It concerns me that the area has become so technical, instead of less.

I am concerned also, and support the expansion of the law in regard to the place of women in the work force. The concerns of provisions in regard to vesting, the concerns of provisions in regard to portability, the concerns related to those women who enter the work force for a limited time, remove themselves from the work force to take on the traditional roles of wife and mother, and their pension benefits, therefore, become interrupted.

The fastest growing group of poor Americans in our society is women 65 and older. The median income for men 65 and older is $5,526 per year, and for women over 65, it is $3,008, for minority women over 65, it is $2,413. Although the sum for males over 65 is not one any of us in this room believe we could live on, the fact that the sum for women is not even half, or less than half of that amount is shocking, to say the least.

The expansion of benefits under ERISA is important for women. We support the provisions and hope that the committee will address the technical aspects of making the law enforceable as well as the expansion of benefits for all.

Thank you.

Senator MATSUNAGA. Thank you very much. We appreciate your testimony, Ms. Mitgang.

[The prepared statement of Ms. Mitgang follows:]

STATEMENT OF IRIS F. MITGANG, CHAIR, NATIONAL WOMEN'S POLITICAL CAUCUS

Mr. Chairman and members of the Committee, my name is Iris F. Mitgang. I chair the National Women's Political Caucus, a nationwide, multi-partisan organization with 45,000 members and 300 state and local chapters across the country. The major goal of the Caucus is to obtain equal representation for women in elective and appointive office and central to reaching that objective is the achievement of economic justice.

The Caucus is very pleased to testify in regard to S. 209, the ERISA Improvements Act of 1979. The committee has previously heard extensive evidence, in our testimony of February 7, 1979, on the economic inequities suffered by American women and in particular the special hardships faced by older women, the importance of pensions, and ERISA in particular in alleviating the poverty these women face. I am here as an organizational leader and as a technical expert on pensions. I practice law before the California courts and teach a course in community property and California family law. I hope I can help therefore to clarify the impact of ERISA on women, particularly those women who are widowed and divorced.

The fastest growing group of poor Americans is women 65 and older. The median income for men 65 and older is $5,526, while the median income for women 65 and older is $3,008, and for minority women it is only $2,413. There are 961,000 or 10.5 percent of men 65 and over who live below the poverty line, but there are 2,216,000 women or 16.5 percent of women 65 and over living in poverty and 41.2 percent or 457,000 minority women 65 and older who live in poverty.

The provisions in the ERISA Amendments which afford protection for former spouses and early widows are commendable but I must express NWPC's disappointment in this bill's failure to address the very fundamental problems that working women face in obtaining pension benefits. Whereas ERISA has made some modest improvements for women, the Act does not begin to offer pension protection for a majority of working women because of their employment patterns. Look at these facts: only 21 percent of the women in the private labor force are covered by pensions and only 10 percent of female retired workers receive a private pension. Their annual pension averages $950, which is less than half of the average $2,080 received by retired men.

This committee has acknowledged the virtual exclusion of many women from the benefits of pension programs. In essence, this is because private pension plans are structured on the assumption of a continuous worker, in the same job for the whole of his (her) adult life. Women's work patterns frequently do not conform to this model. Even with the influx of women into the paid labor force women are still clustered in sales and service jobs which don't traditionally offer pension plans. Women are more likely than men to take time out for child rearing, to change jobs if their spouse is transferred, and to work part-time or part year because they still bear the major responsibility for their families.

The minimum standards required by ERISA are simply inconsistent with varied patterns of women workers and hence women are denied pension benefits: because they often work for periods too short for their pensions to vest.

Half of all women have been on their present job only 2.8 years (as contrasted with 4.6 for men). The median figures for full-time women workers covered by private pension plans are somewhat better 6.8 (as contrasted by 9.2 for men) but still not long enough to vest under the typical pension that gives pensions only to those who work 10 years:

Because they may take time away from work to raise families. Even if they stay on the job 10 years they are likely to find that break-in-service rules combined with rules denying them credit for years worked before age 22 make it almost impossible to vest in their pension plan.

Because they change jobs and the absence of any portability requirements force them to forfeit pension credits they may have built up.

Though the Amendments to ERISA that the committee is considering today do not deal with these issues of critical importance to working women, I would like to urge that the committee give priority to major reforms of the vesting and portability standards to enable a majority of female retirees to draw benefits from private pension plans.

I will now comment on the provisions in S. 209 which provide long overdue protection for widows and ex-spouses of covered workers. As this committee recognized in its consideration of the Displaced Homemakers legislation enacted last year, protection for these women is especially important because death or divorce is a time of extreme vulnerability in their lives. They are suddenly on their own, often after many years of financial dependence; and without recent job experience or current job skills, they are in dire economic straights.

NWPC therefore fully supports section 127 of this bill which offers pension rights protection to widows whose spouses are vested, but die before the minimum retirement age anticipated by the plan. Under current law, if a vested worker dies "prematurely," his widow is not entitled to any of the pension benefits which he and his spouse earned and anticipated. The Caucus believes it is absolutely necessary to close this loophole, which has a devastating effect on widows, currently precluded from collecting fully earned benefits because their spouse died before an arbitrarily fixed date.

We are concerned however, that this section does not go far enough. If a pension plan participant elects protection for a surviving spouse in the event of a pre-retirement death, she must accept a reduced benefit. NWPC believes that this is unfair, because the labor performed in earning the pension is the same regardless of whether the worker dies before or after the "standard" retirement age. Vesting should be irrelevant to these concerns.

Furthermore, while the Act requires an affirmative action for the survivor not to receive a pension, the election is made alone by the plan participant—in all likelihood without the spouse's awareness of the existence of the option. The Caucus recommends therefore, that this section be amended to require that the affected spouse be required to sign in writing, any waiver of this option or that the election to eliminate survivor's benefits be found against the law.

Finally, the Caucus endorses sections 128 and 155 which clarify that ERISA does not forbid divorced women from receiving a portion of their ex-spouse's pension benefits in a property settlement following the dissolution of a marriage. These sections recognize that a pension is often the only substantial asset of a marriage and re-inforce a State court's ability to award a portion of the pension benefits to an ex-spouse. While NWPC recognizes the differences between the Railroad Retirement Act and ERISA, I must report to you that women across the country were outraged by the Supreme Court decision in the Hisquierdo case denying a divorced woman a portion of her ex-spouse's pension which had been awarded her a part of a community property settlement. Such divisions have long been recognized under California law. The law of California recognizes marriage as an economic partnership. Earnings and the fruits of labor are owned equally by the marital partners. And although such laws are on the books only in the eleven western community property States, the law elsewhere is rapidly changing regarding community property and the concept of equalized property has been enacted in Maryland, Wisconsin, Kentucky and is pending in other States.

We are pleased that ERISA has been clarified to insure that the injustice under Hisquierdo is forbidden under private pension plans but to make the law work we have additional concerns.

One concern is that there be no anti-assignment clause in ERISA in order that the judgments regarding proportional or other division of pensions be in fact enforceable under State law (often a wife is regarded as a creditor instead of an equal owner where this occurs).

Another concern is that there be no anti-anticipation clause in the law, i.e., in the case of divorce where other property is not divisible or incapable of sale. It is important to be able to award and ascertain a lump sum value regarding a pension in order to equalize in fact the awards of property to each spouse.

The area is complicated and the answers incomplete but I thank you, Mr. Chairman for the opportunity to address these issues before your committee today.

Senator MATSUNAGA. Next we have a panel of two witnesses, Mr. Jeffrey R. Gates, a lawyer with Hewitt Associates; and Mr. Cecil A. Ray, a lawyer with Hughes & Hill.

STATEMENT OF JEFFERY GATES, ESQ., HEWITT ASSOCIATES

Mr. GATES. Thank you, Senator Matsunaga.

My name is Jeff Gates, and I am here representing Hewitt Associates, a consulting firm from outside Chicago. I am addressing issues in S. 1240.

You are, I am sure, very much familiar with past congressional support for employee stockownership, particularly among members of the Finance Committee. S. 1240 has additional provisions that make employee stockownership more attractive, and also provisions that would solve certain existing problems for employee stockownership plans.

Due to the lateness of the hour, I thought that I would hit some of the major issues, and ask that the statement be submitted for the record.

Senator MATSUNAGA. Without objection, it is so ordered.

Mr. GATES. The first major provision is the provision permitting the tax credit incentive to become a permanent part of the Internal Revenue Code.

In 1975, when the initial provision was introduced, it was available for 2 years. In 1976, it was extended through 1980, and recently the 1978 act extended it through 1983. The congressional uncertainty that this approach applies has been detrimental to the adoption of ESOP's and to their prevalence.

In the past 3 years, our firm has surveyed the Fortune industrial thousand, and the 300 largest nonindustrial firms to determine the prevalence of tax credit ESOP's and common plan characteristics.

By way of introduction, let me move to the next section, that being the major provision, really, of the bill which would be to permit companies to take a tax credit based on 1 percent of payroll as alternative to the current provision permitted 1 percent of investment credit.

I think that if you will turn with me for a moment to page 11 of this buff covered testimony, you will see a chart indicating nothing really surprising, simply that the investment credit version of the ESOP is most attractive to firms who have a large amount of investment credit.

It has been challenged on the floor of the Senate by a number of people whether that is a particularly equitable approach. A large number of companies, the labor intensive firms can get no advantage from this provision due to the small amount of investment expenditures they make during the year. This provision would correct that by providing an alternative payroll based credit for labor intensive companies.

The third major provision is one allowing companies to deduct as a section 404 expense the amount of dividends paid out on a current basis to employees in employee stockownership plans. The intent of this comes from the idea of trying to make stockownership comprehensible, trying to make it a motivational factor, trying to get employees to appreciate stockownership, and begin to think and act as owners.

I guess the thing that comes most readily to mind for me is a quote from the Moliere saying that perhaps the best type of appreciation is the one that you can stick in your pocket, and this is really meant to make employee stockownership a visible, tangible benefit.

The fourth major provision would enable an employee stockownership plan to be treated as a charitable organization for income, State and gift tax purposes. Again, the philosophy being that currently affluent shareholders can either leave their estate to their relatives and friends, and end up with Uncle Sam taking the bulk of it, or they can put it in a public purpose foundation. This provision would enable them to leave their wealth to their employees, who helped them to create their wealth, and it also has the double advantage of keeping that wealth within the tax system.

The next provision would allow a tax-free distribution to any employee who has been in a plan for 3 years, a tax-credit ESOP, the first tax credit would be received tax free and taxed when sold. Again, the rationale being that if one of the objectives of these types of plans is to broaden stockownership in the population at large, does it make good tax sense, once that objective is attained, to turn around and require an employee to sell part of the stock in order to pay a tax on it.

Also, S. 1240 would permit an employee to set up an IRA, an individual retirement account, even though he participates in a tax credit employee stock ownership plan, provided he is not participating in any other employer sponsored plans.

The last provision of the bill would permit a three-way tradeoff in what are currently known as flexible benefit programs, also known as cafeteria plans. It seems to have been a conceptual inconsistency in the Internal Revenue Act of 1978, and this would clarify that particular provision.

There are several other provisions that I could touch on, but due to the lateness of the hour, Senator, I will leave those for your perusal.

That completes my testimony.

Senator MATSUNAGA. I take it that you support S.1240?

Mr. GATES. Yes, Senator, I do.

STATEMENT OF CECIL A. RAY, ESQ., HUGHES & HILL

Mr. RAY. Mr. Chairman, my name is Cecil Ray, and I am an attorney in private practice in Dallas. I have prepared a detailed written statement, which I would like to have printed in the record in full, so I will not read that.

Senator MATSUNAGA. Without objection, it is so ordered.

Mr. RAY. I am appearing in support of section 17 of Senate bill 1240, which would amend 404 of the Internal Revenue Code, and permit a deduction of up to 25 percent of compensation of the employees covered by a profit-sharing plan, and a stockownership plans, when one employer makes a contribution to both plans.

The need for this amendment results from the Internal Revenue Service adopting a ruling position which impedes the establishment of employee stockownership plans, such as those of the stock bonus type. Such a position, I believe, is contrary to the congressional policy of encouraging stock ownership by employees, and it is contrary to the provisions of the code.

Thirty-seven years ago, the Congress set the rules for deductions of employee benefit plans in the Revenue Act of 1942. The rules remained in effect largely unchanged until ERISA was passed in 1974, when they changed some deductions by imposing minimum standards on funding for pension plans.

The Revenue Act of 1942 recognized the difference between pension and annuity plans on the one hand, and profit-sharing and stock bonus plans on the other. Therefore, a deduction of up to 15 percent of compensation was provided for an employer with either a profit-sharing plan or a stock bonus plan.

It also provided that where an employer had two profit-sharing plans, or more, they were treated as one for purposes of the 50 percent limit, and likewise if you had two or more stock bonus plans, they also were aggregated and you were limited to 15 percent of compensation.

The code provision, section 404(e)(3)(A), did not attempt to aggregate a single profit-sharing plan with a single stock bonus plan established by the same employer in order to limit the deductions to 15 percent of covered compensation. The statutory language, as I have spelled out in detail in my written statement, speaks of two or more stock bonus or profit-sharing plans. The use of the word "or" indicated a choice of the kind of trusts that were available to taxpayers. The word "or" is not a conjunctive requiring a combination of the types of trusts for imputing these limits.

In 1956, the Treasury issued its regulations under this act, the last regulations, and it did not require an aggregation of profit-sharing plans and stock bonus plans. The same document, however, did require an aggregation of annuity plans, and the language used was different and should be given different effects.

Another part of the Revenue Act of 1942 required that plans of different kinds, which is profit-sharing and annuity plans, or pension plans, stock bonus or annuity plans or pension plans, those plans would be combined, and you would have a 25 percent deductible limit, rather than 15 percent.

With the law in this posture now, the Revenue Service issued a private ruling in January 1979, which held an employer must treat his profit-sharing plan, and his proposed ESOP of the stock bonus type as one plan, and therefore be limited to a deduction of 15 percent.

The employer in the case in question could not do that because he was already setting aside 15 percent of compensation for his employees because his profits were great, due in part, he had contended, to the motivation caused by the profit-sharing plan.

The Revenue Service gave us no citation of authority for, as I think I have demonstrated, there is none, unless the Congress in 1942 used the word "or," when they intended to use the word "and," otherwise there would be no way to come up with this result.

The question probably never arose before ERISA because the Congress in 1974 and 1976, and in 1978, gave impetus to encourage stockownership by employees. The policy seems to be an important one to me because this country in the seventies faced the need of capital formation and stockownership plans was one way to enhance that policy.

The private ruling, I think, has a chilling effect on new employee stock ownership plans, where companies have resorted to profit-sharing plans in the past in order to give their employees an incentive to work harder and produce more. I think that this is inconsistent with congressional policy, as I read it, and section 17 of Senate bill 1240 will continue this long-standing policy by permitting a deduction of 25 percent of compensation where an employer has both a profit-sharing plan and wants to put in a new ESOP.

I don't understand the revenue impact that I saw this morning, because it shows that this would be a $20 million item, I think, in revenue, but this can be accomplished by an employer setting up a money purchase plan and an ESOP, and it can be done under present law. Indeed, I think the present law permits the result we are asking for, but the consequences and difficulty of litigating this type of question for a qualified plan is not something that you look forward to with great relish.

Thank you for letting us appear today, Senator.

Senator MATSUNAGA. Thank you very much, Mr. Gates and Mr. Ray.

Should the subcommittee have questions, we will submit them to you in writing. Your full statement will appear in the record.

[The prepared statements of Messrs, Gates and Ray follow:]

Statement of Jeffery R. Gates
HEWITT ASSOCIATES
before
The Senate Finance Subcommittee on
Private Pension Plans and Employee
Fringe Benefits
regarding S.1240
"The Employee Stock Ownership
Improvements Act of 1978"
December 5, 1979

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SUMMARY OF PRINCIPAL POINTS

Need for Additional ESOP Legislation

- Past Congressional support for employee stock ownership concept, particularly in Committee on Finance.
- New legislation (S.1240) needed to provide new incentives for ESOP adoption.
- Additional ESOP legislation will solve certain existing problems for ESOPs.

The Employee Stock Ownership Improvements Act of 1974

- Permanence of tax credit would encourage adoption of ESOPs by demonstrating firm Congressional support.
- New payroll-based tax credit would encourage employee stock ownership in companies where investment tax credit is not significant.
- Dividend deduction provision will allow immediate tangible benefits of stock ownership to pass to employees.
- Charitable deduction provision allows wealthy shareholder to transfer stock to employees rather than to private tax-exempt foundation. Also retains such wealth in the tax system.
- The tax-free distribution of small amounts would promote the Congressional objective of broadening stock ownership.
- The tax credit provided for small businesses to establish an ESOP would help to overcome a principal disincentive to the adoption of such plans.
- The pass-through voting requirement for all defined contribution plans seems inappropriate. Pass-through voting for ESOPs is more appropriately limited to publicly-traded corporations. The expense and burden of proxy solicitation by closely-held corporations poses a major impediment to ESOP adoption.
- Permitting a deduction for the matching feature of the tax credit ESOP eases the administrative burden and encourages participation.
- Permitting a participant in a tax credit employee stock ownership plan to also establish an Individual Retirement Account (IRA) would provide an additional incentive to adopt such plans.

- By raising the tax deductible limitation for any combination of defined contribution plans, employers would be provided an additional incentive to acquire company stock on behalf of their employees.

- The ability to provide a three-way trade-off in a flexible benefits program will correct a conceptual inconsistency of existing law and will provide another means by which employees can acquire employer stock.

- Other changes proposed by S.1240 would solve certain problems under existing law.

SUMMARY OF S.1240

S.1240 would amend the Internal Revenue Code of 1954 as follows:

- Permanence of Tax Credit

  The original tax incentive for tax credit employee stock ownership plans (as provided in the Tax Reduction Act of 1975) was available for only two years. The Tax Reform Act of 1976 extended the availability of the additional investment tax credit through 1980. At present, the additional credit expires December 31, 1983. The Congressional uncertainty that this approach implies has inhibited the growth of employee stock ownership plans. By making the tax credit a permanent feature of the Code, S.1240 would encourage the adoption of employee stock ownership plans.

- Alternative 1% Payroll Credit

  As an alternative to the additional one percent (1%) investment tax credit for employee stock ownership plans, S.1240 would permit an employer to claim a tax credit of not more than one percent of the annual compensation of plan participants.

  At present, the tax credit employee stock ownership plan is adopted primarily by large, capital-intensive corporations (see Appendix). Labor-intensive companies do not invest enough in capital equipment to make a tax credit employee stock ownership worthwhile; the benefit per employee is simply too small. S.1240 would correct this discrimination against labor-intensive companies by granting a company the option of claiming either the one percent (1%) employee stock ownership plan investment tax credit (plus the optional extra one-half percent (1/2%) matching feature) or an employee stock ownership plan tax credit of up to one percent (1%) of the payroll of employees participating in the plan.

- Deduction for Dividends Paid

  An employer would be allowed a deduction under Code Section 404 for the amount of any dividends paid to participants on their stock in the plan, provided such dividends are distributed on a current basis.

  This provision permits a corporation to pay, and its employees to realize, an ownership income. Such a second source of income is intended to foster a sense of commitment and motivation on behalf of a company's employee-owners. It is hoped that by encouraging employers to pay such an ownership income, employees will begin to feel more a part of the nation's private property system and will begin to think and act as owners.

- <u>Certain Transfers Treated as Charitable Deductions</u>

An employee stock ownership plan could provide that the plan be treated as a charitable organization for income, estate and gift tax purposes, provided any contribution, bequest or similar transfer of employer securities is made pursuant to plan provisions, allocations are made in a nondiscriminatory manner, and no allocation of such amounts is made to any related persons or to any shareholder owning more than 25% of the value of any class of outstanding securities.

This provision is intended to encourage affluent taxpayers to make gifts and/or bequests to employee stock ownership plans. It is hoped that such donations will provide a tax-favored means to reconnect the ownership of capital with a broader base of private individuals, most of whom would be the employees who contributed to the building of the donor's wealth.

In addition, this provision is intended to provide an incentive to keep such capital assets within the nation's tax system. Under present law, contributions to charitable organizations are exempt from taxation. Thus, assets left to such an organization are lost to our system of taxation. By encouraging an individual to leave his property to an employee stock ownership plan, these assets would remain within the tax system and would be taxable to employees upon distribution from the plan.

- <u>Small Distributions Received Tax Free</u>

The first $5,000 of any lump-sum distribution from a tax credit employee stock ownership plan would be exempt from taxation on distribution, provided the distributee has been a participant in the plan for at least three calendar years prior to the date of distribution. A primary objective of employee stock ownership plans is to provide an opportunity for personal capital accumulation. The rationale for this provision stems from the idea that once this objective has been attained, the Code should not then, in effect, require that a portion of this capital be sold to pay taxes due on the distribution.

- <u>Credit for Establishment of Employee Stock Ownership Plans by Small Employers</u>

  Due to the complexity of leveraged employee stock ownership plans, S.1240 would provide a tax credit to offset up to $5,000 of the cost of establishing such a plan by an employer which has less than 100 employees.

- <u>Voting Rights in Defined Contribution Plans</u>

  Code Section 401(a)(22) (added by the Revenue Act of 1978) would (after December 31, 1979) provide for the pass through to plan participants of voting rights in certain situations on closely-held employer stock held in profit sharing plans, stock bonus plans, money purchase pension plans, and employee stock ownership plans. S.1240 would delete this section.

  The intent of this provision of S.1240 is to encourage the adoption of employee stock ownership plans. If this provision is not deleted, corporations with such plans will be required to provide pass-through voting with respect to corporate matters which (by law or charter) must be decided by more than a majority vote of outstanding common shares voted. The expense and burden of proxy solicitation poses a major impediment to ESOP adoption. Retention of this provision will inhibit the adoption of employee stock ownership plans and some of those now in effect may be terminated.

- <u>Use of Nonvoting Stock</u>

  Under present law, if an employer with an employee stock ownership plan has a registration class of securities, pass-through voting is required on allocated shares. For other employers, pass-through voting on allocated shares is limited to corporate matters which (by law or charter) must be decided by more than a majority of outstanding common shares voted. S.1240 would permit the acquisition of non-voting stock, provided the plan acquires such stock from a shareholder(s) who has held such stock for at least 24 months. In many corporations (both publicly traded and closely-held), there is outstanding stock of a nonvoting type. This provision would enable an employee stock ownership plan to acquire such stock.

- <u>Matching Employee Contributions</u>

  Current law permits an employer to claim up to an extra additional one-half percent (0.5%) investment credit, provided employees contribute a matching amount of cash to the plan. Due to the complex and

56-943 O - 80 - pt.2 - 10

costly requirements relative to the contributory feature, and due to the timing difficulties accompanying funding with the investment tax credit, employers have been hesitant to adopt the matching element as part of a tax credit employee stock ownership plan. S.1240 would permit an employer to make the matching contribution on behalf of plan participants. The employer would be eligible for a deduction under Code section 404 for amounts so contributed without regard to the limitations of Code section 404(a).

- <u>IRA Eligibility</u>

  At present, an employee participating in a qualified plan may not establish an Individual Retirement Account (IRA). The average annual benefit to an employee under a tax credit employee stock ownership plan is generally considerably less than the amount which the employee could put into an IRA. The effect is to provide a disincentive to the establishment of and the participation in tax credit employee stock ownership plans. S.1240 would permit employees who are participating in a tax credit employee stock ownership plan but who are not participating in any other qualified plan to establish and contribute to an IRA.

- <u>Tax Deduction Limitations for Combined Plans</u>

  Under existing law, an employer is eligible for a deduction under Code Section 404 for amounts contributed to a defined contribution plan (i.e., a profit sharing plan, a stock bonus plan, an employee stock ownership plan or a money purchase pension plan). The amount that may be deducted in any taxable year is generally limited to 15% of the compensation of plan participants. When a money purchase pension plan is combined with any other defined contribution plan, however, Code Section 404(a)(7) provides that this tax deductible limitation shall not exceed 25%. S.1240 would apply the tax deductible limitation of Code Section 404(a)(7) to any combination of two different defined contribution plans. This would provide an additional incentive for employers to acquire company stock on behalf of their employees.

- <u>3-Way Trade-Off in Flexible Benefits</u>

  The Revenue Act of 1978 enabled a company to offer its employees greater personal flexibility in the design of their own employer-provided benefits. Existing law permits an employee to choose between cash and welfare benefits under Code Section 125(d) or between cash and deferred profit sharing under Code Section 401(k). An employer with such a flexible benefits program currently may not, however, offer employees a choice of cash, welfare benefits or deferred profit sharing. S.1240 would correct this conceptual inconsistency by allowing for a three-way trade-off under a flexible benefits program. For employers who choose to do so, this provides another means by which employees can acquire stock in the company for which they work.

- <u>Cash Distribution Option and Put Option for Stock Bonus Plans</u>

S.1240 would extend to stock bonus plans the cash distribution option and put option provisions currently applicable only to employee stock ownership plans. The cash distribution provision would correct what currently appears to be an artificial distinction between stock bonus plans and employee stock ownership plans. The requirement for a put option will provide protection for plan participants by insuring that a market is provided for stock received in a distribution from a stock bonus plan.

- <u>Limitations on Stock Distribution</u>

A participant entitled to a distribution from an employee stock ownership plan currently has a right to demand that his benefit be distributed in the form of employer securities. In certain situations (e.g., independent newspapers), stock ownership is limited (by corporate charter or by-laws) to those actually employed by the company. For such companies, employee stock ownership plans are not presently attractive. S.1240 would permit such a company to require any former employee to resell any employer securities to the company at fair market value upon termination of service with the employer.

- <u>Availability of Additional Tax Credit Percentage</u>

Under present law, a public utility is denied the additional tax credit if a State regulatory agency requires the credit to be treated for ratemaking purposes in any way other than as though the amount had been contributed by common shareholders. Where, for example, a State regulatory agency requires the additional investment tax credit to be passed-through as a reduction in the taxpayer's cost of service for ratemaking purposes, this requirement operates as a deterrent to the establishment of tax credit employee stock ownership plans because a utility is, in effect, thereby required to pay out the tax credit twice -

once as a contribution to the plan and then again as a rate reduction to consumers. The intent of S.1240 is to permit the tax credit regardless of how a regulatory agency requires the additional credit to be treated.

- <u>Special Limitation for Employee Stock Ownership Plans</u>

  Code Section 415(c)(6) presently provides a special higher dollar limitation on the amount of contributed stock which may be allocated to participants in employee stock ownership plans. This same limitation arguably does not apply to cash which is contributed to these plans and used to acquire stock. Because the result should be the same in either situation, S.1240 clarifies that the special higher dollar limitation shall apply in either case.

- <u>Valuation of Securities in Tax Credit Employee Stock Ownership Plans</u>

  Existing law requires that publicly traded employer securities contributed to the plan must be valued over the 20 consecutive trading days immediately preceding the employer's due date for filing its income tax return for the taxable year. Because employers make contributions at other times during the year, this provision seems to be unnecessarily restrictive. S.1240 provides that the 20-day averaging period shall be the time preceding the actual contribution of employer securities to the plan.

- <u>Extraordinary Forfeiture Allocations</u>

  An employer utilizing a leveraged employee stock ownership plan is generally committed to making annual contributions to enable the plan to repay the leveraged amount. It is possible that extraordinary forfeitures from unanticipated employee turnover may, when combined with employer contributions to the plan, cause the limitations of Code Section 415 to be exceeded. In determining the limitations of Section 415, S.1240 provides that an employer need not take into account the amounts attributable to such extraordinary forfeitures (as defined by the Secretary).

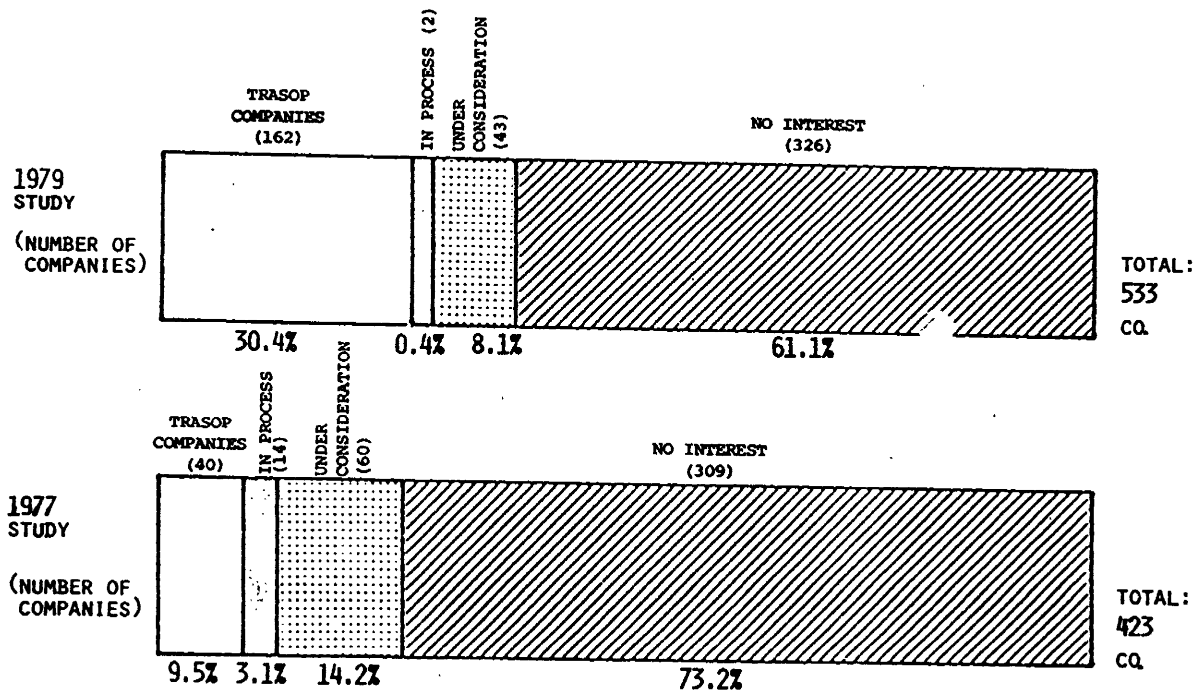
- <u>Individual Trustee</u>

  S.1240 would permit an individual to act as trustee of plan assets when a terminated Keogh plan is replaced by a qualified plan adopted by a proprietorship or partnership which incorporates. Current law requires that such assets be trusteed by a bank, resulting in an unnecessary expense.

- <u>ESOPs and Tax Credit ESOPs</u>

  Prior to the Revenue Act of 1978, leveraged employee stock ownership plans were known as "ESOPs" and employee stock ownership plans funded with the investment tax credit were known as TRASOPs (due to their origin in the Tax Reduction Act of 1975). The 1978 Act labeled ESOPs as "leveraged employee stock ownership plans" and TRASOPs as "ESOPs". S.1240 would return to the prior terminology, with leveraged employee stock ownership plans again being designated as "ESOPs" and with TRASOPs being known as "tax credit employee stock ownership plans."

I. TRASOP PREVALENCE IN FORTUNE-LISTED COMPANIES



II. TRASOP PREVALENCE BY INDUSTRY GROUP

TOTAL SURVEY PARTICIPANTS:

1979 - 533 COMPANIES

1977 - 423 COMPANIES

UTILITY INDUSTRY: 88.6% OF 35 COMPANIES IN 1979 SURVEY,
69.2% OF 26 COMPANIES IN 1977 SURVEY.

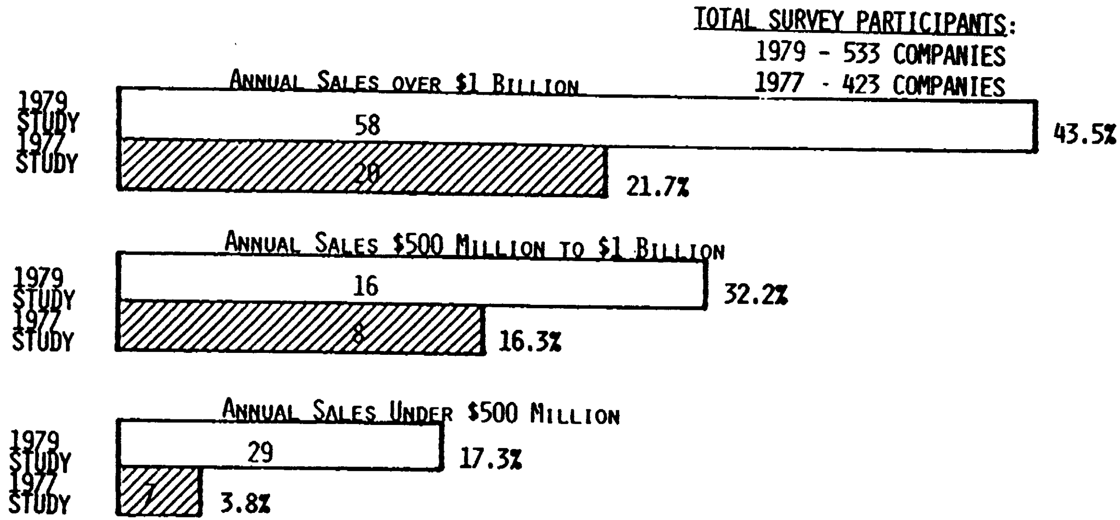
PETROLEUM REFINING: 85.7% OF 21 COMPANIES IN 1979 SURVEY,
41.6% OF 24 FUEL INDUSTRY COMPANIES IN 1977 SURVEY.

PAPER INDUSTRY: (PAPER, FIBER AND WOOD) 66.7% OF 24 COMPANIES IN 1979 SURVEY,
44.4% OF 9 COMPANIES IN PAPER INDUSTRY ONLY (1977 SURVEY).

IN 1979, RELATIVELY STRONG TRASOP CLUSTERINGS WERE ALSO FOUND IN THE FOLLOWING INDUSTRIES:

METAL MANUFACTURING:	45% OF 20 COMPANIES
TRANSPORTATION:	38% OF 25 COMPANIES
CHEMICALS:	35% OF 34 COMPANIES
FOOD PRODUCTS:	30% OF 30 COMPANIES
RETAIL:	25% OF 19 COMPANIES

III. TRASOP PREVALENCE BY COMPANY SIZE
(INDUSTRIAL COMPANIES ONLY)



IV. TRASOP CHARACTERISTICS

ELIGIBILITY/PARTICIPATION

MOST PLANS COVER ALL OR MOST EMPLOYEES MEETING AGE/SERVICE REQUIREMENTS.

- 40.9% OF PLANS COVER ALL OR MOST EMPLOYEES.
- 28.3% OF PLANS COVER ALL OR MOST SALARIED AND NON-UNION HOURLY EMPLOYEES.
- 30.8% OF PLANS COVER ALL OR MOST SALARIED EMPLOYEES.

SEVERAL PLANS EXCLUDE OFFICERS, DIRECTORS OR MEMBERS OF EXECUTIVE STOCK OR INCENTIVE PLANS.

COVERED COMPENSATION

THERE APPEARS TO BE A TREND TOWARD USING AN INDIVIDUAL EARNINGS CEILING OF LESS THAN THE FULL $100,000 PERMITTED FOR ALLOCATION PURPOSES.

- 31% OF PLANS IN THE 1979 STUDY USED A LOWER CEILING.
- 15% OF PLANS IN THE 1977 STUDY USED A LOWER CEILING.

BENEFIT AMOUNT

THE AVERAGE ANNUAL EMPLOYEE BENEFIT IS LESS THAN $200. OF THE COMPANIES RESPONDING TO THE 1979 STUDY:

- 55% EXPECT AN AVERAGE EMPLOYEE BENEFIT OF LESS THAN $200.
- 35% EXPECT AN AVERAGE EMPLOYEE BENEFIT OF $200 TO $500.
- 10% EXPECT AN AVERAGE EMPLOYEE BENEFIT OF MORE THAN $500.

IV. TRASOP CHARACTERISTICS (CONT'D)

MATCHING EMPLOYEE CONTRIBUTIONS

THE ADDITIONAL ½% TAX CREDIT FEATURED IS GRADUALLY BECOMING MORE PREVALENT.

- 33.1% OF PLANS IN THE 1979 STUDY INCLUDE THE MATCHING FEATURE (53 COMPANIES).
- 16.4% OF PLANS IN THE 1978 STUDY INCLUDE THE MATCHING FEATURE (23 COMPANIES).
- 2.5% OF PLANS IN THE 1977 STUDY INCLUDE THE MATCHING FEATURE (1 COMPANY).

SOURCE: HEWITT ASSOCIATES SURVEY OF TAX REDUCTION ACT ESOPs - 1979, 1978, 1977 (COPYRIGHT).

Additional Information

Provided below is additional information regarding the prevalence of TRASOPs and the important characteristics of plans that have been implemented:

Prevalence by Industry Grouping

Code: ( ) - Survey participants (total of 533 companies).
(A) - Company has implemented a TRASOP.
(B) - Company is in process of implementing.
(C) - Company is considering implementing.
(D) - Company is not considering implementing.

	A	B	C	D
Survey Participants (533)	30.4%	0.4%	8.1%	61.1%
Industry Groupings:				
Beverages (7)	57.1%	-	14.3%	28.6%
Chemicals (34)	35.3%	-	-	64.7%
Electronics/Appliances (28)	10.7%	-	-	89.3%
Financial Institutions (55)	7.3%	-	9.1%	83.6%
Food Products (30)	30.0%	3.3%	3.3%	63.4%
Glass, Concrete, Abrasives, Gypsum (14)	50.0%	-	7.1%	42.9%
Industrial & Farm Equipment (40)	12.5%	-	7.5%	80.0%
Measuring, Scientific & Photographic Equipment (17)	23.5%	-	17.7%	58.8%
Metal Manufacturing (20)	45.0%	-	25.0%	30.0%
Metal Products (27)	22.2%	-	3.7%	74.1%
Mining and Crude Oil Production (13)	61.5%	7.7%	-	30.8%
Motor Vehicles (21)	14.3%	-	9.5%	76.2%
Paper, Fiber & Wood Products (24)	66.7%	-	4.2%	29.1%
Petroleum Refining (21)	85.7%	-	4.8%	9.5%
Pharmaceuticals (11)	9.1%	-	18.2%	72.7%

TRASOP Prevalence (continued)

	A	B	C	D
Retail (20)	25.0%	-	5.0%	70.0%
Rubber & Plastics Products (7)	14.3%	-	28.6%	57.1%
Shipbuilding, Railroad & Transportation Equipment (7)	14.3%	-	14.3%	71.4%
Textiles & Vinyl Flooring (12)	33.3%	-	-	66.7%
Transportation (21)	38.1%	-	14.3%	47.6%
Utilities (35)	88.6%	-	5.7%	5.7%
Other Companies (65)	4.6%	-	12.3%	83.1%

Covered Compensation

Any individual's annual compensation in excess of $100,000 must be disregarded for allocation purposes. However, compensation up to a lower stated limit may be used if desired. Among 158 surveyed TRASOPs:

- One hundred twelve (70.9%) include the $100,000 limit on individual annual compensation.
- One plan (0.6%) has a $75,000 limit on individual annual compensation.
- Fourteen plans (8.9%) include limits of from $25,000 to $50,000 of individual annual compensation.
- Six plans (3.8%) include limits of from $10,000 to $20,000 of individual annual compensation.
- Fifteen plans (9.5%) include limits of from $1,000 to $7,500 of individual annual compensation.
- Ten plans (6.3%) basically make a per capita allocation and include up to $1 or $100 of individual annual compensation.

Lowering the level of covered compensation has the effect of narrowing the (dollar value) range of annual allocation awards among plan participants. Seventy percent of last year's surveyed TRASOPs included the $100,000 limit on individual annual compensation.

Reasons for Not Implementing a TRASOP

One hundred sixty-two companies provided their reason(s) for not implementing a TRASOP. A summary of the most prevalent reasons are shown below:

Reason(s)	Prevalence
Benefit per employee too small	68 (42.0%)
Benefit per employee too small and excessive administrative cost or complexity	35 (21.6%)
Benefit per employee too small, excessive administrative cost or complexity, and regulatory uncertainty	16 (9.9%)
Stock ownership potential available in other plans	9 (5.5%)
Not interested in providing employee stock ownership	9 (5.5%)
Regulatory uncertainty	5 (3.1%)
No need for tax credit	5 (3.1%)
Others	15 (9.3%)
TOTAL	162 (100.0%)

In addition, it is interesting to note that 19 companies made unsolicited comments regarding their interest in the labor-intensive TRASOP (a TRASOP where the tax credit equals a specified percentage of total payroll). It appears a number of companies not currently having a TRASOP would take advantage of a labor-intensive TRASOP, if it were to become available.

Approximate Benefit Level Provided by TRASOPs

To gain some insights into the benefit levels provided by TRASOPs, survey participants were asked to give their best estimates of the following:

1. The number of employees participating in the TRASOP.

2. The covered compensation of participating employees.

3. The amount of their company's most recent annual qualifying capital expenditures.

Based on these estimates, a benefit per thousand dollars of compensation was computed. The following table displays the range breakdown of the benefit amounts for 114 companies which were able to provide data on this question. Companies allocating the TRASOP contribution on an essentially per capita basis (for example, where the covered compensation is a relatively small amount such as $1 to $7,500) are not included in this table.

Benefit/Thousand Dollars of Compensation

Industry	$0-$7.99	$8-$15.99	$16-$23.99	$24-$31.99	$32-$39.99	$40 & Over
Utilities	5	7	3	3	1	3
Petroleum Refining	4	8	2	0	0	1
Mining & Crude Oil Production	0	0	3	2	0	1
Paper, Fiber, & Wood Products	5	3	3	2	0	0
All Others	22	12	8	8	1	7
TOTAL	36 (31.6%)	30 (26.3%)	19 (16.7%)	15 (13.2%)	2 (1.7%)	12 (10.5%)

If we assume that the average employee earns $15,000/year, we can translate the above figures into a total benefit amount for the average employee. Of course, the actual amount allocated to any particular employee would be dependent on his particular covered compensation. In those cases where the allocation is done on an essentially per capita basis, the table below will reflect the benefit for that covered compensation amount rather than the $15,000 figure.

Total Benefit Amount for Average Employee

Industry	Under $100	$100-$199	$200-$299	$300-$399	$400-$499	$500 & Above
Utilities	4	5	5	4	1	4
Petroleum Refining	3	9	0	2	0	1
Mining & Crude Oil Production	0	0	0	3	2	1
Paper, Fiber, & Wood Products	4	3	3	2	1	0
All Others	30	13	9	7	6	7
TOTAL	41 (31.8%)	30 (23.2%)	17 (13.2%)	18 (13.9%)	10 (7.8%)	13 (10.1%)

Using this methodology, 71 plans (55.1%) of the 129 companies able to provide data, anticipated an average contribution of less than $200. This is not surprising since it is well recognized that TRASOPs generally provide a small benefit relative to more traditional capital accumulation plans. It is interesting to note, however, that over 10% of the plans expect to provide a benefit of $500 or more. Thus, in certain companies, a TRASOP may provide a fairly substantial benefit.

<u>Additional 1/2% Tax Credit Based on Employee Contribution</u>

The Tax Reduction Act of 1975 was amended by the Tax Reform Act of 1976 to allow for an additional 1/2% tax credit if employees agree to make voluntary contributions of a similar amount.

Among 160 surveyed TRASOPs:

- Fifty-three plans (33.1%) provide for the possibility of an additional 1/2% tax credit.

- Four plans (2.5%) do not presently provide for the possibility of an additional 1/2% tax credit, but will be amended to provide for such a possibility.

- Sixteen plans (10.0%) do not presently provide for the possibility of an additional 1/2% tax credit; companies are waiting to see what administrative guidance the IRS may give regarding such a provision.

- Eighty-seven plans (54.4%) do not presently provide for the possibility of an additional 1/2% tax credit and are not expected to be amended to include such a provision.

For utilities, twenty-two plans (71.0%) do provide for the additional 1/2% tax credit. In the petroleum refining industry, four plans (22.2%) provide for the extra credit. Three companies in both the mining and crude oil production industries (37.5%) and the paper, fiber, and wood products industries (20.0%) provide for this option.

While 10.0% of the companies are waiting to see what administrative guidance the IRS may give regarding the 1/2% tax credit, 54.4% have decided not to provide the additional 1/2% tax credit. The principal problem appears to be determining how much individual employees will contribute while adhering to the legislative rules which stipulate that:

- All participants must be allowed to contribute.
- No participant may be required to contribute.
- The matching employer contribution will be allocated in an amount equal to each employee's matching contribution.

It appears that unless the TRASOP benefit is fairly substantial, many companies have decided that the additional administrative burden outweighs the value of the additional 1/2% tax credit. However, the incidence of surveyed TRASOPs provided for the additional 1/2% tax credit has increased substantially over the past three years. In last year's survey, 16.4% of the surveyed TRASOPs provided for the additional tax credit (compared to the current 33.1%). In 1977, only 2.5% of the TRASOPs provided the 1/2% tax credit.

Timing of Distributions

Except for death, disability, or separation from service, distributions to a participant may not occur until the end of the 84th month beginning with the month in which the stock is allocated to a participant's account. Distributions, however, may be scheduled at any later date (subject to the same exceptions). If a distribution is made at the end of each seven-year cycle, however, then favorable lump-sum tax treatment will be unavailable. On the other hand, distributions

56-943 O - 80 - pt.2 - 11

only at termination delay the receipt of the benefit and, perhaps, part of any motivational impetus provided by the plan. Administratively, distribution only at termination may also be simpler.

One hundred sixty-one companies responded to this issue. One hundred plans (62.1%) make distributions only at termination of employment. Thirty plans (18.7%) make rolling seven-year payouts. Twenty-six plans (16.2%) give participants a choice between rolling seven-year payouts and distributions only at termination. One plan (0.6%) gives participants a choice between rolling nine-year payouts and distributions only at termination. Two plans (1.2%) make distributions only at termination except in the case of financial hardship. Two plans (1.2%) plan to make distributions seven years after the last contribution.

APPENDIX

SURVEY OF
TAX REDUCTION ACT ESOPS
HIGHLIGHTS REPORT

April 1979

Hewitt Associates

SURVEY HIGHLIGHTS

During the months of January and February 1979, Hewitt Associates conducted its third annual TRASOP (Tax Reduction Act Employee Stock Ownership Plan) survey of the 1,000 largest industrial companies and the 50 largest commercial-banking, life-insurance, diversified-financial, retail, transportation, and utility companies as listed in the 1978 Fortune Directory.

Purpose of Survey

The primary purpose of the survey was to gather information on the prevalence of TRASOPs and to examine the important characteristics of plans that have been implemented.

Five hundred thirty-three companies participated in the survey. Participating companies span a wide cross section of business and industry and fall into the general groupings shown below:

Company Groupings	Number of Companies
Industrial Companies	
• Sales over $1 billion	154
• Sales of $500 million to $1 billion	59
• Sales under $500 million	185
All Industrial Companies	398
Non-Industrial Companies	
• Financial institutions	55
• Retail companies	20
• Transportation companies	21
• Utilities	35
All Non-Industrial Companies	131
Anonymous Responses	4
All Participants	533

TRASOP Prevalence

Survey participants were asked to indicate the current status of a TRASOP in their company. Of the 533 companies participating:

- One hundred sixty-two companies (30.4%) have implemented a TRASOP (plan has been formally adopted by the board of directors).

- Two companies (0.4%) are in the process of implementing a TRASOP (internal decision has been made to implement a TRASOP, but plan has not been formally adopted by board of directors).

- Forty-three companies (8.1%) do not presently have a TRASOP but are considering implementing such a plan.

- Three hundred twenty-six companies (61.1%) do not presently have a TRASOP and are not presently considering implementing such a plan.

Although last year's survey indicated significant corporate activity in the TRASOP area, this year's survey demonstrates only a slightly higher degree of prevalence. Below is a year-by-year breakdown of TRASOP prevalence.

	1979 Survey	1978 Survey	1977 Survey
Companies having implemented a TRASOP	30.4%	27.2%	9.4%
Companies in the process of implementing a TRASOP	0.4	1.5	3.3
Companies considering implementing a TRASOP	8.1	9.2	14.2
Companies not considering implementing a TRASOP	61.1	62.1	73.1
	100.0%	100.0%	100.0%

Utilities and certain other capital-intensive industries continue to be responsible for much of the activity that has occurred. For example, the survey companies which have implemented or are in the process of implementing a TRASOP include:

- 88.6% of the thirty-five utilities,
- 85.7% of the twenty-one companies in the petroleum refining industry,
- 69.2% of the thirteen companies in the mining and crude oil production industries, and
- 66.7% of the twenty-four companies in the paper, fiber, and wood products industries.

Among industrial companies, TRASOP prevalence appears to be influenced by company size as well as by industry. A breakdown of prevalence data into size groupings shows that the following companies have implemented or are in the process of implementing a TRASOP:

- 43.5% of companies with annual sales over $1 billion,
- 32.2% of companies with annual sales of $500 million to $1 billion, and
- 17.3% of companies with annual sales under $500 million.

It appears that the prevalence of TRASOPs has increased only slightly in all size categories over the past year.

	Of All Industrial Survey Companies in the Following Size Categories, % Which Have Implemented or Are in the Process of Implementing a TRASOP		
Sales	1979 Survey	1978 Survey	1977 Survey
$1 billion and over	43.5%	41.4%	21.7%
$500 million to $1 billion	32.2	24.6	16.3
Under $500 million	17.3	14.4	2.2

TRASOP Characteristics

The survey also examined TRASOP characteristics, focusing on the 162 plans of companies which have implemented a TRASOP. These plans reveal the following prevalences:

- 93.8% are separate plans (not attached to an existing company plan).

- 40.9% of the plans are extended to all or most employees (meeting age/service requirements) and 59.1% are extended to all or most salaried employees (or salaried and non-union hourly employees); however, several plans exclude officers, directors, or members of executive stock or incentive plans.

- 70.9% of the plans use the $100,000 individual annual maximum of covered compensation for allocation purposes; 29.1% use a limit of less than $100,000.

- Of the 129 plans responding to the issue, 71 plans (55.0%) anticipated a benefit for the average employee of less than $200 for the most recent year, 45 plans (34.9%) anticipated a benefit of from $200 to $500, and 13 plans (10.1%) anticipated a benefit of more than $500.

- 35.2% of the plans use some form of the maximum service requirement (up to three years) for participation. This is made possible by the fact that a TRASOP must provide for immediate vesting.

- 33.1% of the plans provide for the additional 1/2% tax credit available because of employee contributions.

- 62.1% of the plans make distributions only at termination of employment; 18.7% make rolling seven-year payouts; 16.2% give participants a choice between rolling seven-year payouts and distributions only at termination.

SUMMARY OF STATEMENT BY CECIL A. RAY, JR.
BEFORE COMMITTEE ON FINANCE, UNITED STATES SENATE
IN SUPPORT OF SECTION 17 OF S.1240

For more than 35 years, §404(a)(3)(A) of the Internal Revenue Code was not interpreted to require a single deduction equal to no more than 15% of compensation when an employer made contributions under both a qualified profit-sharing plan and a qualified stock bonus plan. Then, in January of this year, the Internal Revenue Service issued a private ruling indicating its opinion, which was essentially devoid of supporting legal arguments, that took such a restrictive view of §404(a)(3)(A). The interpretation of the Service is contrary to the language of §404(a)(3)(A), which provides that a single deduction of 15% of compensation applies only to contributions "to 2 or more stock bonus _or_ profit-sharing trusts [emphasis added]" and does not require such a limitation in the case of contributions to one or more stock bonus trusts _and_ one or more profit-sharing trusts.

The above misinterpretation of the Service, which ignores the disjunctive language of the statute, and also thwarts the clearly expressed intent of Congress to encourage the establishment of employee stock ownership plans (ESOPs). It effectively prevents the parent company of a controlled group of corporations from extending coverage under its stock bonus ESOP to employees of a subsidiary corporation when the subsidiary already contributes 15% of compensation to a qualified profit-sharing plan. At the same time, however, the parent could extend the ESOP to cover the employees of a subsidiary with a qualified money purchase pension plan instead of a profit-sharing plan because a higher limitation on deductible contributions to such ESOP would be available in the case of this subsidiary.

This inequitable result would be corrected by Section 17 of S.1240, which would provide for a deduction of 25 percent of covered compensation in accordance with §404(a)(7) of the Code when an employer made contributions under a qualified stock bonus plan (including an ESOP) and a qualified profit-sharing plan.

It does not appear that this amendment would have a significant impact on revenue because, in my experience, it is not the type of provision which would encourage employers to restructure their employee benefit plans, since any combination of two or more different types of plans would be subject to the same 25% limitation under §404(a)(7).

Committee on Finance
United States Senate
Statement of
Cecil A. Ray, Jr., Attorney, Dallas, Texas
December 5, 1979

Mr. Chairman:

My name is Cecil A. Ray, Jr. I have practiced law for 18 years in Dallas, Texas. My practice has emphasized Federal income, estate and gift taxation and, for the past several years, I have devoted a substantial portion of my practice to the law as it relates to employee benefit plans that are qualified under section 401 _et_. _seq_. of the Internal Revenue Code (the "Code"). This includes serving as a lecturer at the SMU Law School in the taxation of deferred compensation plans both before and after the enactment of ERISA.

I am appearing in support of Section 17 of S.1240 which would amend § 404(a)(3)(A) of the Code to provide that an employer who contributes to both a profit-sharing plan and a stock bonus plan will be allowed a deduction of up to 25% of covered compensation in accordance with § 404(a)(7) of the Code. Section 404(a)(3)(A) permits a deduction of up to 15% of covered compensation for contributions to a profit-sharing or stock bonus plan. In its current form, § 404(a)(3)(A) limits a deduction with respect to stock bonus and profit-sharing trusts to

> "...15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan."

The last sentence of this subparagraph further provides that

> "If the contributions are made to 2 or more stock bonus or profit-sharing trusts, such trusts shall be considered a single trust for the purposes of applying the limitations in [section 404(a)(3)(A)]."

The statutory language appears to be clear. I believe that the use of the word "or" indicates that separate 15% limitations are to be applied for each plan; the mere fact that deductions for contributions to both stock bonus trusts and profit-sharing trusts are limited by the same subparagraph of the Code should not be grounds for treating these different kinds of plans as a single plan. The last sentence does not purport to combine a single profit-sharing and single stock bonus trust for purposes of the limitation.

The Revenue Act of 1942 expressed a policy to encourage profit-sharing and stock bonus plans. The legislative history indicates that the Congress did not wish to restrict contributions to such plans to 5% of compensation as in the case of pension plans. The committee reports recognized that motivation of employees and increased productivity were stimulated by such plans and such was essential to the war effort at that time. There appears to be no conscious thought given to restricting employers having both types of plans except where they had two or more profit-sharing or two or more stock bonus plans.

In 1974, 1976, 1978, a definite congressional policy emerged which encouraged the establishment of Employer Stock Ownership Plans (ESOPs). ESOPs were considered essential to increased capital formation, which was deemed necessary to deal with the economic problems of the 1970's. The provisions enacted in 1976 and 1978 overruled the Internal Revenue Service's attempts to restrict the use of ESOPs by finalization of certain proposed regulations.

For the past 35 years, § 404(a)(3)(A) has not been interpreted (whether in committee reports or by regulation) so as to indicate that employers which established both a profit-sharing and a stock bonus plan would be limited to 15% of covered compensation. In January of 1979, however, the Internal Revenue Service ruled that an ESOP, qualified as a stock bonus trust, and a separate, qualified profit-sharing trust must be aggregated and treated as a single trust for purposes of determining the limitation on the deductibility of employer contributions under § 404(a)(3)(A) of the Code. (A copy of this private letter ruling is attached hereto.) This interpretation misconstrues the language and the intent of § 404(a)(3)(A) of the Code and also thwarts the clearly expressed congressional policy of encouraging the establishment of ESOPs.

This result is particularly evident in the case of a controlled group of corporations consisting of a holding company with various subsidiaries, most of which have pension plans. If, for example, one or more subsidiaries have profit-sharing plans which will generate a deduction equal to 15% of compensation based on the percentage of profits contributed each year in the foreseeable future, and the holding company's ESOP is a stock bonus plan, the deduction for contributions to the stock bonus plan is, according to this ruling, to be determined under section 404(a)(3)(A). If, with respect to employees covered by the profit-sharing plan, their employer is limited to a deduction equal to 15% of compensation, no contribution for those employees can be made under the ESOP. If, on the other hand, as the current version of section 404(a)(3)(A) provides, a deduction of 15% of compensation is allowed for the profit-sharing plan and a similar deduction of 15% of compensation is allowed for the stock bonus plan, the ESOP could be established for the employees presently covered by a profit-sharing plan. However, the interpretation of the Internal Revenue Service in the recent private ruling penalizes the most productive employees of subsidiaries, (those covered by a profit-sharing plan which provides the strongest performance motive) because they cannot participate in the ESOP even though their efforts make their employers the most profitable.

As will be discussed in more detail later in this statement, section 1.404(a)-9 of the regulations clearly imposes the primary limitation of 15% of compensation on each type of plan considered separately and aggregates the limitation only where there are two or more profit-sharing or stock bonus trusts. This is in contrast to the provisions of section 1.404(a)-4(c) of the regulations which state

> "Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan."

Since these two sentences in different sections of the Regulations were proposed by the same Treasury Decision (T.D. 6203, adopted on September 24, 1956), there should be a different meaning ascribed to the different language used.

I believe the current provisions of § 404(a)(3)(A) of the Code have been erroneously construed by the Internal Revenue Service's private letter ruling issued earlier this year. Consequently, I urge the adoption of the amendment to § 404(a)(3)(A) made by section 17 of S.1240. In order that there be no possible room for an erroneous interpretation that the 25% limitation of § 404(a)(7) is not applicable, it is suggested that line 15 on page 21 of S.1240 be rewritten to read as follows:

> "paragraph 7 shall be applied in lieu of the limitations imposed by this subparagraph on contributions made to two or more stock bonus or profit-sharing trusts."

As so modified the amendment to § 404(a)(3)(A) of the Code proposed by Section 17 of S.1240 would read as follows:

> "However, if the contributions are made to one or more stock bonus plans and to one or more profit-sharing plans, the limitations set forth in paragraph 7 shall be applied in lieu of the limitations imposed by this subparagraph on contributions made to two or more stock bonus or profit-sharing trusts."

From a reading the attached ruling, it is evident that the Internal Revenue Service did not cite a single authority or statutory provision in support of the conclusion that

> "The qualified profit-sharing plan and the ESOP, qualified as a stock bonus plan, both of which are maintained by an employer which does not maintain a qualified pension plan, shall be considered a single plan for purposes of applying the limitations in section 404(a)(3)(A). Therefore, the maximum deduction for contributions to both plans is 15 percent of the covered employees' compensation."

This conclusion is supported by reasoning which is contrary to the statutory language, regulations, and Congressional purpose of encouraging establishment of ESOPs. Further, the Internal Revenue Service did not give any recognition to the differences between stock bonus plans, including employee stock ownership plans, and profit-sharing plans in its reasoning which reads as follows:

> "Section 1.401-(b)(1)(iii) of the Regulations describes a stock bonus plan as being similar to a profit-sharing plan except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company.
>
> "Since profit-sharing plans and stock bonus plans are treated as similar plans, an employer that establishes both a profit-sharing plan and a stock bonus plan should be limited to the same maximum deduction as an employer that establishes either two profit-sharing plans or two stock bonus plans. The distinguishing feature between the two types of plans, that benefits in a stock bonus plan are distributable in stock of the employer, is not such as would justify a deduction limit of 30 percent in the situation where an employer maintains both types of plans instead of either two profit-sharing plans or two stock bonus plans. Our conclusion that a limit of 30 percent was not intended is supported by the fact that neither section 404(a)(3)(A) of the Code or the Regulations thereunder which describe a limit of 15 percent when certain plans are combined,

> nor section 404(a)(7)(A) or the Regulations thereunder which describe a limit of 25 percent when certain other plans are combined, would permit a deduction of the magnitude of 30 percent."

The following detailed discussion of the current law is presented to demonstrate the clearly erroneous position taken by the attached private letter ruling which has a chilling effect on the establishment of new ESOPs in those situations where employees are already covered by profit-sharing plans. It appears clear that the result obtained by covering employees with a profit-sharing plan and an ESOP can mostly be obtained by converting the profit-sharing plan to a money purchase pension plan, which, like a profit-sharing plan, is a defined contribution plan with individual accounts for participants. A money purchase pension plan is basically a retirement plan, however, and contributions to it may not be geared to profits. Therefore, it cannot provide the incentive and motivation that is inherent in a profit-sharing plan. Moreover, the notion that a deduction of up to 25% of compensation is available for contributions to a stock bonus trust and a money purchase pension trust but is not available for contributions to a stock bonus trust and a profit-sharing trust because the deduction limitations are contained under the same subparagraph of § 404(a)(3) just does not make any sense from the standpoint of tax equity. In general, the Service's notion that neither the Internal Revenue Code nor the regulations would permit "a deduction of the magnitude of 30 percent" is based on a false concern for the size of the numerical percentage. It is well recognized that the deduction for a contribution to a single pension plan is not limited to a percentage of compensation and could very well exceed 30 percent in a given situation.

DETAILED DISCUSSION
OF § 404(a) OF CURRENT LAW

1. General Statutory Pattern. Although the precise formulas for determining the limitations on deductions for contributions to defined benefit plans have changed over the years, section 404(a) of the Code continues to state the general rules governing the deductible limits for contributions to qualified employee benefit plans in substantially the same language that was used by Congress in amending § 23(p) of the 1939 Code in the Revenue Act of 1942. Section 404(a)(1) limits the deductible contributions to a pension plan to the amount necessary to fund the promised pension benefits. This section remained essentially unchanged until ERISA. Section 404(a)(2) limits deductible contributions for purchases of retirement annuities with essentially the same language used in 1942.

With respect to profit-sharing and stock bonus plans, § 404(a)(3) limits deductions to

> 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit sharing plan.

As in the case of deductions for contributions to pension trusts (limited by § 404(a)(1)) and to annuity plans (limited by § 404(a)(2)) the limitations of § 404(a)(3) apply to each plan separately. Unlike subparagraphs (1) and (2), however, subparagraph (3) of § 404(a) limits deductions where two or more profit-sharing plans or two or more stock bonus plans are established by the same employer as follows:

> If the contributions are made to 2 or more stock bonus or profit sharing trusts, such trusts shall be considered a single trust for purposes of applying the limitations in [§404(a)(3)(A)].

Thus, except for the limitations imposed by § 162 relating to reasonableness of compensation and except for the practical limitations inherent in the amount that an employer can realistically commit to fund a defined benefit plan (in light of the requirement that the plan be permanent), the basic limits on deductibility are contained in these three subparagraphs.

In addition to these basic limitations on deductions, § 404(a)(7) further limits deductions by providing a maximum deduction for two or more plans which cover the same employee. This overall ceiling applies to certain combinations of the four types of plans described in the subparagraphs in § 404(a)(1), (2), and (3). Section 404(a)(7) provides in part:

> If amounts are deductible under paragraphs (1) and (3), or (2) and (3), or (1), (2) and (3), in connection with two or more trusts, or one or more trusts and an annuity plan, the total amount deductible in a taxable year under such trusts and plans shall not exceed ... 25 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries of the trusts or plans....

Since § 404(a)(7) does not, by its terms, limit deductions for contributions made to two or more plans under the same subparagraph of § 404(a) (e.g., two pension plans, two annuity plans, two

56-943 0 - 80 - pt.2 - 12

profit-sharing plans, or two stock bonus plans) it was necessary for the regulations under subparagraphs (1) and (2) to aggregate two or more plans of the same type if deductible contributions were to be limited thereunder. This was done in Regs. § 1.404(a)-4(c) with respect to pension and annuity plans covering the same employees.

Unlike § 404(a)(7) and § 1.404(a)-4(c) of the regulations, § 404(a)(3)(A) relating to aggregation of two or more profit-sharing or stock bonus plans does not require that the plans have common employees. The reason for this more restrictive application of the aggregation concept to profit-sharing or stock bonus plans is not readily apparent. Perhaps the nature of profit-sharing and stock bonus plans in contrast to pension and annuity plans (as discussed below) explains the more restrictive treatment for them.

The critical question for purposes of this ruling request is whether the above-quoted language of § 404(a)(3)(A) related to two or more stock bonus or profit-sharing trusts is correctly interpreted to limit an employer to a deduction of no more than 15% of the compensation of the employees covered by both trusts rather than to 15% of compensation with respect to employees covered by the profit-sharing trust and another 15% of compensation with respect to employees covered by the stock bonus trust. Analysis of the regulations and the syntax of the statutory language will demonstrate that the statutory purpose is effected by permitting a deductible limit of 30% of compensation.

The provisions of § 404(a)(7) indicate a statutory purpose to limit the amount that may be deductible where two or more plans or trusts of different kind are established. Where two or more plans of the same kind are established, the basic limitation on deductible contributions, contained in § 404(a)(1), (2) or (3) should be applied as if all plans of the same kind were one plan. This purpose is explicitly set forth in § 404(a)(7) and in the part of § 404(a)(3)(A) that deals with two or more profit-sharing or stock bonus trusts. The mere fact that deductions for contributions to both stock bonus trusts and profit-sharing trusts are limited by the same subparagraph (3) of § 404(a) should not be grounds for treating these different kinds of plans as a single plan in derogation of the statutory purpose and especially the disjunctive language in § 404(a)(3)(A).

2. The Regulations. The regulations, § 1.404(a)-9(b)(2), merely reiterate the language of § 404(a)(3)(A) concerning the need for aggregation as a single trust in the case of contributions to "2 or more profit-sharing or bonus trusts," without attempting to apply this language to two plans consisting of a profit-sharing plan and a stock bonus plan. Under either the language of § 404(a)(3) or the regulations thereunder (§ 1.404(a)-9(b)(2)), if an employer establishes two profit-sharing (or two stock bonus) plans, they are treated as one plan and the deduction for contributions thereunder is limited to 15% of compensation even though the two plans do not cover any of the same employees.

On the other hand, the regulations, § 1.404(a)-4(c), issued under § 404(a)(1) provide that

> Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan.

This aggregation of two pension plans or of two annuity plans is necessary because § 404(a)(7) does not limit deductible contributions to plans of the same kind. However, § 404(a)(7) does limit such deductions when there are plans of different kinds, the deductions for which are determined under the enumerated combinations of subparagraphs (1), (2) and (3). In addition, however, the regulation quoted above, § 1.404(a)-4(c) contains language at the end thereof which indicates that aggregation of both pension and annuity plans are required. This language provides that the "<u>total</u> deductions for <u>all</u> such plans are <u>also</u> subject to the limitations which would be applicable thereto if they constituted a single plan." (emphasis added). As will be developed below, this additional language which requires aggregation of different kinds of plans does not appear either in § 404(a)(3)(A) or in § 1.404(a)-9(b)(2) of the regulations issued thereunder.

Unlike the treatment of pension and annuity plans provided for by § 1.404(a)-4(c), (where both kinds of plans are aggregated) profit-sharing plans are, in accordance with § 404(a)(3)(A) and § 1.404(a)-9(b)(2), to be aggregated only with profit-sharing plans and stock bonus plans only with stock bonus plans. The absence of a phrase in either the Code or regulations which refers to the "total deductions for all such Plans" forces this conclusion. The other provisions of the above-quoted part of § 1.404(a)-4(c) are almost identical with § 404(a)(3)(A) and § 1.404(a)-9(b)(2) of the regulations. Therefore, if an employer establishes a profit-sharing and a stock bonus plan (whether or not they cover any common employees) the employer is not limited to 15% of compensation of employees covered by the plans where the same employees are covered by both plans; but, rather, since there is no statutory reference to overlapping plans, 15% of compensation paid to the employees covered under each plan can be deducted with respect to each plan. No other combination of plans would increase the amount deductible since § 404(a)(3)(A) would aggregate a third plan of either the profit-sharing or stock bonus type and § 404(a)(7) would do so where common employees are covered both by a profit-sharing (or stock bonus) plan and a pension or annuity plan, or both.

Where the same employees are covered, establishing both a profit-sharing and stock bonus plan can raise the deductible limit to 30% of compensation. It must be kept in mind, however, that the requirement of profits before a profit-sharing contribution can be made provides an uncertainty as to the amount to be contributed which is absent in pension or annuity plans. This uncertainty justifies a potentially different deductible amount as a percentage of compensation. The difference between this 30% and the 25% rate under § 404(a)(7) is not unreasonable in light of the fluctuation in profits. This 30% rate was consistent with the carryover limit under the second sentence of § 404(a) (3)(A), related to make-up contributions, until § 2004(b) of ERISA reduced this limit from 30% to 25%. This is additional evidence of a statutory purpose not to aggregate profit-sharing and stock bonus plans under the last sentence of § 404(a)(3)(A).

A lower limit on deductibility might even cause an employer to discontinue either the profit-sharing or the stock bonus plan. Of course, the employer could replace one of these plans with a pension plan or an annuity plan in order to take advantage of the higher limitation on deductibility afforded by § 404(a)(7), but the added cost of changing from a defined contribution plan to a defined benefit plan or a money purchase pension plan could outweigh the advantage of greater deductibility under § 404(a)(7). Thus, the likely net result of limiting the deductions to 15 percent of compensation in the case of contributions to a profit-sharing plan and a stock bonus plan would be to cause the elimination of one of these plans or, at least, to cause a reduction in the combined contributions to both plans by subjecting them to a proviso that together they should not exceed 15 percent of compensation.

3. Analysis of Statutory Language. The language of § 404(a) (3)(A) clearly indicates that subparagraph (3) applies to stock bonus and profit-sharing trusts separately by the repeated use of

the disjunctive word "or" throughout § 404(a)(3)(A) rather than the conjunctive word "and."

The provisions of § 404(a)(3) provide:

(3) Stock bonus and profit-sharing trusts.--

> (A) Limits on deductible contributions.-- In the taxable year when paid, if the contributions are paid into a stock bonus or profit-sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under section 501(a), in an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. (emphasis added)

The end of subsection (a)(3) repeats the use of disjunctive language in the following provision:

> The term "stock bonus or profit-sharing trust," as used in this subparagraph, shall not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in paragraph (1). If the contributions are made to 2 or more stock bonus or profit-sharing trusts, such trusts shall be considered a single trust for purposes of applying the limitations in this subparagraph. (emphasis added)

The above provision clearly states that, while two or more stock bonus trusts are treated as one trust in applying the deductible limit of 15 percent of compensation and two or more profit-sharing trusts are also treated as a single trust for this purpose, a stock bonus trust and a profit-sharing trust are not so aggregated. The last sentence of § 404(a)(3)(A) above, is to be contrasted with the language used in § 1.404(a)-4(c) which adds additional language which is necessary to cause the aggregation of different kinds of plans, i.e., "and the total deductions for all such plans ... are also subject to the limitations which would be applicable thereto if they constituted a single plan." (emphasis added) This additional language is absent both from § 1.404(a)-9(b)(2) of the regulations issued under § 404(a)(3)(A) and the statute itself. Since both sections of the regulations were promulgated by T.D. 6203 on September 24, 1956, the use of the additional language in § 1.404(a)-4(c) should be given a different meaning from the similar but truncated provision in § 1.404(a)-9(b)(2).

In the last sentence of § 404(a)(3)(A) two related clauses support the conclusion that stock bonus and profit-sharing trusts are not to be aggregated. First in the dependent, qualifying clause, ("If the contributions are made to 2 or more stock bonus or profit-sharing trusts,") the phrase "2 or more" modifies "stock bonus or profit-sharing" because the intention is to describe the kinds of trusts, and the phrasing implies a choice of alternatives. Therefore the phrase provides a limitation on alternatives. In such case the 15% limit on deductions would be applied against the compensation of covered employees once for the profit-sharing plan and once for the stock bonus plan. To recast the phrase without ambiguity, it would read "either 2 or more stock bonus or 2 or more profit-sharing trusts, ..." This recasting was done in a different way in § 1.404(a)-4(c).

In addition, the sentence is complicated by the use of "or" in the phrase "stock bonus or profit-sharing trusts". By use of "or", the sentence separates the two kinds of trusts. The phrase "2 or more", therefore, modifies each; i.e., "2 or more stock bonus" or "2 or more profit-sharing." If the phrase "2 or more" were intended to combine the two kinds of trusts, then either it should read

(a) "2 or more stock bonus and profit-sharing trusts" (which would bring the two kinds of trusts together as a group), or

(b) "2 or more stock bonus or profit sharing trusts, or combination of stock bonus and profit-sharing trusts".

The use of the conjunctive "and" makes the number of trusts, not the kinds of trusts, the thrust of the limitation. The use of almost identical language in § 1.404(a)-4(c) of the regulations with respect to "2 or more pension or annuity plans," but with additional conjunctive language, clearly demonstrates that combination of the two kinds of trusts was not intended here.

Finally, Congress has expressed, again and again, encouragement for the establishment of ESOP's. To interpret the last sentence in § 404(a)(3)(A) as limiting the number of trusts would unnecessarily frustrate a clearly defined congressional purpose. See, e.g., Joint Committee on Taxation, Summary of the Tax Reform Act of 1976 (H.R. 10612, 94th Cong., Public Law 94-455), Sec. 803(b), Employee Stock Ownership Plan Regulations, reprinted in 1976 - 3 C.B. 454-57.

Internal Reven Service

Department of the Treasury

Significant Index No. 0404.05-00

Washington DC

Person to Contact:

[redacted]

Telephone Number:

[redacted]

Refer Reply to:

[redacted]

Date:

JAN 22 1979

[redacted]

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

A = [redacted]
B = [redacted]
C = [redacted]
D = [redacted]

Gentlemen:

This is in response to the request for a ruling submitted on your behalf by your authorized representative concerning the amount of contributions that may be deducted under section 404(a)(3)(A) of the Internal Revenue Code of 1954.

In his letter, your representative states that A and its controlled group established B, an employee stock ownership plan (ESOP), in 1978. B is designed to qualify under Code section 401(a) as a stock bonus plan.

As a consequence of the adoption of B by A's subsidiaries, some employers will have employees covered by both a pension and a stock bonus plan; others will have employees covered by only the ESOP; and two employers, maintaining profit-sharing plans, will have employees covered by both a profit-sharing plan and the ESOP.

The ESOP provides for contribution in such amounts as A shall determine, not to exceed the amounts deductible under section 404(a) of the Code. Contributions are to be made in cash or company stock and are allocated on the basis that the proportion of covered compensation of the participant bears to covered compensation of all participants entitled to an allocable share of the company contribution for that year.

A ruling is requested that the maximum amounts deductible under section 404(a)(3)(A) for contributions to a qualified profit-sharing plan and an ESOP, qualified as a stock bonus plan, both maintained by an employer which does not maintain a qualified pension plan are:

(a) Contributions to the profit-sharing plan which do not exceed 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees covered by the plan, and

(b) Contributions to the ESOP (stock bonus plan) which do not exceed 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees covered by the plan;

even though most employees of the employer are covered by both plans.

Section 404(a)(3)(A) of the Code limits the deduction for contributions to a profit-sharing or stock bonus plan to 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees covered under the plan. That subparagraph further provides that when contributions are made to two or more stock bonus or profit-sharing trusts, the trusts will be considered a single trust for purposes of applying the limitations of section 404(a)(3)(A).

Section 404(a)(7)(A) of the Code provides a further deduction limit by providing a maximum deduction of 25 percent of compensation for two or more plans which cover the same employee. This overall ceiling applies to certain combinations of the four types of plans described in sections 404(a)(1), (2) and (3).

Section 1.404(a)-4(c) of the Income Tax Regulations provides that where two or more pension and annuity plans cover the same employee, the plans must be aggregated and treated as a single plan to determine whether the deduction limitation is exceeded.

Your representative has requested us to interpret section 404(a)(3)(A) as meaning that two or more stock bonus trusts are treated as one trust in applying the deductible limit of 15 percent of compensation, and that two or more profit-sharing trusts are also treated as a single trust for this purpose; but that a stock bonus trust and a profit-sharing trust are not so aggregated. This interpretation would mean that an employer which maintained both a stock bonus trust and a profit-sharing trust would be entitled to deduct up to 15 percent of the compensation of the employees covered by each trust, for an overall deduction limit of 30 percent of compensation.

However, we conclude that an employer which maintains both a stock bonus trust and a profit-sharing trust is subject to the same 15 percent of compensation deduction limit described in section 404(a)(3)(A) as an employer which maintains two or more stock bonus trusts or an employer which maintains two or more profit-sharing trusts.

Section 1.401-1(b)(1)(ii) of the Regulations defines a profit-sharing plan as a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. A profit-sharing plan must also provide a definite pre-determined formula for allocating contributions among participants and for distributing the accumulated funds after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as lay-off, illness, disability, etc.

Section 1.401-1(b)(1)(iii) of the Regulations describes a stock bonus plan as being similar to a profit-sharing plan except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company.

Since profit-sharing plans and stock bonus plans are treated as similar plans, an employer that establishes both a profit-sharing plan and a stock bonus plan should be limited to the same maximum deduction as an employer that establishes either two profit-sharing plans or two stock bonus plans. The distinguishing feature between the two types of plans, that benefits in a stock bonus plan are distributable in stock of the employer, is not such as would justify a deduction limit of 30 percent in the situation where an employer maintains both types of plans instead of either two profit-sharing plans or two stock bonus plans. Our conclusion that a limit of 30 percent was not intended is supported by the fact that neither section 404(a)(3)(A) of the Code or the Regulations thereunder which describe a limit of 15 percent when certain plans are combined, nor section 404(a)(7)(A) or the Regulations thereunder which describe a limit of 25 percent when certain other plans are combined, would permit a deduction of the magnitude of 30 percent.

For the foregoing reasons, we conclude that the qualified profit-sharing plan and the ESOP, qualified as a stock bonus plan, both of which are maintained by an employer which does not maintain a qualified pension plan, shall be considered a single plan for purposes of applying the limitations in section 404(a)(3)(A). Therefore, the maximum deduction for contributions to both plans is 15 percent of the covered employees' compensation.

We have sent copies of this ruling to your authorized representatives, C and D , as requested in the power-of-attorney.

Sincerely yours,

AD Fields

A. D. Fields
Chief, Employee Plans
Technical Branch

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

[Whereupon, at 4:15 p.m., the subcommittee adjourned, subject to call of the Chair.]

[By direction of the Chairman the following communications were made a part of the hearing record:]

STATEMENT OF AMERICAN AIRLINES, INC.

December 4, 1979

COMMITTEE ON FINANCE
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND FRINGE BENEFITS

STATEMENT IN SUPPORT OF S.989

This statement is submitted for the record on behalf of American Airlines, Inc.

Thank you for the opportunity to testify in support of S.989. The bill would provide that certain aggregation rules would not apply in determining whether distributions from money purchase plans are eligible for rollover treatment.

Many companies, including American Airlines, have two employee pension plans. One is a defined benefit plan from which employees usually take benefits as lifetime annuities. The other is a money purchase plan from which employees have historically preferred to take single sum distribution. Before ERISA, such a distribution was eligible for preferential tax treatment. However, under existing law, the single sum distribution is denied favorable tax treatment. Such treatment is only available if the employee receives a complete distribution from both pension plans. This is an ERISA provision known as the aggregation rule.

Under S.989, employees participating in both a defined benefit plan and a money purchase plan of the same employer would be allowed to rollover a single sum distribution from money purchase plan without requiring a total distribution from the defined benefit plan of the same employer. The bill would also provide that if a total distribution from a money purchase plan is rolled over, a later distribution from the defined benefit plan could also be rolled over but would not qualify for the special income averaging rules or capital gain treatment.

In short, the bill would alleviate an unintended hardship while promoting the Congressional policy of encouraging individual retirement accounts.

The bill would apply to taxable years beginning after December 31, 1974. However, effectiveness for taxable years beginning after December 31, 1978 would be acceptable to us.

We respectfully urge your favorable consideration of S.989.

We also wish to draw your attention to H.R.4298, a bill introduced by Mr. Rostenkowski in the House which would accomplish substantially the same result. Hearings were held on September 27, 1979 before the Subcommittee on Special Revenue Measures of the Ways and Means Committee and the bill was marked-up on November 27, 1979. It is understood that the bill was approved. We also support H.R.4298.

A detailed statement is also submitted for the record.

T. F. Quinn, Jr.
Vice President -
Tax and Insurance
American Airlines, Inc.

December 4, 1979

Amendment of Section 402(a)(6)
of the Internal Revenue Code of 1954

This memorandum is submitted to request consideration of an amendment of section 402(a)(6) of the Internal Revenue Code of 1954 to provide limited relief from the aggregation rules set forth in section 402(e)(4)(C) for a single sum distribution at retirement from a money purchase pension plan maintained by an employer who also maintains a defined benefit pension plan. The request for amendment is made in the belief that the present aggregation rules in section 402(e)(4)(C), which were enacted as part of the Employee Retirement Income Security Act of 1974 ("ERISA"), impose a hardship on employees which was not intended by Congress. The limited relief sought is the insertion of a statutory provision making a single sum distribution at retirement from such a money purchase pension plan eligible for rollover treatment.

Prior to the amendment of section 402 in 1974, a distribution from a qualified pension or profit sharing plan constituted a "lump sum distribution" for Federal income tax purposes it it cleared the employee's balance in a single plan (or in some cases only in a single trust under a plan). The aggregation rules adopted in 1974 require that "for purposes of determining the balance to the credit of an employee . . . all trusts which are part of a plan shall be treated as a single trust, all pension plans maintained by the employer shall be treated as a single plan, all profit sharing plans maintained by the employer shall be treated as a single plan, and all stock bonus plans maintained by the employer shall be treated as a separate plan . . . ."

According to House Report No. 93-779, issued by the House Ways and Means Committee on February 5, 1974, a principal purpose of the new aggregation rules was to "prevent tax avoidance". (H. R. Rep. 93-779, at pp. 151-2, reprinted in 1974-3 Cumulative Bulletin 394-95.) However, rather than preventing tax avoidance, the application of the aggregation rules penalizes employees by apparently treating a single distribution to retiring employees from an independent money purchase pension plan maintained by their employer as being subject to ordinary income tax simply because that employer also maintains a defined benefit pension plan under which employees will receive benefits in the traditional annuity form.

56-943 O - 80 - pt.2 - 13

The situation of employees of American Airlines illustrates this hardship. American Airlines has, since 1942, maintained Retirement Benefit Plans to provide pensions for its employees upon their retirement. In the mid-60's, American established several Variable Benefit Plans for the same groups of employees; the Variable Benefit Plans were money purchase pension plans which could, at the option of each employee, provide a lump sum at retirement or a variable annuity at retirement. The Retirement Benefit Plans and the Variable Benefit Plans were independently funded and administered (in much the same way that another company's pension and profit sharing plans would have been funded and administered) and cover all classes of the company's employees.

Most American Airlines employees receive annuities under their Retirement Benefit Plan and elect to be paid single distributions from their Variable Benefit Plan. Until 1974, distributions from the Variable Benefit Plans were eligible for the special treatment accorded lump sum distributions. Since the amendment of section 402(e), however, the aggregation rules have barred treatment of a distribution from a Variable Benefit Plan as a lump sum distribution and have the effect of taxing any gain on such distribution as ordinary income. Employees may neither benefit from the special ten-year averaging provisions contained in section 402(e) nor obtain treatment as long-term capital gain of the portion of their distribution attributable to plan participation prior to 1974 nor are such employees entitled to rollover treatment. Participation in the Variable Benefit Plans is voluntary and the effect of the aggregation rules in especially harsh because it denies any favorable tax treatment to employees who participated in the plan for periods when the Code provided that a single sum distribution would be a lump sum distribution.

Ironically, if the Variable Benefit Plans had been profit sharing plans (under which contributions would be made only in the event that sufficient profits were earned) distributions would continue to qualify for the special tax treatment contained in section 402. Since the only necessary difference between a money purchase pension plan and a profit sharing plan is the addition of a single sentence limiting the source of contributions under the latter plan to the employer's profits, it is difficult to understand why Congress should have intended an employee covered by a defined benefit plan and a money.purchase pension plan to lose the favorable tax treatment while retaining that treatment for employees covered by a defined benefit plan and a profit sharing plan. Such a position merely penalizes an employee if his employer creates a second qualified plan, to provide benefits in addition to those provided under a defined benefit plan, without imposing a limitation, based on profits, on the level of contributions to the second plan.

The unintended hardship could be substantially alleviated by amending section 402(a)(6) of the Code to permit rollover treatment to a single sum distribution at retirement from a money purchase pension plan maintained by an employer who also maintains a defined benefit pension plan. The proposed amendment would merely extend to retiring employees under the circumstances described the same benefits which are accorded participants in terminating plans under section 402(a)(5).

T. F. Quinn, Jr.
Vice President
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Barbra H. Rolfe
Employee Benefits

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December 6, 1979

Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Subject: Revenue Act of 1978 - Act. Sec. 366
<u>Medical Reimbursement Plans - IRC 105 (h)</u>

Gentlemen;

Here is another fringe benefit that starts to line up with ERISA and then turns away again. Furthermore, the regulations are not yet issued and the local Internal Revenue Service knows nothing about any advance determinations being available as mentioned in the Conference Committee Report.

The act itself goes into the 70% coverage requirement. It then goes into the permitted exclusion of certain employees up to three years, under age 25, those in union plans, non-resident aliens, and part-time or seasonal employees.

Once again, those of us in benefits administration think of 1,000 hours during some plan/fiscal year, but the Conference Committee Report is less generous and suggests that part-time could be considered less than 35 hours a week and less than nine months a year. Will employees find this easy to understand?

Quoting from the Senate Committee Report: "Under the Bill, a plan is discriminatory if it provides greater benefits for key employees than other employees. For example, a plan would be discriminatory if benefits thereunder are in proportion to employee compensation. No advance determination by the Internal Revenue Service is required."

Here we are again, the regulations are not out and the rewriting of every Medical Reimbursement Plan in the country is indicated, because all this is effective 1-1-1980. Will employers wish to provide this benefit any more when they can no longer cover an even percent of pay to anyone eligible for a benefit that year? Many we know have indicated they would not.

Comments on what is in store and when we may expect it will be most appreciated.

Respectfully submitted,

Barbra H. Rolfe

Barbra H. Rolfe

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December 5, 1979

Mr. Michael Stern, Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, DC 20510

Re: Pension Plan Hearings

Dear Mr. Stern:

In reading Commerce Clearing House's publication informing us that the Subcommittee was holding hearings on the pension plan bills, I would like to submit the following information for your consideration.

The sections in ERISA that deal with employer liability are creating serious financial problems for small or medium size corporations with pension plans. Prior to ERISA, there were many plans that defined benefits but were actually defined contribution plans. Courts are now including what was intended to be defined contribution plans as defined benefit plans, creating a liability on employers on termination. It is absolutely unfair to place a liability on an employer when the plans as adopted prior to ERISA stated that there would be no liability on the employer over and above the funds that were contributed to the plan. Placing a liability on an employer that was not intended is certainly an unfair provision. It is requested that you amend the employer liability section of the law and remove employer liability on plans adopted prior to the effective date of ERISA in instances when no wrong doing or fraud has been committed.

There was a provision in ERISA to provide that employers could buy an insurance furnished by the Pension Benefit Guaranty Corporation, however, as you know, no such insurance plan has been developed by PBGC. The net result is that plans that have terminated since the effective date of ERISA are having to pay into Pension Benefit Guaranty Corporation or are fighting claims rendered by Pension Benefit Guaranty Corporation to the extent of 30% of the net worth of the companies adopting the plans.

This employer liability caused by plan terminations is an unfair provision in ERISA. Many of these terminations are being made as a result of companies going out of business, merging or selling out and other various reasons. It is certainly unfair to take 30% of a company's net worth to fund a plan in which the contract originally adopted stated that there would be no further liability on the employer. This is particularly hard on a company in financial difficulties or in instances when companies are sold. No purchasing company will assume a liability on a balance to be placed into a pension fund.

Your attention to this employer liability section would be greatly appreciated by many small and medium size businesses. Thank you for your consideration.

Yours very truly,

MORRISON AND SMITH

Claud A. Morrison
Certified Public Accountant

CAM:tw

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W. M. Reed
Senior Vice President

December 6, 1979

Mr. Michael Stern
Staff Director
Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Stern:

We would like to offer a few comments regarding one of the recent amendments to the proposed ERISA Improvements Act (S. 209) now pending before the Senate Finance Committee.

As we understand it, the proposed preemption exception for laws substantially identical to the Hawaii Prepaid Health Care Law has been expanded. Specifically, it now appears that the amended bill would except from ERISA preemption all state health care laws which require that employers provide certain benefits to their employees or which regulate the manner of providing those benefits.

Fundamentally, we believe that, even with continuing preemption in the areas of reporting and disclosure and fiduciary obligations, the introduction of duplicative, multi-state regulation re-establishes the patchwork of conflicting laws and regulations which Congress intended to prevent through ERISA. Employers have been struggling with the extraordinarily complex provisions of ERISA for the past several years. It is, in our view, wholly unreasonable to complicate the situation further by permitting additional layers of regulation at the state level, particularly on a "blanket" authorization basis under which it is not possible to even predict what ultimate burdens may result.

We believe that state regulation in the health benefits area would lead to overly burdensome administration and increasing plan costs. Additionally, any effort at benefits "uniformity" and consistency, which Atlantic Richfield fully supports, would be defeated. These effects are inevitable under such a scheme, in our judgement. What might result from ingenious State legislative and regulatory efforts is, of course, an unknown. But any such path of erosion will surely trace back to this modification of general preemption.

In our opinion, regulation of health benefits by the states should at least be founded on some recognized deficiency in the record of federal regulation. More regulation, as opposed to improved regulation, is not a solution.

Atlantic Richfield firmly supports the need to monitor and control welfare plans. We believe the answer lies with federal law. In any event, if the proposed exception is adopted it should, at a minimum, carry the protection of a required certification by the Secretary of Labor as a condition to a particular State Law's effect.

Sincerely,

W. M. Read

Enclosure (5 copies of this letter)

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December 6, 1979

The Honorable Lloyd M. Bentsen
United States Senate
Washington, D. C. 20510

Re: Hearings on Williams-Javits Bill (S.209) and <u>the Bentsen ERISA Simplification Act (S.1089)</u>

Dear Senator Bentsen:

We are writing to you on behalf of our client, Towers, Perrin, Forster & Crosby (TPF&C). TPF&C is a large international employee benefit consulting firm that represents approximately 2,500 clients, including 80 of the largest 100 industrial companies and 280 of the largest 500 industrial companies.

A number of TPF&C's clients are domestic corporations which operate outside of the United States. In connection with such operations, these companies often maintain pension plans for non-resident aliens. TPF&C and these companies object strenuously to an administrative position recently taken by the Internal Revenue Service in connection with such plans. In a private letter ruling, the IRS denied deductions to a U.S. employer for contributions it made to such a plan because the plan did not meet all of the qualification requirements for retirement plans of Section 401(a) of the Internal Revenue Code. Not only was a deduction denied for such contributions at the time they were made to an irrevocable employee trust, but also at the time benefits were paid out of the trust to employees. Thus, under the Service's present position, no deduction for the provision of pensions to non-resident aliens would ever be allowed.

We submit that no U. S. social policy is involved in the provision of pensions to non-resident aliens. Thus, a tax deduction for contributions to pension plans covering non-resident aliens should not be conditional on compliance with United States rules governing the qualification of retirement plans. Furthermore, it is virtually impossible to have a plan maintained for non-resident aliens comply with both U. S. law and foreign law because of the complexities added to the U. S. pension laws by the Employee Retirement Income Security Act of 1974 (ERISA).

Consequently, legislation is necessary to amend Sections 162 and 404 of the Internal Revenue Code to permit the deduction of amounts paid or accrued to provide pension benefits for such non-resident alien employees. Such legislation would also resolve any doubt that such payments or proper accruals reduce the accumulated profits of foreign subsidiaries for purposes of computing the allowable foreign tax credit. Finally, a technical amendment to Section 679 of the Internal Revenue Code is necessary to insure that such pension trusts maintained primarily for the benefit of non-resident alien employees cannot inadvertently become subject to the grantor trust rules of the Code.

A detailed memorandum describing the foreign pension plan problem and potential legislative solutions is attached to our letter.

Respectfully submitted,

Herman F. Bruyner

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December 6, 1979

Re: Foreign Branch and Foreign Subsidiaries' Pension Plans

(1) Section 404(a)(5)

(a) Overview

The IRS has recently issued a private letter ruling in which it denied deductions to a U. S. employer operating through a foreign branch for contributions to a pension plan maintained for non-resident alien employees of the branch. The deduction was denied both at the time the contributions were made and at the time distributions were made to the employees. For the reasons stated below, this ruling position probably will hold up in the face of taxpayer challenges, in the absence of legislation. The IRS has also issued a Technical Advice holding that the pension reserves of a German corporation are not deductible in computing "earnings and profits" for foreign tax credit purposes. In this case, the Treasury Department has the apparent authority to change its position, but if the Treasury declines to exercise that authority, legislation will also be required to avoid costly litigation of this issue.

(b) General

Section 404 of the Internal Revenue Code provides that an employer may deduct contributions to deferred compensation plans only when actually paid, and then only if the rules of Sections 162 or 212 are met, as well as the specific rules of Section 404. Contributions to deferred compensation plans which are qualified under Section 401(a) of the Code generally are deductible, within statutory limits, in the year the contribution is made (or the prior year if made by the time for filing the employer's tax return, including extensions, for the prior year). In order to be qualified under Section 401(a), a plan of deferred compensation must comply with a myriad of rules, including the numerous requirements added to the Code by ERISA.

If a deferred compensation plan does not meet the requirements of Section 401(a) of the Code, the deductibility of contributions to it is governed by Section 404(a)(5). Under this Section, an employer is entitled to a deduction for contributions only in the year such contributions are includable in the income of employees participating in the plan, and then only if separate accounts are maintained under the plan for each participating employee. The present version of Section 404(a)(5) was added to the Code by the Tax Reform Act of 1969. Prior to that time, Section 404(a)(5) had provided that an employer was entitled to a deduction for contributions to a non-qualified plan only if the employees' rights to such contributions were nonforfeitable at the time of the contributions. Thus, the 1969 amendment of Section 404(a)(5) appears to have been an attempt to liberalize the law, as well as to bring it into concert with the rules of Section 83, which also was added to the Code by the Tax Reform Act of 1969. Under both Sections 404(a)(5) and 83, the employer is entitled to a deduction at the time the employee must recognize income from the contribution or transfer of property, which is generally at the time the employee has no substantial risk of forfeiture (i.e., becomes vested).

The limitation under Section 404(a)(5) that separate accounts must be maintained for each employee was apparently considered a necessary adjunct to the basic rules of that Section in order to insure that the calculation of the proper amount of the employer deduction would be possible. Without separate accounts for each employee, it would be extremely difficult, but perhaps not impossible, to determine the amount of employer contributions to be deducted.

One inconsistency in this logic, however, is that under Section 402(b), also as amended by the Tax Reform Act of 1969, an employee is taxable on contributions to a non-qualified plan at the time he becomes substantially vested, regardless of whether separate accounts are maintained. Further, the regulations under

Section 402(b) provide that if otherwise unknown, the amount of income taxable to the employee may be determined under any method utilizing recognized actuarial principles consistent with the provisions of the plan and the employer's funding method for the plan, or under the method set forth in the regulations. See Regs. §1.402(b)-1(a)(2). Presumably a similar method could be used to determine the portion of the taxable amount attributable to employer contributions, as opposed to earnings thereon. It should be noted that there is very little legislative history with respect to the issues of computing the employer's deduction or the employee's income in the absence of separate accounts.

There are two basic types of deferred compensation plans, defined benefit plans and defined contribution plans. Under a defined contribution plan, an employee generally is entitled to his share of employer contributions plus any trust earnings allocated to his account. Such plans traditionally maintain separate accounts for each employee; consequently, the separate account rule of Section 404(a)(5) presents no problem in this situation. However, defined benefit plans generally provide for a specific benefit to be paid to employees upon termination of employment, often based on a formula involving years of service and earnings (e.g., an annual benefit commencing at age 65 of 2% of the average earnings of the employee over his last five years of service multiplied by all of his years of service). Employer contributions under such a plan generally are actuarially determined on an aggregate basis taking into account assumed mortality, employee turnover, and interest assumptions. Typically, there is no individual allocation of contributions and trust earnings to covered employees, nor is such an allocation feasible. Thus, compliance with the separate account rule of Section 404(a)(5) is not feasible for such plans. This appears to be particularly true in light of the Service's Regulations interpreting the separate account rule of Section 404(a)(5) to require compliance with the "separate share" rule of Section 663(c) of the Code (dealing with the calculation of the net distributable income of a trust with multiple beneficiaries). Regs. §1.404(a)-12(b)(3). It would seem from a reading of the Regulations under Sections 404(a)(5) and 663(c) that even if it would be actuarially possible to determine at any time the value of an employee's interest in a trust under a non-qualified pension plan attributable solely to employer contributions, deductions generally would not be permissible.

An exception to the rules of Section 404(a)(5) was added by Section 1022(j) of ERISA. That Section provides that for taxable years commencing after December 31, 1973, the separate account rule will not be applicable with respect to non-resident aliens covered by a plan maintained by an employer engaged in a trade or business in a foreign country if the employer is required by the laws of the foreign country to make payments to its employees based on periods of service in the event of separation from service. While the separate account rule is eliminated, deductions are still postponed until employees become vested. The Section apparently was the result of a lobbying interest on behalf of one particular company.

One further exception to the rules of Section 404(a)(5) is that unfunded pensions paid directly to former employees are deductible by the employer when paid. The existence of separate accounts for each employee would be irrelevant in this situation since the employee is not taxed until actual payment is made, and then on the entire amount of the payment.

(2) Foreign Branch Pension Plans

(a) Recent Developments

In Private Letter Ruling 7904042, the IRS made clear that the rules of Section 404(a)(5) of the Code apply to plans maintained by a U. S. corporation for employees of a foreign branch. In that ruling, six U. S. subsidiaries of a U. S. parent corporation established defined benefit pension plans in seven different countries to cover solely non-resident aliens employed in their foreign branch offices. While these plans had met the qualification requirements of Section 401(a) prior to amendment by ERISA (except that foreign situs trusts were being used to fund the plans), the employer found it impossible to conform the plans to the requirements of ERISA due to conflicts with foreign pension laws.

The Service held that the deductibility of employer contributions to the plans was governed by Section 404(a)(5), not Section 162, so that deductions only would be allowed at the time the employees became substantially vested, and then only if separate accounts were maintained. Since separate accounts were not maintained, the employer would not be entitled to a deduction at the time of vesting. The Service went on to hold that furthermore, no deduction would be allowed at the time of distributions from the trust to the employees, since again, no separate accounts had been maintained, and thus it would be impossible to determine the portion of distributions which represent employer contributions as opposed to trust earnings.

It appears that most U. S. companies which operate abroad through branches and maintain deferred compensation plans for non-resident aliens do so through the vehicle of a non-qualified defined benefit plan. Therefore, on the basis of the rationale of Private Letter Ruling 7904024, such companies may well be facing an audit challenge to what has apparently been the common practice of deducting contributions to such plans in the year of the contributions.

(b) Potential Legislative Solutions

Since the Service appears to be interpreting the literal language of Section 404(a)(5) properly, a legislative solution probably will be necessary. Several possible alternative legislative routes are possible:

(i) Extend Section 1022(j) of ERISA (dealing with foreign plans mandated by foreign law) to cover all foreign plans. This is a logical extension of Section 1022(j), but unfortunately would probably not provide most employers with much relief since deductions would still have to be postponed until actual vesting. Also, Section 1022(j) only applies to non-resident aliens and foreign branch plans sometimes cover U. S. citizens working and hired abroad (as opposed to U. S. citizens sent abroad by the employer who are usually covered by the U. S. employer's plan).

(ii) Amend Section 404(a)(5) so as to exclude from its scope plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are non-resident aliens, with the basic qualified plan deduction rules of Section 404 then being made applicable (i.e., employer deduction at time of contributions). Title I of ERISA (the Labor Title) contains a similar exclusion from all of its provisions for such plans, and it might be argued that a logical extension of that exclusion should have been made in the qualified plan area. It can be argued that there is no reason to require an employer to comply with ERISA in order to immediately deduct contributions to plans maintained abroad primarily for non-resident aliens. This is particularly true where such plans meet all requirements of foreign pension laws.

(iii) Amend Section 404(a)(5) as described above, except provide that employer deductions will be governed by Section 162 instead of the general rules of Section 404 applicable to qualified plans. In this manner, a deduction could be obtained for unfunded plans maintained by foreign branches.

(3) Section 679

(a) General

An additional problem with respect to non-qualified plans of deferred compensation maintained by a foreign branch of a U. S. company and funded through a foreign situs trust is that the trust may be treated under Section 679 of the Code (as added by the Tax Reform Act of 1976) as a grantor trust if there is a U. S. beneficiary of the trust. A trust will have a U. S. beneficiary in a year if any part of the income or corpus of the trust may be paid to or accumulated for the benefit of a U. S. person (i.e., citizen or resident) during the year.

The effect of the employee trust being treated as a grantor trust during a year is that the employer will be taxable on all of the income of the trust for that year attributable to all employer contributions. Additionally, any undistributed net income of the trust as of the end of the year preceding the year in which there is a U. S. beneficiary will also be taxed to the employer.

Section 679(a)(1) specifically excludes from its purview foreign situs trusts which meet all of the requirements of Section 401(a) of the Code (other than the foreign location of the trust). Due to the absence of a similar exclusion for non-qualified plans, and the silence of the legislative history on this point, the Service has initially taken the position in an uncirculated first draft of regulations that Section 679 extends to foreign situs non-qualified employee trusts. If this position is finalized, it could have far reaching effects on such trusts. Even if only non-resident aliens were initially covered by a trust, it would become a grantor trust if one of the employees became a U. S. person in a year during which he had an interest in the trust. This would be the case even if he became a U. S. person later in a year during which he had previously received a total distribution of his interest in the trust. Similarly, benefits accumulated for or paid to a U. S. spouse of a non-resident alien employee would have the same effect on the trust.

An argument may be made that Section 679 does not extend to cover any employee trusts. Employee trusts, whether or not qualified, generally do not present the potential for tax avoidance which formed the basis for the passage of Section 679. Very briefly, Congress was seeking to eliminate the ability of a U. S. grantor to transfer investment assets to a foreign situs trust which had U. S. beneficiaries (generally his children or grandchildren) and thereby provide for the tax free accumulation of income for such beneficiaries. (Generally such trusts were established in tax haven countries so that not only was U. S. taxation avoided, but so was any taxation of the trust income until distribution to the U. S. beneficiaries). Bona fide employee pension plans established by a branch operation of a U. S. company which covers principally non-resident aliens are not customarily established for such a purpose.

(b) Possible Solution

A legislative solution should be sought as an adjunct to the legislation dealing with Section 404(a)(5) of the Code.

(4) Pension Plans of Foreign Subsidiaries

(a) General

Related questions regarding the proper treatment of amounts paid or accrued with respect to pension plans maintained by and covering the employees of foreign subsidiaries also have been raised recently. Of particular concern is the position taken by the National Office of the IRS in Technical Advice Request LTR 7839005, which held that the pension reserves of a German corporation are not deductible in computing "earnings and profits" for purposes of the allowable foreign tax credit. For purposes of this discussion it will be assumed that the annual pension contribution is determined by actuarial methods and would be a proper accrual under regulations Section 1.446-3(c). Under German law, the accrual represents a legal liability and restricts the payment of dividends. Finally, the accrual is deductible for German income tax purposes.

In LTR 7839005, the IRS took the position that an accrued pension liability did not reduce the "earnings and profits" of a

German Gmbh because such amounts would not have been deductible under Code Section 404(a). The stated basis for this determination was that no amounts were "paid" rather than the fact that the pension reserve arrangement did not constitute a qualified plan under Subchapters D and F of the Code. If the issue involves only the question of accrual versus payment, then only certain foreign countries, including Germany, are involved. However, if the rationale of LTR 7904042 were applied to foreign corporations, the issue could become the question of deductibility under Section 404(a) and payments made to the pension plans of virtually every foreign subsidiary could be disallowed. In either event, the Internal Revenue Service appears to be imposing inappropriate standards on the deductibility of such amounts in computing the accumulated profits of a foreign corporation for purposes of Section 902 of the Code.

Although the same issue can arise in other contexts under U.S. law (i.e., the computation of subpart F income or the gain on the sale or exchange of stock taxable under Section 1248 as ordinary income), the most common situation involves the determination under Section 902 of the amount of foreign income taxes attributable to an actual dividend received by a U.S. corporate shareholder of a foreign corporation. In order to avoid double taxation, the United States allows a foreign tax credit for the income taxes paid by a foreign corporation with respect to a dividend received by a domestic corporation owning a requisite percentage of the voting stock of the foreign corporation. This "deemed paid" credit was introduced into the Code by the Revenue Act of 1918. The mechanics of the computation involve deriving a ratio of the amount of the dividend paid to the "accumulated profits" of a foreign corporation for that year. The foreign income tax paid by the foreign corporation is multiplied by this ratio to determine the amount of tax attributable to the dividend.

The amount of the accumulated profits of a foreign corporation is, therefore, critical in determining the amount of foreign taxes which are "deemed paid" with respect to a dividend distribution. Since the foreign taxes paid were computed under foreign law, any increase in the foreign corporation's accumulated profits determined under U.S. standards, reduces the amount of foreign income tax deemed to be paid with respect to a particular dividend distribution. Thus, the "disallowance" of a deduction increases the foreign corporation's accumulated profits and reduces the amount of foreign income taxes deemed paid under Section 902.

"Accumulated profits" is statutorily defined only as "gains, profits, and income". Prior to 1962, accumulated profits in the denominator of the above described formula included the foreign income tax. American Chicle Co. v. United States, 316 U.S. 450 (1942). The Revenue Act of 1962 amended the formula for dividends from foreign corporations, other than "less developed country corporations", by providing that the accumulated profits used in the denominator of the ratio fraction are reduced by the foreign income taxes. The Tax Reform Act of 1976 required a similar adjustment to be made with respect to the accumulated profits of all foreign corporations.

Despite the obvious significance of the mechanics of determining the accumulated profits of a foreign corporation, there have been few administrative pronouncements and little case law dealing with the specific adjustments to be made to a foreign corporation's "book income". On the other hand, there are an excessive number of generalized rules regarding the computation of a foreign corporation's income and the appropriate rate for translating foreign currencies into U.S. dollars. In many cases, more than one of these generalized rules may apply to a single distribution from a foreign corporation. The policy reasons for the differences in the required calculations are not readily apparent. Moreover, the use of the term "earnings and profits" in Section 964, which is limited by its terms to the subpart F provisions, coupled with the subsequent administrative adoption of that term in the regulations under Section 902 has created unfortunate confusion in this area. The various required calculations include:

(i) For taxable years beginning prior to December 31, 1962, the applicable rules are presumably those set forth in Rev. Rul. 63-6, 1963-1 C.B. 182 and I.T. 2676, XII-1 C.B. 48 (1933), despite the fact that Rev. Rul. 63-6 was declared obsolete by

Rev. Rul. 72-281, 1972-2 C.B. 654 and I.T. 2676 was declared obsolete in Rev. Rul. 70-293, 1970-1 C.B. 282.

(ii) For taxable years beginning after December 31, 1962 with respect to which the foreign corporation had no subpart F income reportable under Section 951 of the Code and was not included in a minimum distribution election by a United States shareholder, where the taxpayer has made no election under Regulation Section 1.902-1(g), there appears to be no published authority regarding the appropriate calculation of accumulated profits.

(iii) For taxable years beginning after December 31, 1962 where the foreign corporation has no subpart F income reportable under Section 951 and was not included in a minimum distribution election by United States shareholder, but where a timely election has been made under Regulation Section 1.902-1(g), accumulated profits are computed under Regulation Section 1.964-1(a) through (c). This requires the foreign corporation's profit and loss statement to be adjusted to reflect U.S. accounting standards and to incorporate certain specified U.S. tax accounting standards (which include a requirement that the method of accounting "reflect the provisions of Section 446 and the regulations thereunder" but makes no reference to pension plans).

(iv) For taxable years beginning after December 31, 1962 and before December 31, 1975, where the foreign corporation had been included in a minimum distribution election, accumulated profits are computed under Regulation Section 1.964-1(a) through (e) whether or not a minimum distribution was required for the taxable year. Rev. Rul. 75-111, 1975-1 C.B. 185. The additional steps required by sections (d) and (e) of the Section 1.964-1 regulations result in the use of a "net worth" method of calculating annual income.

(v) For taxable years beginning after December 31, 1962, if the United States shareholder reports any of the income of the foreign corporation as subpart F income under Section 951 of the Code, accumulated profits are apparently computed under Regulations Section 1.964-1(a) through (e) (the net worth method).

Thus, for any taxable year in which a foreign corporation had subpart F income, or in which it was included in a minimum distribution election, its accumulated profits must be computed using the net worth method. The "deductibility" of a particular item, including the accrual of a pension liability, becomes immaterial under a net worth or "balance sheet" method of calculating income. However, for all other years a foreign corporation must use some form of the profit and loss method and deductibility is an issue. Allowing the pension accrual to reduce earnings under the net worth method, but disallowing the deduction under the profit and loss method, appears to be both inconsistent and illogical.

(b) Arguments Against Current IRS Position

There are many different, administratively derived rules for computing "accumulated profits" applicable to various years.

Different "profit" figures can be derived depending in part on various elections made by United States shareholders and in part on the types of income generated by the foreign subsidiary. In applying these multiple rules it appears that the IRS may have lost its perspective in defining "accumulated profits" for purposes of Section 902. The use of the term "earnings and profits" rather than "accumulated profits" for purposes of Section 902 may be indicative of the confusion in this area and may partially explain the holding in LTR 7839005. The two terms are not the same and the standards to be applied in computing the amounts thereof need not be identical. Furthermore, earnings and profits for purposes of Section 964(a) and the regulations thereunder may be different than earnings and profits under other Code provisions.

The IRS has held that accumulated profits of a foreign corporation are "essentially similar" to earnings and profits. I.T. 2676, supra, and Rev. Rul. 63-6, supra. There is no requirement that they be identical. Given the purpose of Section 902 of the Code, the calculation of accumulated profits should reflect the legal and practical considerations involved in being a foreign legal entity engaged in business in a foreign jurisdiction. At one time, the IRS said:

> "It is important in establishing the amount of accumulated profits that it be based as a fundamental principle upon all income of the foreign corporation available for disbution to its shareholders, whether such profits be taxable by the foreign country or not." I.T. 2676, supra, at 50.

The accrued pension liability of a German corporation is not available for distribution to shareholders.

It should be obvious that any differences between foreign pension schemes and those which have been legislatively developed by the United States should be taken into account in computing the accumulated profits of a foreign corporation. Different social policy objectives and different ways of achieving those goals should be recognized. It is clearly unreasonable to require foreign corporations to meet the specific tests for deductibility under Section 404(a) of the Code with respect to the computation of "accumulated profits" for purposes of Section 902.

Moreover, it should be noted in connection with earnings and profits computed under the regulations under Section 964(a), that the mechanics of those regulations, which start with "the books of account regularly maintained by the corporation", do not require the disallowance of any amounts other than those set forth in Regulations Sections 1.964-1(b) and (c). The only test under those sections which pension accruals would be required to meet are the accounting standards under Section 446 of the Code.

Even if the IRS were to insist that accumulated profits for purposes of Section 902, and earnings and profits under Section 964(a), must be computed in the same manner as earnings and profits under other Code provisions, the accrued pension liabilities should still be allowed as deductions. Earnings and profits should measure the ability of a corporation to make distributions which are properly to be recorded as returns on its shareholders' investment, rather than the return of their capital. Thus, accumulated profits, like earnings and profits, should reflect increases in the net worth of the corporation in excess of the capital contributed. Luckman v. Commissioner, 418 F.2d 381, 383 (7th Cir., 1970).

The concept of earnings and profits parallels the concepts embodied in taxable income, but statutory deductibility is not necessarily applicable to the computation of earnings and profits in a United States context, and certainly should not be applied in computing the accumulated profits or the Section 964(a) earnings and profits of a foreign corporation. The pension accruals create a legal liability and have an economic impact which reduces the corporation's ability to pay dividends. Jacob M. Kaplan, 43 T.C. 580 (1965). The disallowance of pension liabilities under Section 404(a) was not, under either the statutory language or the legislative history, intended to carry over into the computation of earnings and profits. See Divine v. Commissioner, 500 F.2d 1041 (2d Cir. 1974) and Luckman v. Commissioner, supra.

Under Regulation Section 1.446-1(c)(1)(ii) an expense accrues when "all events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." If the accrued pension liability meets this "all events" test, such amounts should reduce accumulated profits and Section 964(a) earnings and profits. Rev. Rul. 75-515, 1975-2 C.B. 117, states:

> "In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law."

In the case of a foreign corporation that concept should obviously include the requirements of foreign law. Where accrued German pension liabilities are proper accruals under generally accepted accounting principles and where such amounts are proper deductions for foreign income tax purposes, they should be deductible in computing accumulated profits for purposes of Section 902.

(c) Potential Solutions

(i) Administrative Solution: The Treasury Department appears to have ample grounds to reverse the position taken by the IRS in LTR 7839005, and to permit the deduction of pension accruals as well as payments to foreign pension plans in computing the accumulated profits or the Section 964(a) earnings and profits of foreign corporations.

(ii) Legislative Solution: The proposed amendment to Section 404(a)(5), described in Section 2(b)(iii) above, could be phrased in terms of "amounts paid or accrued" to plans maintained outside the United States which should resolve this issue for foreign corporations as well as for foreign branches of domestic corporations.

LEE, TOOMEY & KENT

VALLEY FORGE CONSULTING CORPORATION

November 28, 1979

Mr. Michael Stern,
Staff Director
Committee of Finance
Room 2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: S. 1089

Dear Mr. Stern:

As a firm that administers to several hundred Pension and Profit Sharing Plans which have from one to twenty-five participants each, we would like to make the following comments:

Comment #1: Proper administration of a Defined Contribution Pension Plan requires certain procedures whether or not the result of these procedures must be reported to the I.R.S. Once these procedures are completed it is only a minor additional step to complete the related I.R.S. Forms.

Comment #2: The concept of "long form" filing every three years combined with "short form" filing during the intermediate two years will provide no practical reduction of Pension reporting requirements. It is much easier to deal with the same form year after year than to switch to one form to another two out of every three years.

Comment #3: Recently inacted Department of Labor requirements which set forth the content, style, and format of Summary Annual Reports require a report which contains an abundance of irrelevant information. A participant wants to know

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what is going on with his account, not what is going on with the total of all accounts. We contend that disclosure to an individual participant of the following information should at least be an accepted alternative to these Department of Labor S.A.R. regulations:

1. Account balance at the beginning of the year.
2. Account balance adjusted for investment performance.
3. Contributions and forfeitures allocated.
4. Account balance at the end of the year.
5. Portion of account balance that is vested.

A disclosure statement of this type is particulary appropriate where individual participants are allowed to direct the investment of their individual accounts and where investment performance in individual accounts is not proportional to investment performance by the entire Trust.

Comment #4: Annual reports to plan participants which are prepared in accordance with requirements referenced in Comment #3 above, often results in plan participants receiving information regarding other plan participants which they should have no legal right to obtain.

For example: Consider the following situation where there are only two participants in a 10% Money Purchase Pension Plan. One participant can easily compute the salary of the other participant by subtracting his or her individual contribution from the total contribution and dividing the result by 10%.

Must an owner of a small business disclose to his employees his compensation and his profits? Isn't this information to be considered private? Doesn't disclosure in accordance with the style suggested in Comment #3, provide all necessary information to individual participants and also protect the rights of other participants?

Yours truly,

Jack C. Holland,
President

JCH:sw

STATEMENT
OF THE
AMERICAN SOCIETY OF PENSION ACTUARIES
TO THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND
EMPLOYEE FRINGE BENEFITS
SENATE FINANCE COMMITTEE
DECEMBER 3, 1979

The American Society of Pension Actuaries is a national professional society whose 1800 members provide actuarial, consulting and administrative services to approximately 25 percent of the qualified retirement plans in the United States.

We have previously submitted comments on S.209 and S.1089 to the Senate Committee on Labor and Human Resources, and these comments are attached.

At this time, we should like to discuss a matter that is causing a great deal of concern in the actuarial community. This problem relates to the IRS position on providing automatic adjustments to the 415 maximum limitation in a defined benefit plan and funding for increases in the 415 limitation which may be reasonably anticipated.

Section 415(b)(1) of the Internal Revenue Code provides that the benefits with respect to a participant in a defined benefit plan cannot exceed the lesser of $75,000 or 100% of the participant's average compensation for his high three years. Section 415(d) of the Code provides that the Secretary or his delegate shall annually adjust the $75,000 amount for increases in the cost of living in accordance with regulations prescribed by the Secretary of the Treasury. To date, no regulations have been issued even though 5 years have passed since ERISA was enacted. However, the Secretary has annually adjusted the $75,000 limit of section 415(b)(1) to allow for increases that have occurred in the cost of living. Section 5.02 of Revenue Ruling 75-481 provides that until regulations are issued, a plan may not provide for automatic adjustments of the dollar limitations set forth in Sections 415(b)(1)(A) (defined benefit plans) and 415(c)(1)(A) (defined contribution plans). However, Information Release 1681, dated November 21, 1976, stated that defined contribution plans would be allowed to incorporate by reference changes to the maximum dollar limitation.

Based on Revenue Ruling 75-481, IRS has consistently refused to qualify defined benefit plans which contained an automatic adjustment of the 415(b)(1) dollar limitation. Several taxpayers have litigated this issue, and the Tax Court has recently ruled in three cases in contradiction of Revenue Ruling 75-481 that defined benefit plans may contain language automatically implementing cost-of-living increases in the $75,000 maximum benefit (now $98,100).

The three Tax Court cases were:

Consultants & Actuaries Inc. vs. Commissioner of Internal Revenue (Docket No. 2551-79"R") (Matter of Stanley Carson, M.D.)

Consultants & Actuaries Inc. vs. Commissioner of Internal Revenue (Docket No. 5520—79"R") (Matter of MDOR)

Consultants & Actuaries Inc. vs. Commissioner of Internal Revenue (Docket No. 5521-79"R") (Matter of Gregory J. Szal, M.D.)

The Tax Court entered decisions in favor of the petitioners in the cases cited above after the Internal Revenue Service agreed with the counsel for the taxpayers to enter said decisions. In spite of this, no action has been taken by IRS to withdraw Revenue Ruling 75-481. It is our understanding that the District Offices of the IRS are still refusing to qualify defined benefit plans which contain language which automatically increase the dollar maximums of IRC 415(b)(1). Of course, it is much more inconvenient and costly to adjust the maximum benefit each year through plan amendments, than to do so through the vehicle of an automatic adjustment clause.

More serious than the question of automatic adjustments is the IRS position which prohibits funding for benefits beyond the current 415(b)(1) limitation. First, since a plan sponsor cannot claim a deduction for funding of benefits not provided by the plan, the sponsor would be effectively prevented from funding for future benefit increases unless the plan included an automatic adjustment clause. Secondly, it is the Internal Revenue Service position that you cannot consider such benefit projections for funding purposes even if the plan provides for automatic increases.

We believe the position of the IRS in this matter is contrary to the intent of Congress in enacting Section 412(c)(3) of the Internal Revenue Code which provides:

> "ACTUARIAL ASSUMPTIONS MUST BE REASONABLE.—For purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

The position of the IRS places the actuary in the very difficult position of not being able to consider future benefit projections in calculating the current funding requirements, when, in his or her best estimate, such future benefit projections should be taken into account. If the actuary is prohibited from anticipating future increases in the 415 benefit limits, each increase in projected benefits which results from a 415 adjustment would have to be funded over shorter and shorter periods of time, resulting in a ballooning of contribution levels at the end of a participant's period of service. A normal cost pattern of this type would make it more difficult for sponsors to comply with the minimum funding requirements than would otherwise be the case and might even jeopardize the financial stability of the plan.

We believe a workable solution to the problem we have described here would be to develop language in the legislative history of S.209 which would make it clear that it was not the intention of Congress, in enacting ERISA, to preclude a plan from providing automatic adjustments to the 415(b)(1) limitation. Furthermore, the language in this legislative history should make it clear that it was the intention of Congress to permit deductions for funding of benefit projections in excess of the current 415(b)(1) limitation when such benefit projections may be reasonably anticipated in the actuary's best judgment.

In summary, we f el that:

1) The current position of the IRS with respect to automatic adjustment provisions, and funding for future benefit projections which the actuary in his or her best judgment can reasonably anticipate, seriously inhibits the implementation of Section 412(c)(3) of the Internal Revenue Code.

2) Appropriate language in the legislative history on S.209 as to the intent of Congress in this area should resolve this problem.

The American Society of Pension Actuaries would be happy to work with the staff of this Subcommittee with respect to this matter.

STATEMENT
OF
BRIAN W. KRUSE PRESIDENT, AND WILLIAM C. SPENCER
CHAIRMAN GOVERNMENT AFFAIRS COMMITTEE,
AMERICAN SOCIETY OF PENSION ACTUARIES
BEFORE THE SENATE
COMMITTEE ON HUMAN RESOURCES
FEBRUARY 8, 1979

The American Society of Pension Actuaries is a national professional society consisting exclusively of pension plan actuaries and consultants. Our 1700 members provide actuarial, consulting and administrative services to approximately 25 percent of the qualified retirement plans in the United States.

Our Society is pleased to be able to offer comments on S. 209, a bill which if enacted will make many significant improvements in the private pension system. We heartily endorse one of the express purposes of the ERISA Improvements Act of 1979 that it is in the national interest to provide for the present and future needs for retirement income by "strengthening and improving private employee pension benefit plans."

That the system needs strengthening and improving is shown by statistics which indicate that the private pension system has not grown in proportion to the growth in the labor force since the enactment of ERISA. Bureau of Labor Statistics figures reveal that, as of October 1974, the total non-agricultural workforce (excluding government personnel) was 64.8 million. The comparable figure for October 1978 was 71.7 million. The percentage growth over this four-year period was approximately 10.7 percent.

On the other hand, PBGC statistics with regard to defined benefit pension plans demonstrate that this part of the private pension system has grown very little since 1974.

The latest PBGC Annual Report, issued for the fiscal year ending September 30, 1977, indicated that approximately 33 million participants were covered under the Title IV insurance program -- roughly the same number as was originally covered under Title IV when ERISA was enacted. This Annual Report stated that while there were a large number of terminations since enactment of ERISA (about 18,000 as of September 1977), the bulk of them involved small plans and that, in fact, perhaps 650,000 more people were covered by the termination insurance program in 1977 than when ERISA was passed. Such statistics suggest that there has been about a 2 percent growth in participant coverage under Title IV defined benefit plans since ERISA was passed as compared with over a 10 percent increase in the labor force.

Unfortunately we are unable to obtain accurate post-ERISA statistics on total pension coverage. We believe, however, that the statistics cited represent the plans which provide the vast majority of Americans with the retirement income they receive from the private pension system. Furthermore, defined benefit plans are the only type of retirement plan under which it is possible to design a retirement benefit that bears a specific relationship to the employee's working compensation. While not all employees are best served by defined benefit plans, it is possible to create equity with a defined benefit plan whereas it is not always possible with a defined contribution plan.

Thus, as the above figures certainly indicate prompt action must be taken to stimulate the growth of the private pension system. In this regard we would like to express our views on various aspects of the proposed legislation and to offer the resources of our Society for any future needs of your Committee including the study regarding mandatory cost-of-living increase provisions in private retirement plans.

DISCLOSURE OF PARTICIPANT'S
STATUS UNDER PENSION PLAN

ERISA requires a plan administrator to provide a participant upon request, based on the latest available information, a statement of the total benefits accrued and the proportion of nonforfeitable benefits accrued. Participants may request benefit accrual information only once during any twelve-month period. Act Section 111 will permit a plan administrator to provide an annual statement of benefits accrued which will satisfy the ERISA requirements. This will serve to reduce the administrative costs of providing information randomly to participants throughout a twelve-month period.

There is, however, one area of concern relating to the requirement that the annual benefit accrual statement be based "on the latest available information." While it was probably intended, our Society urges the Committee to clarify the provision to permit a plan administrator to make reasonable approximations as to the salary and service history of a participant when preparing for all participants these annual benefit accrual statements. Our Society believes this is necessary, not because employers do not maintain records sufficient to determine benefits due but rather that these records are not easily accessible on an annual basis. Typically, the information readily available is the participant's current salary, date of employment and date of birth. From this information, a statement of the approximate benefits accrued may be prepared. Developing a participant's prior service history and, in the case of salary related plans, determining a period of prior average salary, is costly if it is necessary to annually produce this information to prepare statements for all participants in a plan. It would appear prudent, however, to require that the plan administrator reflect on the statement the basis of the approximation used for determining the benefit accrual.

It is our feeling that plan administrators will be more inclined to produce a statement of benefits accrued for all participants on an annual basis if it is clear that reasonable approximations may be utilized.

ELIMINATION OF SUMMARY ANNUAL REPORT

We emphatically support the proposal that would eliminate the requirement for distribution of copies of a summary annual report to each plan participant each year. Experience of practitioners has been that few employees who are participants in retirement plans are interested in the information contained in the summary annual report and that the expense of duplicating the form and distributing it to participants is almost totally unnecessary.

IMPROVEMENT OF REPORTING REQUIREMENTS

Our Society supports any effort made to improve the current reporting requirements. We are aware, that significant progress has been made to eliminate some of the duplicative and unnecessary reporting. Your Committee by adopting Act Section 114 has made a helpful first step toward the ultimate elimination of all unnecessary reporting requirements.

OPINIONS OF ACTUARIES AND ACCOUNTANTS

Our Society strongly supports the provisions of Act Section 115 relating to the reliance by the enrolled actuary or accountant in the other's work product. This area of the law has resulted in undue expense to retirement plans. Moreover, since there are some accounting firms that employ actuaries, there are documented cases where, unsolicited, actuaries who are members of accounting firms performing audits of retirement plans, reviewed the work of the enrolled actuary retained by the plan and questioned the methods and assumptions used by the plan's enrolled actuary. This review by the accounting firm or its actuary creates a potential conflict of interest in addition tó substantial unnecessary cost.

PARTICIPATION ON A PLAN YEAR BASIS

At the present time a plan must calculate an employee's service for participation on the basis of the employment year rather than the plan year which may be used for vesting and benefit accrual purposes. The employer, however, for the purposes of participation may switch to a plan year provided the employee receives credit for two years of service if he completes the requisite hours of service during the initial employment and plan years. In other words, the switch to the plan year creates an overlapping computation period.

The required overlapping period is troublesome to employers because they are unable to understand why an employee must be given two years of service for what may be as little as 13 months of employment. It has been the experience of some members of our Society that employers are discouraged from adopting the option of providing 100 percent vesting with a three year participation requirement because of the required overlapping period. Moreover, many plan administrators have found that participants are confused over the different computation periods, i.e., the employment year, plan year and overlapping year. Furthermore, the current ERISA participation requirements have forced employers to utilize two entry dates for participation purposes if they wish to require 1000 hours of service during the initial computation period. Permitting a plan year computation period would enable employers to bring employees into the plan once a year and still require 1000 hours of service.

For these reasons our Society would support the provision which permits participation on a plan year basis except the trade-off under the bill, in our view, is unreasonable. Under the bill, the employer who utilizes a plan year computation period for participation must give credit for all the employee's service including years of service when the employee fails to complete 1000 hours of service. Thus, the employer who wishes to maintain all records on a plan year basis, in order to avoid extra recordkeeping and reporting and disclosure, along with the confusion caused by different computation periods, must credit service for vesting and benefit accrual in situations where other employees are not required to receive credit.

Generally, it is unlikely that permitting plan year participation creates a situation where an employee would not enter a plan in advance of the current ERISA requirements. Unless there are specific abuses, for which rules may be designed, our Society believes that an employer should be permitted to use a plan year computation period for all purposes.

SURVIVOR PROTECTION

Act Section 127 would require plans to provide death benefits for all participants with 10 or more years of vested service. It is our view that the impact of this provision with respect to defined contribution plans (e.g., money-purchase plan, profit-sharing plan, etc.) is the repeal of ERISA §203(a)(3)(A), relating to forfeiture on death of the participant, in the case of a participant who completes 10 years of service. If this is the only impact with respect to defined contribution plans we would support this change. Our members generally find that defined contribution plans provide 100% vesting on death of the participant.

In our view, however, the primary purpose of a defined benefit pension plan is to provide retirement benefits, rather than death benefits. While we sympathize with the motives behind such a proposal, we would like to point out that, in most cases, the death benefit available under such a provision will be relatively small. On the other hand, there would be significant complexities involved in providing such a benefit under a defined benefit pension plan and in explaining it to participants. Consequently, our Society is of the opinion that an insurance program outside the scope of the pension plan would be a more appropriate vehicle for providing death benefits.

56-943 O - 80 - pt.2 - 16

We suggest, therefore, that this proposal be abandoned or, at a minimum, that employers who provide a death benefit outside the pension plan that would be at least equivalent to that which would be required under Act Section 127 be relieved of the obligation to provide the benefit under the defined benefit pension plan.

FUNDING TO TAKE ACCOUNT OF FUTURE AMENDMENTS

Act Section 131 permits an actuary to take into account all provisions of the plan, including provisions which have not yet affected any participant's entitlement or accrual of benefits. This section of the bill is consistent with the actuary's other ERISA responsibilities to use reasonable actuarial methods and assumptions which in combination offer the actuary's best estimate of anticipated experience under the plan. It is not necessary, however, to require the actuary, as the bill does for plan years beginning after December 31, 1980, to take into account plan provisions which are not at that time in effect. An actuary would be required as mandated by ERISA to take this into account in the performance of his duties to arrive at actuarial assumptions which represent his best estimate.

We feel that the projection of future benefits for the purpose of establishing the minimum funding requirements under a plan is an integral part of the actuary's selection of assumptions which are used to determine plan costs and, as a result, there should be no need to mandate that provisions be taken into account which have not yet affected the entitlements of plan participants.

ADVISORY COUNCIL

Act Section 151 would require at least one of the members of the Labor Department Advisory Council to represent employers maintaining small plans. Our Society believes this is an excellent provision. We suggest, however, that a similar requirement be imposed with respect to the PBGC Advisory Committee. We think this would be particularly appropriate in light of the fact that the bulk of terminations filed with PBGC have involved small plans.

IMPACT OF INFLATION ON RETIREMENT BENEFITS

We would caution against any legal requirement that private retirement plans automatically respond to increases in the cost-of-living. The provision of automatic cost-of-living increases in private pension plans make two dangerous presumptions:

(1) That the private sponsored retirement plan is a never-ending entity that will always have a source of contributions; and

(2) That there is a relationship between the performance of the investments made by a retirement plan and the cost-of-living.

As a matter of fact, the retirement systems of private companies cannot be expected to continue indefinitely into the future, in view of industrial, technological and economic changes in society and a requirement that would place future unknown liabilities on private concerns would almost certainly act as a deterrent to the adoption of such plans. Experience of the last few years has demonstrated that the market value of equity investments, which are a primary investment of retirement plans, can be severely depressed at the same time that inflation is extreme. It is still too soon to know whether inflation will be brought under control. Therefore, to mandate inflation adjustments in defined benefit pension plans would negate the effect of the tax incentives the bill provides for adopting new plans because adopting plans are voluntary employer decisions for the most part.

If the Committee decides to study an automatic cost-of-living provision our Society would like to offer its resources to assist the Committee.

CERTAIN EMPLOYEE CONTRIBUTIONS

QUALIFIED RETIREMENT PLANS

The United States private pension system has been behind the systems of other countries for many years because deductions of employee contributions to such plans have not been allowed. For this reason, we strongly support Act

Section 203 which would permit a deduction by the employee of contributions made to qualified plans. Our Society believes that such deduction would provide a strong incentive to establish and maintain tax qualified retirement plans. Furthermore, we support elimination of the phase-out adopted in section 303 of S. 3017. Generally we agree that some provision, such as the discrimination standard, must exist in order to insure that the benefits of the tax deduction are spread among a cross-section of employees. Our Society, however, has not had an adequate opportunity to study all the details of the proposed discrimination standard in this section of the bill. We will give this further consideration and possibly present additional testimony at a later date. Finally, we believe the restriction with regard to plans which require mandatory contributions is unjustified. The most prevalent and certainly the most significant reason for requiring employee contributions to a qualified plan is to enable employees to accrue more adequate retirement benefits than would be possible if the employer were the sole source of funding for the plan benefits. Undoubtedly, there are cases where the requirement for employee contributions tend to discourage plan participation by younger, lower paid employees, but these cases clearly are in the minority. Employers will differ widely in financial abilities to fund an adequate pension plan and in philosophies regarding the possible methods of funding the plan. It is our view that Congress should not discriminate against plans which provide for mandatory employee contributions but should continue to allow the parties to decide which type of plan best suits their needs.

CREDIT FOR THE ESTABLISHMENT OF
QUALIFIED PLANS BY SMALL EMPLOYERS

Offering a tax credit for small employers adopting new retirement plans is a necessary first step in providing incentives that will help restore the momentum that was slowed by the enactment of ERISA for adoption of new plans.

The credit differs from last year because it has certain limitations which are intended to target the credit to benefit the small employers who need the tax subsidy. The limitations in Act Section 204, however, are unrealistic and create difficult administrative problems. For example, the limitation on profits, whereby an employer with profits in excess of $50,000 may not claim the credit, is much to low. Furthermore, the profits of a business may be easily manipulated in order to achieve a profit figure. For this reason, the limitation would require new restrictions and tests which will serve to frustrate the intent of the provision to encourage employers to adopt plans by reducing costs and frustrations. On these grounds our Society recommends that the Committee abandon any limitations, or if the Committee believes a limitation is necessary, it should relate to easily understood tests such as the number of employees.

Our Society, however, continues to be concerned over the alarming reduction in the number of new defined benefit retirement plans adopted since the enactment of ERISA. A number of factors have contributed to this reduction in defined benefit plans as a result of ERISA. Among the factors are the following: (a) the contingent liability exposure of an employer who, because of business necessity, might find that it must terminate a plan, (b) the commitment to fund the plan, (c) the expense attendant to the administration of this type of plan, and (d) required premium payments to the Pension Benefit Guaranty Corporation.

With this in mind, there is a need for special incentives for employers to adopt defined benefit plans, that will help to offset the increased expenses of their operation. In this regard, we would recommend the following:

1. An additional tax credit equal to 20% of the credit provided under Act Section 204 could be extended to employers who adopt new defined benefit plans, as opposed to defined contribution plans;

2. Premiums paid to the Pension Benefit Guaranty Corporation could be structured in such a way that each plan pays a flat annual charge and an additional annual charge based on a percentage of the amount by which the present value of vested benefits exceed plan assets. This

would cause those plans which have significant unfunded vested liabilities to bear a greater and more equitable proportion of the insurance risk which in fact is created by such plans;

3. Defined benefit plans should be exempt from the requirements of IRS Revenue Procedures 75-49 and 76-1. Such plans should be permitted to qualify under the Internal Revenue Code with the election of any of the three statutory vesting schedules contained in the Code and without being subjected to the "key employee test" or the "turnover test". The most objectionable element of these IRS revenue procedures is the apparent requirement that total years of service with the employer be counted for purposes of "4-40" vesting, rather than merely the employee's length of service following adoption of the plan. The requirement to count years of pre-plan service can cause a defined benefit plan to have a significant unfunded vested liability on its effective date and can act as a strong deterrent to the adoption of defined benefit plans.

SPECIAL MASTER OR PROTYPE PLANS

We can see no reason for legislation which would further increase the profusion of "special master or prototype plans". There are already provisions in the law and regulations for (a) prototype plans adopted by financial institutions, which can be joined by individuals and employers wishing to join them, (b) "pattern" plans which can be submitted to IRS offices by certain practitioners for approval as to form and, (c) so-called "multiple-employer plans" which can be joined by unaffiliated participating employers wishing to participate in the benefits offered by group participation in such plans. While such master or prototype plans may result in some savings to a participating plan sponsor, they encourage persons who are not qualified to advise sponsors on the long-term impact of retirement plan decisions. In our experience, this has resulted in many plan sponsors adopting retirement plans which are inadvisable in relation to the sponsor's circumstances and making inappropriate investments as a result of the misconception that the savings associated with a "form" plan will out-weigh the consequences of poor investment performance. The complexity of the private retirement plan system as a result of over fifty (50) years of law, the substantial number of options available to plan sponsors, actuarial considerations and ERISA, have created a situation where the greatest need is for a group of professional pension practitioners who are trained in the subject and ethically or legally required to act in conformance with governmental requirements and the public's best interests.

LEGAL STATUS FOR PENSION CONSULTANTS

With the creation of the status of enrolled actuary in ERISA, Congress first recognized pension plan practitioners as professionals. Under ERISA, individuals who are able to pass certain tests and have a reasonable period of responsible pension actuarial experience are "licensed" by the federal government to certify to retirement plan costs. More recently, on January 24, 1979, a revision of the regulations governing the practice requirements before the Internal Revenue Service permit an enrolled actuary to practice before the Internal Revenue Service on issues involving employee benefit plans.

Currently, there are approximately 2,800 actuaries who have been enrolled by the Joint Board for the Enrollment of Actuaries. Since this is the sole source of federally sanctioned "expertise" in the pension field, the public tends to regard enrolled actuaries as the only pension professionals qualified to give advice in retirement plan matters. Actually, only a small percentage of the work required in connection with the operation of qualified private retirement plans require the services of an enrolled actuary. According to the Internal Revenue Service (IR-1950), only 24% of the plans qualified during the period January-September, 1977, were defined benefit plans while the balance were defined contributions plans, which do not require the services of an enrolled actuary under ERISA. The requirements of most defined contribution plans currently in effect are being met by professional pension plan consultants, who are neither recognized under ERISA, nor regulated, permitted to practice before the Internal Revenue Service or required to meet ethical or educational standards.

Consultants most frequently assist the employer in selecting the type of retirement plan, the design of the specific benefit formula and the calculation of its effect. In addition, consultants work with attorneys in reducing the plan to writing and meeting qualification standards, preparing explanations and the Summary Plan Description, administering the plan, including allocation of a participant's account balances under defined contribution plans and communication of accrued and vested benefit information to participants on an annual basis, completing reports required by governmental agencies, recommending the plan's funding method and providing assistance to the employer during audit. Since many retirement plans retain the services of both a consultant and an actuary, most pension consulting firms employ both consultants and actuaries. In contrast to the 2,600 enrolled actuaries, there are approximately 10,000 to 15,000 pension consultants providing services to labor and industry who are neither recognized by the law, required to meet uniform standards, nor permitted to practice before the Internal Revenue Service on issues involving employee benefit plans.

Recommendation

The solution to this problem is to create a form of legal status for qualified pension consultants:

1. Through legislation - Congress could set rules establishing practice requirements for qualified pension consultants. ASPA would be pleased to offer specific recommendations for enrollment, methods to determine qualification and rules of conduct.

2. By regulation - Internal Revenue Service could create a status similar to that enjoyed by enrolled actuaries, which would permit limited practice before the Internal Revenue Service for qualified pension consultants.

The American Society of Pension Actuaries, which began its Certified Pension Consultants program in 1976, and the International Foundation of Employee Benefit Plans have already addressed the need to establish education criteria. Both organizations are sponsoring graduate level courses of instruction and an exhaustive examination program. During 1977 and 1978, 1,135 students sat for ASPA's certified pension consultant exams. Techniques for testing the knowledge of consultants are continuing to be developed and could be accepted in lieu of governmental examinations as evidencing qualification to practice.

The substantial benefit and practical advantage of this approach is clear. A professional body of pension plan practitioners, who are ethically bound to operate plans within the spirit as well as the letter of the law and who are subject to censure for wrongful acts, would be a most effective extension of ERISA. The pension community could then identify those professional practitioners who have met standards of character and knowledge imposed by an impartial authority. High standards of educational expertise, practical experience and ethical behavior could be maintained and monitored. The public trust would be assured. Finally, the majority of qualified retirement plans, which do not even require the services of an enrolled actuary, could avail themselves more readily of the services of an individual who had demonstrated a high level of competence and could engage that pension professional with greater confidence.

We urge, for the benefit of all, serious consideration be given to creating some legal status for the pension consulting profession by providing some government recognition.

American Society of Pension Actuaries

1700 K STREET N.W., SUITE 404, WASHINGTON, D.C. 20006
(202) 785-4366

November 7, 1979

Steve Sacher
Special Counsel,
Committee on Labor & Human Resources
Rm. 4230, DSOB
Washington, D.C. 20510

Dear Mr. Sacher:

The American Society of Pension Actuaries would like to take this opportunity to comment on S. 1089, the ERISA Simplification Act of 1979. We wholeheartedly endorse the objective of this bill to simplify compliance with ERISA. Certainly the administrative burden involved in complying with ERISA has been a significant factor in the decrease in the ratio of new pension plans to terminated plans from 14.4 in 1973 to 4.3 in 1978.

We believe the provisions under S. 1089 which would eliminate the PBGC Premium Form and the Summary Annual Report, and provide taxpayers an option to file forms required under ERISA with the annual income tax forms will help alleviate the costs involved in ERISA compliance.

There is another area, however, which we believe should be addressed in S. 1089, namely the proposed triennial reporting system. Specifically, we suggest that a provision be included in S. 1089 mandating the use of the current 5500-C & K Forms for the plan year beginning in 1979.

Under the proposed triennial reporting system, plans with fewer than 100 participants would file an expanded 5500-C and K every third year, and a one page registration statement (5500-R) the other two years. The sponsoring agencies (Internal Revenue Service, Department of Labor and the Pension Benefit Guaranty Corporation) have asserted that the triennial reporting system will minimize the ERISA reporting and record-keeping requirements. We do not concur. Most of the work required at present would still have to be done in the years the 5500-R is filed, such as reconciling receipts and disbursements, preparing balance sheets and making the actuarial calculations. The effort to record this information on a form is minimal once the work is done. On the other hand, the information required in the year the expanded 5500-C or K is due is substantially greater than that now required. The proposed 5500-C is five pages long, for example, as compared to 3 pages for the present Form.

Adapting to the proposed triennial reporting system would be an expensive process, involving considerable amounts of re-education time for the personnel involved and substantial adjustments to the data processing systems utilized. Even after the initial adaptation costs . .e out of the way, the proposed triennial system, as indicated above, would involve substantial additional administrative burdens on a continuous basis.

Congressmen Thompson and Erlenborn have written to the General Accounting Office asking for an investigation into the procedures and activities of the administrative agencies having jurisdiction in the area of pension and welfare plans. Specifically, GAO was asked to look into the adequacy of the agencies' data collection and processing systems, the completeness, accuracy and value of the data in the form in which it is collected, and the use or lack thereof of the information received. This investigation is now under way. Pending completion and assessment of this report, it would seem particularly inappropriate for IRS, DOL, and PBGC to be proposing changes in the 5500 Forms which involve substantial new reporting requirements.

IRS, DOL, and PBGC have concluded that the proposed triennial reporting system is not significant under their regulations prescribing certain procedural requirements for significant matters. ASPA believes this proposal is quite significant, and that its adoption will be another factor encouraging plan sponsors to terminate plans and discouraging the formation of new plans.

It should be noted that the administrative cost impact of ERISA has been particularly severe in the small plan area. The summary of the Cost of Government Regulation Study developed by Arthur Anderson & Co. for the Business Roundtable stated, in part, that "The incremental administrative costs of ERISA are disproportionately greater for small businesses than for larger businesses. For example, the ten smallest employers incurred average incremental costs per employee in 1977 nearly seven times those of the ten largest."

Mandating the use of the current 5500-C and K Forms for the plan year beginning in 1979 would provide an opportunity for a thorough review of the proposed triennial reporting system, including a detailed analysis of the administrative cost increases that would result from the substantial new reporting requirements involved in the proposed system. It would also allow time for completion and assessment of the GAO investigation.

Sincerely yours,

Chester J. Salkind
Executive Director

IOLANI SPORTSWEAR, LTD.

November 29, 1979

Senator Spark M. Matsunaga
U. S. Senate
Washington, D. C.

Dear Senator Matsunaga,

I regret I cannot be at the hearing on S-1958. Instead I wish to make the following statements.

I started Iolani Sportswear, Ltd. in 1954 with four girls and in 1966 I acquired Young Hawaii, Inc. The Profit Sharing Plan began in 1963.

I always wanted to share my future success, whatever it was going to be, with those who contributed. I learned from my immigrant parents the purposefulness of sharing, and from my Italian combat experience in WW II that no man is an island by himself, rather closely interconnected with those who share the same hardships and risks. Yet, in setting the plan up, I was very cognizant of the difference to my own self interest that failure is not shared in the same way like success. I also knew apparel styling and manufacturing business was indeed volatile, that if the plan was to succeed it needed another component to give it more stability and continuity. At that time real estate seemed to be the best to balance off the ups and downs of the garment business. Then to further insure its stability, Iolani would be the major tenent to guarentee cash flow.

Also at this time, I decided not to own any personal real estate as I would be making the primary decisions. I felt it was morally wrong and entirely indefensible if questions of conflicts of interest became an issue in the future. So the plan was launched in 1963 with Iolani's initial contribution of $14, 990. But in order for the Plan to own its first real estate venture, which was $450,000, I pledged all my personal assets including my home to collateralize the borrowing and mortgage.

In the beginning, I had a lot of fantasies like a million dollar fund, looking through a $15,000 contribution, in my lifetime. Another was $50,000 to $100,000 to persons who gave us 30 years of her working life to us.

No longer are my dreams fantasies, but very real. Our assets are close to $3,000,000, cash balances around $700,000, and no debt. Even till today, I do not own any real estate. Everything worth buying is in the Fund. I forgot to mention that when I started in 1954, I ~~it~~ began with $5,000 capital.

Mahalo & Aloha,

KEIJI KAWAKAMI

1218 Kona Street, Honolulu, Hawaii 96814 • Telephone 536-8826 • Cable Address: "IOLANI"

STATEMENT ON BEHALF OF CELANESE CORPORATION
TO THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
SENATE FINANCE COMMITTEE
ON
PROPOSED ERISA AMENDMENTS RELATING TO SEVERANCE PAY ARRANGEMENTS

Celanese Corporation ("Celanese") appreciates the opportunity to submit this statement to the Subcommittee concerning the provision in S. 209 which would amend the Employee Retirement Income Security Act of 1974 ("ERISA") to facilitate the making of severance payments to terminated employees. While Celanese supports the general purpose of this proposed amendment, it believes that corrective legislation should more clearly articulate the basic distinction between pension plans and severance pay arrangements.

BACKGROUND

On March 2, 1979, the Department of Labor published final regulations setting forth the circumstances under which severance pay arrangements are not deemed to be pension plans covered under Title I of ERISA (44 Fed. Reg. 11761). These regulations generally provide that, to be excluded from pension plan treatment, the aggregate amount of severance payments made to any individual may not exceed an amount equal to twice his or her annual rate of compensation, and such payments must be completed within two years after termination of service. If an employee's service is terminated in connection with a "limited program of terminations" (a programmed reduction-in-force), the regulations permit the severance payments to be stretched over more than two years, but the aggregate amount of such payments must still be limited to twice annual compensation.

The regulations provide that, where severance payments do not meet these criteria, the employer may seek an advisory opinion that the program of payments does not constitute a pension plan. Since it frequently is not feasible for an employer to obtain an advisory opinion from the Department of Labor while in the process of terminating employees, the criteria set forth in the regulations are generally controlling. In particular, the quantitative limit on severance payments (twice annual compensation) significantly limits the extent to which employers can redress the economic injury suffered by individuals whose employment has been prematurely terminated for reasons beyond their control.

DESCRIPTION OF BILL

Section 102 of S. 209, as approved by the Committee on Labor and Human Resources, would amend section 3(2) of ERISA by adding a new subparagraph (B) relating to the distinction between pension plans and severance pay arrangements and supplemental retirement income arrangements. This amendment would give the Secretary of Labor authority to promulgate regulations prescribing exempted categories under which severance pay arrangements and supplemental retirement income arrangements will not be deemed pension plans under ERISA. In addition, the Secretary of Labor would be given authority to remove any such arrangement from an exempted category if it was found to be a subterfuge to evade ERISA.

The summary and analysis of this provision prepared by the Committee on Labor and Human Resources states that it is designed to provide flexibility to foster the creation and continuance of severance and supplemental pay arrangements. With respect to severance pay arrangements, the summary and analysis states that the present definition of the term "pension plan" under ERISA has unnecessarily circumscribed the Secretary of Labor's authority to delineate the types of severance pay arrangements which are not pension plans and, in particular, that there should be greater flexibility to provide severance pay in reduction-in-force situations.

RECOMMENDATION

Neither the existing ERISA regulations nor the proposed amendment to ERISA set forth in S. 209 address the essential distinction between severance payments and a pension plan. Most typically, severance payments are made to individuals because their employment has been terminated by the employer for reasons other than normal retirement;

such payments are generally completed before normal retirement age. Such payments are made in recognition of economic injury resulting from involuntary termination of employment and plainly do not represent the functional equivalent of a pension plan. The various rules applicable to pension plans under ERISA are designed to protect the retirement benefits promised to employees during the course of their employment. A number of these rules have no rational application to severance pay arrangements, and many such arrangements could not be continued if classified as pension plans. Accordingly, Celanese, and undoubtedly other employers as well, would be required to cut back or discontinue certain severance payments under the guidelines adopted by the Department of Labor. It seems clear that Congress did not intend this result when ERISA was enacted.

S. 209, as well as ERISA itself, recognizes that there is a distinction between severance pay arrangements and pension plans. However, S. 209 would give the Secretary of Labor virtually unbridled and unreviewable discretion to say what that distinction is. While there is a definite need for administrative flexibility, the Department of Labor cannot properly effectuate the intent of Congress in the absence of any statutory guidance on the nature of the distinction between severance pay arrangements and pension plans. The distinction is legislative in character and should not be delegated without standards to the administrative agency.

Therefore, we believe that the objectives of this provision of S. 209 could be better achieved if, in addition to giving the Secretary of Labor further administrative flexibility, the legislation identified the basic type or types of severance pay arrangements intended to be covered. More specifically, the legislation could provide that severance payments made by an employer out of its general assets will not be treated as a pension plan where (a) such payments are made to individuals whose employment has been terminated by the employer prior to normal retirement age and such payments are completed on or before normal retirement age, or (b) such payments are otherwise limited in duration and amount as determined under regulations prescribed by the Secretary of Labor.

Thank you for your consideration.

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December 14, 1979

Mr. Michael Stern
Staff Director of the Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Stern,

This letter is written with respect to hearings which are being held by the Sub Committee on Private Pension Plans and Employee Fringe Benefits of the Senate Finance Committee.

Mueh of my time is spent in the sale and administration of qualified Retirement Plans to small employers, (Corporations, Sole Proprietors, and Partnerships, with less than 25 employees). At the present moment, my associates and I deal with some 100 plus qualified plans of different types.

A common question or thread of comment has been weaving itself back and forth through my new and renewal contacts with clients and prospects. That inquiry concerns the relationship between the current IRA rules on contribution limitations and the interrelationship of those limitations with the amounts currently being contributed by an employeer for his employee/participants in a qualified Pension or Profit Sharing Plan.

As the committee knows any participant in a qualified Pension or Profit Sharing Plan is not allowed a current tax deductible contribution to an individual IRA. Not withstanding the fact, that the contribution to the employers qualified plan for the individual employee is less than what that employer would have been allowed to contribute to an individual IRA, the current regulation does not allow any contribution to be made to that IRA account.

Over and over again, we've had to face the prospect of trying to interpret the IRA rules with respect to individual participants waiving their right to participation in an employers plan so that they might make a larger contribution on a tax deductible basis to an individual IRA. Over and

continued...

over again, I've expressed my feeling that Congress would see the despairty in this situation and would provocate legislation, or encourage regulation which would allow individuals who are participating as employee/participants and a qualified employer sponsored plan to make differential contributions to individual IRA's within the over-all maximums set by IRA.

In fact, the current employer-sponsored simplified retirement program (an IRA-type vehicle) allows for this kind of differential contribution on an individual basis. I believe it's time to broaden that concept to allow for all employee participants of any employee-sponsored qualified plan to be able to do the same.

Mr. Stern, thank you, and the committees consideration in this matter. If you need additional information, please feel free to contact me.

Sincerely yours,

RL Tedoldi

Robert L. Tedoldi, CLU

RLT/kmc

STATEMENT OF THERESE F. PICK

DIRECTOR, BENEFIT ADMINISTRATION AND GENERAL PERSONNEL PRACTICES

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

ON S.209

BEFORE THE SENATE COMMITTEE ON FINANCE

December 28, 1979

This statement is submitted by the American Telephone and Telegraph Company on behalf of the 24 Bell System companies, the names of which are attached to this statement. In my capacity as Director, Benefit Administration and General Personnel Practices, of the American Telephone and Telegraph Company, I am responsible for benefit administration and other related benefit and personnel duties. Many of the comments submitted herein reiterate and update comments filed by H. Weston Clarke, Jr., Vice President, Human Resources, of AT&T with the Senate Committee on Labor and Human Resources (the "Labor Committee") on S.209 in March, 1979 and on S.3017, the "ERISA Improvements Act of 1978," in August, 1978.

I appreciate this opportunity to comment on S.209. We are vitally interested in pensions and other employee benefits and the Employee Retirement Income Security Act (ERISA). Most of the comments submitted to the Labor Committee by Mr. Clarke last March on S.209 and on S.3017 last year, still apply to the version of S.209 now being considered by the Finance Committee. We are pleased with a number of the changes made by the Labor Committee in its mark-up of the current bill. However, there are several new proposals and other sections from both the previous bill (S.3017) and the current version of S.209 that we cannot support.

BACKGROUND

The Bell System has been providing pensions since 1913 from non-contributory plans covering both management and non-management employees. We started prefunding for pensions in 1927. Currently, the Bell System has nearly a million employees and 200,000 pensioners. The promise of our pension plans is backed up by over $21 billion in irrevocable trust funds. Additionally, we maintain a large number of other welfare and pension benefit plans, including dental, health, disability, death benefit, life insurance, Employee Stock Ownership Plans (ESOP) and savings plans. We have prepared numerous summary plan discriptions and other reporting and disclosure documents for these various pension and welfare plans.

Senator Javits' preamble statement to S.209 states that the bill contains general purpose provisions intended to facilitate compliance with ERISA and remove impediments to plan maintenance and termination as well as expand certain provisions regarding plan coverage and benefits. Section 3 of S.209, as reported, indicates the Labor Committee's view that burdens and costs of plan administration can be reduced without jeopardizing the interests of employees. We certainly endorse these statements since plan administration and compliance with ERISA has been quite difficult and confusing at times.

S.209 OFFERS SOME IMPORTANT IMPROVEMENTS

We previously endorsed, in Mr. Clarke's statements of August 1978 and March 1979, and continue to endorse those sections of the bill that facilitate ERISA compliance for Benefit Administrators. We endorse the following six subsections in Subtitle B - Simplifying and Clarifying Amendments, Part 1 - Reporting and Disclosure and Part 2 - Minimum Standards:

Section 112 - Exemptions and Modifications
Section 113 - Elimination of Summary Annual Report
Section 114 - Improvement of Reporting Requirements
Section 115 - Opinions of Actuaries and Accountants
Section 116 - Scope of Accountant's Opinion
Section 121 - Elapsed Time

S.209 has many provisions to be debated and refined. However, it is quite clear that each of the six sections cited above would make ERISA compliance less burdensome. The current ERISA provisions addressed by these sections are recognized as unnecessary burdens by all concerned parties and could be corrected legislatively very quickly. However, this needed legislation should not be delayed while all the controversial items are being debated. It would be more efficient, and at the same time more expedient, if the proposed legislation did not undertake to correct every possible flaw in this massive and complex pension law all at one time. Accordingly, we suggest a separate bill to ameliorate any pressing current problems and the postponement of comprehensive new legislation to accommodate the airing of all views, the resolution of the many debatable issues, and the report of the President's Pension Policy Commission.

RECOMMENDATIONS FOR CHANGES IN S.209

There are several sections in S.209 which we believe need modification. In addition, we believe that other sections, including the new anti-fraud section and the proposal to limit the scope of ERISA preemption, should be eliminated entirely.

Although we agree in principle with the concepts proposed in Section 126, we do feel that some clarification would be helpful. We suggest a clarification, in the statutory language itself, which would indicate that workers' compensation awards may be offset against either (1) disability benefits, or (2) pensions paid on account of disability rather than retirement. We believe such clarification would be consistent with the Labor Committee's views and analysis.

I also want to comment on Section 152, authorizing a Labor Department study regarding mandatory cost-of-living adjustments to private pension plan benefits. This is a major social issue facing our nation today, particularly in light of the rapid rate of inflation experienced over the past few years. Obviously, this problem will be addressed by the Presidential Pension Commission Study. Rather than commission a duplicate study at this time by the Labor Department, it would seem preferable to defer this D.O.L. study until the Presidential Commission has completed its work.

I have a similar comment regarding Title IV - Employee Benefit Commission. Under the President's 1978 ERISA Reorganization Plan, the Department of Labor and the Internal Revenue Service are attempting to resolve their problems regarding the division of regulatory responsibility under ERISA. Therefore, we recommend that this new commission not be set up at this time. Rather, the progress of the Department of Labor and Internal Revenue Service under the Reorganization Plan should be evaluated after a two-year trial period to determine whether or not this new commission is warranted. Additionally, we are concerned that any commission would regenerate many of the administrative problems that originally existed with the dual jurisdiction of the Labor Department and the I.R.S. and would trigger a new lengthy period of adjustments and confusion.

We are particularly concerned with and would like to comment in more detail on the following sections.

SECTION 121 - RECIPROCAL AGREEMENTS

We believe that the history of the development of ERISA indicates that portability was considered desirable by Congress. For example, in 1973 the Senate passed the Retirement Income Security For Employee Act which contained voluntary portability provisions. Also, ERISA in Section 3022(a)(3) provided for establishing a Joint Pension Task Force to study "means of providing for portability of pension rights among different pension plans."

Within the Bell System, a means has existed for over 60 years to provide for portability of pension rights among the pension plans of the Bell System companies. Because the Bell System pension plans have entered into written reciprocal agreements with one another, an employee's service and compensation with all participating companies is taken into account by the plan of his current employing company for the purpose of determining his eligibility to participate in the current employing company's plan, his accrued pension benefit under the plan and the vesting of that accrued benefit. Since all of the participating pension plans compute benefits under the same formulas and impose identical conditions for plan participation and for vesting of benefits, an employee can transfer from one Bell System Company to another with complete portability of his pension benefits.

As many as 8,000 Bell System employees have benefited from the reciprocal agreements within a single year. No employee has ever suffered a loss of pension benefits because of a transfer nor have there been either financial windfalls or hardships to any of the participating plans as a result of these transfers.

We believe that it continues to be the intent of Congress to encourage the implementation of the concepts of portability. However, the Internal Revenue Service has interpreted ERISA Sections 208 and 1015(1) (Section 414(1) of the Internal Revenue Code) in a manner which impedes the development of new reciprocal agreements and discourages the continuation of existing arrangements. In August of 1979, the I.R.S. issued final regulations under IRC Section 414(1) relating to mergers and consolidations of and transfers of assets or liabilities between plans. These regulations treat the transfer of even a single employee under a reciprocal agreement as a transfer of liabilities between the participating plans. The result is that plans which are party to reciprocal agreements must comply with the complex and costly administrative requirements imposed by the regulations. While the regulations contain <u>de minimis</u> rules which might appear on the surface to offer relief from the harsh requirements of Code Section 414(1) when individual employees transfer between plans with portability agreements, the costly administrative procedures which must be established to comply with the <u>de minimis</u> rules are not justifiable in the absence of any evidence whatsoever of abuse of reciprocal agreements. The regulations serve only to frustrate the development of functional, beneficial, voluntary, and largely portable retirement systems.

In its Summary and Analysis of S. 209, the Labor Committee recognized the negative impact which the then proposed IRS regulations would have on reciprocal agreements.

> [T]he Committee has become aware that proposed regulations promulgated by the Internal Revenue Service under Sections 401(a)(12) and 414(l) of the Internal Revenue Code face affiliated companies which have long-established beneficial reciprocity and portability arrangements for their employees with a Hobson's Choice. Under these proposed regulations, such companies, if they wish to continue a decades-long practice of transferring assets and liabilities attributable to pension rights of employees moving from company to company, will have to comply with expensive and burdensome rules requiring actuarial calculations, recordkeeping, disclosure and reporting. Or, these requirements can be avoided, but only by ending the practice of transferring assets and liabilities, freezing an employee's accrued benefit at the time of his or her move from one company to another, and paying multiple, separate pensions upon retirement. This course of action would mean confusion for employees, receipt of multiple benefit status reports, multiple modifications in summary plan descriptions, multiple notifications from the Social Security Administration at retirement time, multiple tax filing requirements, etc....If, however, the final regulations of the IRS regarding these Code sections do not satisfactorily resolve the dilemma created by the proposal, the Committee stands ready to consider such an amendment at the earliest appropriate time. (Committee Print, S. 209, The ERISA Improvements Act of 1979: Summary and Analysis of Consideration, November 1979, 96th Congress, 1st Session, pg. 20)

Section 121 of S. 209 partially addresses the problem imposed by the IRS regulations. However, this section is restricted in that it applies only to individuals who become employed under two or more collective bargaining agreements. Even with the restriction of two or more collective bargaining agreements. Section 121 allows only one of a number of viable alternatives.

It would be highly beneficial to many present and future participants for this Committee to endorse the views expressed by the Labor Committee in order to reflect a uniform Congressional intent to the IRS. Accordingly, we urge, consistent with the Labor Committee's statements in its Summary and Analysis of the bill, that the Finance Committee join in this expression of Congressional intent that ERISA was not meant to be applicable to the transfer of liabilities or assets for individual employees who move between plans pursuant to a written reciprocal agreement.

We would emphasize the high value to participants of the portability benefits to which we are directing your attention. They may be of significantly greater value than the portability provisions contained in the 1973 pension legislation passed by the Senate. Pension rights may be transferred even before a transferring employee is vested. In addition, many plans with portability agreements provide protection against the inflation that occurs between the time an employee transfers and the time he retires. This is particularly true for final pay pension plans. Under many plans' portability provisions, an employee's pension benefit relating to service up to the time of transfer is based on the compensation near retirement rather than only on the compensation just before the transfer.

Plans should be encouraged to develop written reciprocal agreements to facilitate the ability of individual employees to transfer without deleterious restrictions on the transfer of assets or liabilities or both. Only by allowing this flexibility will voluntary portability coverage be encouraged to grow in the future.

SECTION 127 - SURVIVOR PROTECTION

We would suggest that this section be revised to provide the following:

1. A pension plan should be considered to qualify if the substance of this provision is substantially provided for by the existence of a group insurance plan or any other plans providing death benefits.
2. Separated former employees with vested pensions should not be considered as participants for the purposes of this section.
3. The applicable provisions should clearly state that the pension payable to the spouse should be based only on the vested amount of pension.

SECTION 128 AND SECTION 155 - ALIMONY AND SUPPORT PAYMENTS

We strongly support the proposed amendment to Section 206(d) regarding court orders to effectuate marital property rights, child support and alimony payments. We believe that such an amendment to ERISA Section 206(d) and Internal Revenue Code Section 401(a) (13) will resolve a matter of significant current dispute and hopefully terminate the costly and time-consuming litigation involving this issue. However, we would suggest a clarification in the wording of proposed Section 206(d)(3) to identify the appropriate treatment of benefits not yet in pay status. We suggest that such clarification provide that state domestic relations court orders with respect to benefits that are currently in pay status be recognized and enforced but make it clear that such rule does not apply to an active employee or a former employee who is not currently receiving benefits or entitled to currently receive benefits. Without such a limitation, it would be difficult, in many cases, for a plan to ascertain the current value of future benefits (e.g., future pension benefits for an active employee when based upon final average salary). In addition, the amendment, without the limitation, may in itself generate unnecessary, costly and time-consuming litigation and significantly increased administrative and paperwork burdens for plan administrators and trustees. Of course, when benefits become payable, an appropriate order could be served on the administrator or trustee at that time.

SECTIONS 154 (a) & (b) - PROHIBITIONS AGAINST MISREPRESENTATION

The proposed addition to Section 514 (d) clarifying that an interest in an employee benefit plan is not and should not be characterized as or deemed to be a security under the 1933 and 1934 Federal securities laws is a welcome legislative endorsement of the Supreme Court's recent holding in the Daniel case. Although some employee pension plans have previously been subject to such security laws, such continued coverage is either duplicative of or inconsistent with ERISA. We believe that ERISA offers positive and sound protection to participants and their beneficiaries for violation of the basic purposes and tenets of the pension law, i.e., to protect the financial soundness and integrity of employee benefit plans and to foster meaningful and accurate communications concerning such plans. Accordingly, we feel that ERISA, rather than the federal securities law, is the appropriate vehicle for dealing with complaints and disputes involving employee benefits and benefit plans, and we enthusiastically support the proposed addition to Section 514 (d).

However, we are quite concerned by the additional new Section 515, dealing with misrepresentation. We believe that Section 515, if enacted, would have adverse consequences for employee benefit plans and impose further burdens upon the vast majority of reputable fiduciaries and administrators who operate such plans. We believe it likely that Section 515 would generate vexatious and costly litigation without offering any significant new protections to those intended to be covered thereby. There can be little doubt that participants and their beneficiaries are extended adequate protection under the various minimum standard and fiduciary provisions of ERISA as well as the procedural rights and safeguards of Sections 502 and 503. For those employees who are neither participants in nor beneficiaries of an employee benefit plan, we believe that they have adequate safeguards under existing state laws. Regardless of existing law, the instances where nonparticipating employees would be subjected to fraudulent misrepresentations that were not also a violation of ERISA would be few and far between because, in most instances plan documents and communications, such as summary plan descriptions, are made available to all employees regardless of participation.

Despite the foregoing, if the Committee still is of the opinion that the proposed Section 515 is a sound and necessary addition to ERISA, we believe it needs significant clarification in the following respect:

(1) special rules relating to co-fiduciary liability;

(2) whether alleged violations of the provision would be subject to or required to be filed pursuant to the section 503 claim procedures prior to the filing of any court action in order to allow defendants to correct any alleged misconduct;

(3) clear standards as to what constitutes a knowing misrepresentation, and

(4) whether litigation expenses and attorney fees for a successful defendant in a Section 515 action under Section 502 could be paid for by the plan or reimbursed to the successful defendant by the plan or, in the alternative, covered by an insurance policy maintained by the plan, and whether Section 502 (g) (1), as proposed to be amended, would allow for a award of attorney fees to a successful defendant who was not a fiduciary.

SECTION 155 - PREEMPTION

We view with particular interest the proposed amendments to the ERISA preemption provision Section 514. We strongly support the proposed clarification to Section 514 (b)(2)(B) which will result in equal treatment for insured and self-insured plans. Current judicial interpretation of this provision has resulted in a premium for self-insuring by subjecting plans insured through insurance companies to state insurance regulations and varying requirements regarding the extension of certain substantive welfare benefits. We believe such a result is both undesirable and unintended.

However, we are strongly opposed to the proposed provision removing from the preemptive effect of 514 (a) state laws which require employers directly or indirectly to provide health care benefits or services or which regulate arrangements under which such services are provided. We strongly support the objective of uniformity in the administration of employee benefit plans and the provision of benefits provided under such plans. We believe that Congress gave strong support to this objective in the legislative history to and the final passage of Section 514. Certainly, it is not necessary to detail here the many significant administrative, cost and personnel considerations which call for uniformity of benefit treatment on a national basis for large multistate plans and employers. We believe any weakening of the principal of uniformity would be counter-productive for both employees and employers and would needlessly interfere with the free-play of forces which is necessary in the fashioning of benefits which are both meaningful to employees and administratively and economically feasible for employers. Furthermore, we believe that state interests in the welfare and protection of employees are adequately protected under existing Section 4(b)(3) which exempts from ERISA coverage and saves for state regulation plans maintained for the purpose of complying with workers compensation, unemployment compensation and disability insurance laws. Accordingly, we urge that the preemption provision be amended to provide for uniform treatment of insured and self-insured plans, as proposed by the Labor Committee, and not be amended to exempt state laws mandating the provision of certain health care benefits.

SECTION 203 - DEDUCTION FOR CERTAIN EMPLOYEE CONTRIBUTIONS TO A QUALIFIED RETIREMENT PLAN (PROPOSING A NEW SECTION 221 OF ERISA CONCERNING ACCEPTANCE OF EMPLOYEE CONTRIBUTIONS)

We agree with the improvements of the proposed new Section 221 to allow employees to make limited voluntary tax deductible contributions to a retirement plan. The Bell System and many other companies have both defined benefit plans and defined contribution plans. Bell employees can contribute up to 10% of their pay to the defined contribution plans.

However, there is one part of this section which could discourage many of our non-management employees from participating in our new defined contribution plan which became effective January 1, 1979. Subsection (b)(5) states that no deduction is allowed for any amount paid to a plan not in existence on January 1, 1978, if employee contributions to such plan are mandatory or employer contributions are not made unless contributions are made by employees. According to statements in the Views and Analysis section of the Senate Labor Committee's Summary and Analysis, the purpose of this latter provision is to discourage new plans from having mandatory or matching contribution requirements which could be used to reduce participation in the plan by low-income employees. We oppose this restriction against new plans with a matching-employer contributions provision.

The Bell System negotiated a defined contribution plan for its non-management employees effective in January 1979. There are over 600,000 union-represented employees eligible to participate in the plan and place a part of their weekly pay in this plan. The average contribution is about $15 per week. Under the matching-employer contributions provisions of the plan, an employee can contribute as little as $5 a week or as much as $20 a week, depending on his or her rate of pay. The Bell Company matches on a 50% basis the employee's basic contribution.

We have always considered the company's matching amount as an encouragement to participation. We would strongly recommend that this anti-matching restriction for new plans be eliminated from the bill.

This section, absent the anti-matching rule, represents a very positive approach to expanding private sector retirement coverage. We want to encourage all of our employees to become participants, or increase their participation, in our defined contribution plans. Augmenting their future pensions in this way would help alleviate their increasing concerns over the erosive effects of inflation during their retirement years. We support this concept wholeheartedly.

CONCLUSION

Certain business practices both in the Bell System and elsewhere have evolved over a number of years (such as our reciprocal agreement). Many of these practices have worked out very successfully for both employers and employees. We hope that this Committee will take account of acceptable business practices which have withstood the test of time.

There has been an enormous amount of recent legislation and regulation in the benefit area. However, even at this date, only about one-half of the final ERISA regulations have been published since September 1974 when the law was enacted. Company personnel staffs are even now modifying plan texts and procedures because of the recent amendments to the Social Security law, the Age Discrimination in Employment Act, and the Pregnancy Amendments to Title VII.

Meanwhile this current legislation is proposed to correct the flaws in the original ERISA act. Recognized flaws which will clearly reduce the administrative burdens of ERISA should be corrected at the earliest possible date.

The Presidential Pension Commission, the Social Security Administration, the Pension Benefit Guarantee Corporation and others are all conducting studies in the areas of pensions. Therefore, we recommend that a moratorium be taken on additional substantive benefit legislation until the existing statutory programs can be implemented. Our computer programs and personnel procedures are no sooner written when annual changes in government forms call for modifications. A moratorium would allow all of us the time to study and evaluate the effects of the existing legislation. The period of stability would aid all of us in determining if additional legislation is needed and what form it should take.

We thank you for this opportunity to present our views to this Committee.

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company

The Bell Telephone Company of Pennsylvania

Bell Telephone Company of Nevada

Bell Telephone Laboratories, Incorporated

The Chesapeake and Potomac Telephone Companies

Cincinnati Bell, Incorporated

The Diamond State Telephone Company

Illinois Bell Telephone Company, Incorporated

Indiana Bell Telephone Company, Incorporated

Michigan Bell Telephone Company

The Mountain States Telephone and Telegraph Company

New England Telephone and Telegraph Company

New Jersey Bell Telephone Company

New York Telephone Company

Northwestern Bell Telephone Company

The Ohio Bell Telephone Company

Pacific Northwest Bell Telephone Company

The Pacific Telephone and Telegraph Company

South Central Bell Telephone Company

Southern Bell Telephone and Telegraph Company

The Southern New England Telephone Company

Southwestern Bell Telephone Company

Western Electric Company, Incorporated

Wisconsin Telephone Company

Statement of Martin D. Wood, Director
Retirement, Safety & Insurance Department
National Rural Electric Cooperative Association

Hearings on S. 511
Subcommittee on Private Pension Plans
And Employee Fringe Benefits
Senate Finance Committee
December 21, 1979

The National Rural Electric Cooperative Association (NRECA) is the national membership organization for the more than 1,000 consumer-owned electric utilities located in 46 states and serving over 25 million people in 2,600 of America's 3,100 counties.

S. 511, as introduced by Senator Matsunaga, would extend to employees of tax-exempt organizations the same deferred compensation treatment as provided employees of State and Local government. NRECA is pleased to see Congressional interest in clarifying this matter, however, we respectfully are at variance with the treatment outlined in this specific piece of legislation.

The entire matter of the treatment of deferred compensation programs became uncertain when the Treasury Department published a proposed ruling on February 3, 1979. This proposed ruling revised prior Internal Revenue Service determinations and court decisions by setting forth a policy that a taxpayer would be taxed on income the year earned rather than the year received, regardless of participation in a deferred compensation program.

At that time, NRECA took the position that:

(1) There had been no change in the law or court decisions to warrant the proposed rules. The net effect of the rule was to make deferred compensation plans, long recognized in published revenue rulings and court decisions, ineffective for the future. Such plans were expressly authorized by Revenue Ruling 60-31 and Revenue Ruling 69-650 as

well as other revenue rulings and court decisions which were cited in the proposed rules.

(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 had never gone so far as to hold such a promise to be income. The value of such a promise was obviously totally dependent upon the financial status of the employer and, at best, it was incapable of valuation.

(3) Congress was the proper forum for such policy decisions, not the Executive Branch.

Further, in 1978 during this Subcommittee's consideration of S. 2627 a bill that protected deferred compensation plans for units of state and local government, NRECA presented testimony asking that the protection for the continuance of such plans be extended to a broader class of employee, including employees of non-profit electric cooperatives. We argued that the IRS regulations eliminated this employment benefit for all participants regardless of employer-type and that Congress ought to protect the right of participation for all employees, not solely government employees.

In the Tax Revenue Act of 1978, Congress acted to insure continuation of past deferred compensation program treatment for employees of private, taxable employers. Employees of governmental units were permitted to participate in deferred compensation plans limited to $7,500 per year or 33 1/3% of includible compensation whichever was less.

During House Committee consideration, the rural electric cooperatives, fearing that a legislative omission regarding tax-exempt employees would place our deferred compensation plan in jeopardy asked for an amendment to place our deferred compensation plans among the private sector plans. However, as a compromise, we were included in the public employee section.

During Senate consideration we endeavored to have electric cooperative employees and employees of other tax-exempt organizations included in the private sector with the other non-government entities. Although this effort was not upheld during the House-Senate conference, our rationale then, stands today:

(1) Benefit plans for rural electrics, as well as for all tax-exempt organizations, fall within the definition and consideration of private sector benefit plans. These programs include pension, savings and insurance. Deferred compensation, in our opinion, should, therefore, be treated similarly.

(2) Employee benefit packages are a tool used to attract and retain qualified, competent management. This is especially true to industries such as the electric utilities. The differential treatment imposed on the rural electrics by virtue of the $7,500 limitation is unfair recruitment and employee retention burden.

(3) As with other tax-exempt employers, rural electric cooperative employees negotiate with NRECA's member cooperatives over wages, salaries, terms and conditions of employment just as employees of other private sector organizations. <u>Salaries are not fixed as in the public sector</u>.

(4) Employees of cooperatives are in danger of forfeiting their deferred compensation if the employer faces insolvency. Any deferred compensation claim against the employer's assets rests on no firmer ground than those of other creditors. This is again identical to private sector situations.

Further, we do not accept the "tax tension" argument forwarded by Treasury. That is, the tax-paying employer cannot deduct from taxable income, funds placed in a deferred compensation program. This fact, Treasury asserts, serves as a restraint on the amount that private sector employers will allow their employees to defer. We suggest that any such restraint, if it indeed exists, is more than offset by the generally much higher salary levels of employees in the private sector who are likely to defer income, and by the fact that private sector businesses enjoy tax reduction advantages, such as investment tax credits, that lower corporate tax liability to the point that the restraint to which Treasury refers would be minimal. It should also be noted that electric cooperatives do not and cannot use profit-sharing or stock bonus plans as do employees of some types of business. Of course, disparity among the employees of various groups will occur with respect to employee benefits, but to legislate such disparity is, in our view, highly inappropriate.

In summary, NRECA believes that for purposes of deferred compensation all tax-exempt organization employees, including employees of the rural electric cooperatives, should be treated as are private-sector employees as in the Tax Revenue Act of 1978 rather than as employees of state and local government.

LUTHERAN COUNCIL IN THE USA

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Statement of Dr. Charles V. Bergstrom
Office for Governmental Affairs, Lutheran Council in the USA

Submitted to
Subcommittee on Private Pension Plans and
Employee Fringe Benefits
Committee on Finance

December 20, 1979

Mr. Chairman, I am grateful for this opportunity to submit a statement in support of S.1090, S.1091, and S.1092 relating to church pension plans. My name is Dr. Charles V. Bergstrom. I serve as Executive Director of the Office for Governmental Affairs, Lutheran Council in the USA, located here in Washington, D.C. My statement today is submitted on behalf of two member church bodies of the Lutheran Council:

The American Lutheran Church, headquartered in Minneapolis, Minnesota, composed of 4800 congregations having approximately 2.4 million U.S. members; and

The Lutheran Church in America, headquartered in New York City, composed of 6100 congregations having approximately 3.1 million members in the U.S. and Canada.

Pension representatives from both Lutheran church bodies are members of the Church Alliance for Clarification of ERISA, which initiated the three bills under consideration by this Subcommittee.

I want to state at the outset that my statement is an endorsement of the testimony given to the Subcommittee on December 4 by the panel representing the Church Alliance. However, there is one issue at the root of our concerns with regard to S.1090 and S.1091, which clarify the definition of "church plan" under ERISA, requiring further elaboration. This issue involves the current definition

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A Common Agency of the American Lutheran Church, Lutheran Church in America and Lutheran Church-Missouri Synod of "church plan" which prohibits existing "church plans" from covering employees of new church agencies coming into place after January 1, 1974 and requires exempt "church plans" to expel employees of all church agencies by 1982.

"Church plans" are exempt from major portions of the Employee Retirement Income Security Act of 1974 (ERISA). The exemption is based on legitimate church-state concerns founded in the First Amendment to the U.S. Constitution. Language in the Senate report which accompanied ERISA sets forth the basic church-state question on which the exemption of "church plans" is based. Although the specific language quoted below applies directly to the plan termination requirements, it is assumed that this same church-state concern about excessive government entanglement in the affairs of the church underlies the exemption of "church plans" from the provisions of Titles I and II of ERISA. The language is as follows:

> The committee is concerned that the examination of books and records that may be required in any particular case as part of the careful and responsible administration of the insurance system might be regarded as unjustified invasion of the confidential relationship that is believed to be appropriate with regard to churches and their religious activities.

As of 1982, a "church plan" is not eligible for the exemption if it covers employees of church agencies. By defining "church plan" in such a manner which requires a division between the pension plan covering "church" employees and those plans covering the employees of church agencies, the government has made a distinction between the ministry of the church and that of its agencies. The effect of the distinction, which requires the splitting of pension programs, will be to isolate church agencies from their parent church bodies and, through the exhorbitant costs associated with the establishment of new plans, to limit the church's ministry.

In essence, the Federal government through the current definition, has denied the religious character of church agencies and the fact that the work of these agencies is an integral part of the church's mission. The Lutheran church bodies cannot accept such a definition.

This issue mirrors the one surrounding the "integrated auxiliaries" question and the Internal Revenue Service's determination of what ministries are and what ministries are not an integral part of the church's mission insofar as being exempt from filing annual information forms. The Lutheran Council in the USA and its cooperating church bodies firmly opposed the final IRS regulation on the "integrated auxiliaries" question on theological grounds. The cooperating Lutheran church bodies are strongly united in seeking remedies to restore the recognition of the integrity of the church's ministry through its agencies and institutions. In May of this year, a formal statement was adopted by the Lutheran Council in the USA on the "integrated auxiliaries" question. This statement and accompanying public policy recommendation were included in the report of the Lutheran Consultation on the Nature of the Church and its Relationship to Government. The "integrated auxiliaries" position, as adopted by the Lutheran Council in the USA, is as follows:

> Prior to 1969 most religious organizations, including churches and their related agencies, were exempted from filing informational returns with the Internal Revenue Service. The Tax Reform Act of 1969, however, stipulated that all organizations exempt from taxation under Section 501(a) of the Tax Code would henceforth have to file an annual informational Form 990 return--except churches, their "integrated auxiliaries," conventions and associations of churches, the exclusively religious activities of any religious order and exempt organizations with gross receipts under $5,000 annually. The law involves the reporting of information; no payment of taxes is involved.
>
> The problem for the IRS since 1969 has been to define "integrated auxiliaries," since that term had no legal meaning and no common definition among religious groups. In February 1976 the IRS issued proposed regulations which had the net effect of providing for all churches a single and extremely narrow definition of religious mission. Protests by a number of religious organizations led to some modifications in the "final" regulations issued in January 1977, but the regulations continue to be restrictive. Explicitly excluded from the definition of "integrated auxiliaries" are church-related hospitals, orphanages, homes for the elderly, colleges,

universities and elementary schools, although elementary and secondary schools are exempt from filing.

The heart of the issue is that the regulation relative to "integrated auxiliaries" seeks to impose on the churches a definition of "religious" and "church" which the churches cannot accept theologically, one which constitutes an unwarranted intrusion by the government into the affairs of the churches. The narrow definition introduces confusion within the churches and their agencies and institutions. Questions are raised in the agencies and their constituencies about whether these ministries are considered to be part of the churches' mission. It also leads the government to attempt other intrusions into the activities of the churches and church-related agencies and institutions, e.g., the Department of Labor's stance in the unemployment insurance tax issue.

Our churches would probably not object to the disclosure of most of the information required by Form 990 by those agencies and institutions of the church whose ministries appear to have counterparts in the public sphere, if such requirement of disclosure were not predicated upon a denial that those ministries are an integral part of the churches' mission. But the churches object on principle to having any of their ministries, including their agencies and institutions, be treated as "not religious." These agencies and institutions perform ministries which are essential to the churches' mission and must not be put in a different category from the strictly sacerdotal functions of the churches.

In conclusion, I want to state that we applaud Congress for enacting legislation in the interest of providing greater protection to employees covered by private pension plans. The church has the same interest in providing adequate economic security in retirement for its employees and has been operating in the best interests of clergy and lay employees for many years. We will continue our efforts in this regard in the future.

Thank you.

OFFICE OF GOVERNMENT LIAISON

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UNITED STATES
CATHOLIC CONFERENCE

December 19, 1979

Senator Lloyd Bentsen
Chairman
Subcommittee on Private Pension
Plans and Employee Fringe Benefits
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

Re: Amendments to the Pension Act

On behalf of the United States Catholic Conference, the National Organization of the Roman Catholic Bishops, I wish to register strong support for S.1090, S.1091, and S.1092 presently pending before your Subcommittee. The legislation is designed ' › remedy omissions to the basic act that woulo, if not amended, continue existing inequities respecting participation by churches and church agency employees in private pension plans.

The United States Catholic Conference is in agreement with the position presented by the Church Alliance for Clarification of ERISA when that body testified before your Subcommittee on December 4 in support of the above proposals.

I wish to express our deep appreciation for your efforts, past and present, on behalf of meaningful pension legislation, particularly in relation to churches and church agency organizations.

Very truly yours,

James L. Robinson

James L. Robinson
Director

JLR/ctl

AMERICAN HOSPITAL ASSOCIATION
444 NORTH CAPITOL STREET, N.W., SUITE 500, WASHINGTON, D.C. 20001 TELEPHONE 202 638 1100
WASHINGTON OFFICE

STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
TO THE
SENATE FINANCE SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
ON
TAX TREATMENT OF DEFERRED COMPENSATION

December 14, 1979

The American Hospital Association, which represents over 6,100 hospitals and other health care institutions, including both tax-exempt and taxable organizations, appreciates the opportunity to present the following views and recommendations with regard to the taxation of deferred compensation.

At the outset, we wish to state that we favor legislation that would preserve the existing law regarding tax treatment of deferred compensation arrangements maintained by tax-exempt organizations, which is the same treatment accorded by the Revenue Act of 1978 to deferred compensation arrangements maintained by taxable entities. We are opposed to S.511, the bill before your Subcommittee that would place deferred compensation plans of 501(c) tax-exempt organizations under the restrictions and limitations the Revenue Act of 1978 (Public Law 95-600) applied to such plans maintained by state and local governments.

Hospitals and Deferred Compensation Plans

Many hospitals make use of deferred compensation plans which afford their employees the opportunity of receiving and paying taxes on a part of their compensation in later retirement years rather than currently. Such arrangements have proven helpful to hospitals in attracting and retaining qualified talent, including both medical and

CABLE ADDRESS AMERHOSP

managerial personnel. They have also been a useful hospital cost containment tool. They thus bring benefits to the hospital and the public, as well as to the hospital's employees.

<u>Example</u>: If a hospital has under contract a physician or other employee in the 50% tax bracket who seeks to renegotiate his compensation and obtain a $15,000 increase for the next year, he is hoping to wind up with a net pay increase of $7,500 after taxes. The cost to the hospital would be $15,000. If the hospital and the employee agree to a $12,500 binding deferred compensation arrangement in lieu of the proposed $15,000 pay increase for the next year, both the employee and the hospital have gained. The employee has $12,500 for retirement purposes (to be taxed later at perhaps a lesser level) instead of a $7,500 current net pay increase, and the hospital's cost will be $12,500 instead of $15,000. This savings in the hospital's current operating expenses in turn benefits all who purchase care from the hospital and bear a share of the hospital's payroll. Clearly, the deferred compensation arrangement brings benefits to the employee, the hospital, its private pay patients, third-party payers such as Blue Cross, and to state and local governments as purchasers of care for beneficiaries of government programs such as Medicare and Medicaid.

<u>IRS Notice of Proposed Rulemaking, February 3, 1978</u>

Prior to February 3, 1978, future compensation deferred under a binding deferred compensation agreement was, pursuant to IRS rulings and court decisions, not taxed until received by the employee. We believe these long-standing rules are based on sound judicial principles. On that date, however, the IRS issued a proposed regulation to make such deferred compensation currently taxable. The proposed regulation would have applied to plans maintained by both taxable and tax-exempt employers, and to plans maintained by state and local governments. The American Hospital Association strongly opposed the regulation, citing to the IRS the benefits of deferred compensation to hospital employees and to purchasers of hospital care. Following the comment period the IRS did not publish a final regulation.

<u>Revenue Act of 1978 (Public Law 95-600)</u>

As part of the Revenue Act of 1978, Congress acted to preserve (with requirements to prevent a substantial loss of revenue) deferred compensation agreements involving employees of state and local governments. The 1978 Act also specifically provided that compensation deferred under plans maintained by taxable entities shall be taxed in accordance with regulations, rulings, and judicial decisions that were in effect on February 1, 1978, i.e., taxed when received, not currently. The law, however, was silent as to the tax treatment of compensation deferred by employees of nonprofit organizations. The Senate version of the 1978 Act would have accorded deferred compensation plans of nonprofit organizations the same treatment given plans of private taxable entities.

IRS Revives its Proposed Regulation

In June of 1979, the IRS revived its proposed regulation stating that if adopted, it would be applicable only to compensatory payments deferred under a nonqualified plan or arrangement maintained by a tax-exempt organization described in Section 501(c) of the Internal Revenue Code. The effect of such a regulation would be to bar such plans in the nonprofit sector, while they are permitted by the 1978 Act in the private business sector. The AHA has reiterated to the IRS its strong opposition to such a regulation, emphasizing again the importance of such arrangements as a hospital cost containment tool and a help in recruiting and retaining qualified personnel. We also pointed out that tax-exempt hospitals must compete with for-profit hospitals in recruiting skilled and scarce personnel, and are not able to offer profit sharing or stock option plans to employees, as are for-profit entities.

The IRS has not yet decided whether to proceed with issuance of a final regulation on this matter or to await action by Congress on pending legislation.

Pending Legislation

As the members of the Subcommittee know, S.511, introduced by Senator Spark Matsunaga (D-Hawaii) and which is before the Subcommittee, would amend the Internal Revenue Code to place deferred compensation plans of 501(c) tax-exempt organizations under the limitations imposed on deferred compensation of employees of state and local governments by the Revenue Act of 1978.

On December 5, 1979, H.R.6041 was introduced by Representatives Joel Pritchard (R-Wash.) and Norman Dicks (D-Wash.). This bill, which is before the House Committee on Ways and Means, would continue the existing tax treatment of deferred compensation plans of tax-exempt organizations, just as the Revenue Act of 1978 continued the existing tax treatment of deferred compensation plans of taxable employers.

AHA's Position and Recommendations on the Pending Legislation

For the reasons we have stated, the American Hospital Association is opposed to S.511.

We believe that the Congress should act, instead, to reaffirm and clarify the tax status of deferred compensation of employees of tax-exempt hospitals by providing that the amounts deferred shall be taxed in accordance with the rules, regulations, and court decisions in effect on February 1, 1978. This would ensure that nonprofit and investor-owned hospitals and their employees are treated exactly alike with regard to deferred compensation plans and agreements. The result would be both equitable and in accord with the long-established and sound principle that an individual pays taxes on income when it is received. The AHA strongly supports H.R.6041.

Revenue Impact

The legislative proposal we favor would merely preserve existing law and would thus have no effect on the government's tax revenues.

Your Subcommittee's favorable consideration of these recommendations of the American Hospital Association will be appreciated, and we believe clearly in the public interest.

Statement of

Robert H. Stewart III
Chairman of the Board

On Behalf Of
First International Bancshares, Inc.
Dallas, Texas

On S.1958
A Bill to Amend the
Employee Retirement Income Security Act of 1974
For the Purpose of Facilitating The Investment
By Employee Pension Benefit Plans In
Qualifying Employer Real Property

Before The
Committee On Finance
United States Senate
Subcommittee on Private Pension Plans
and
Employee Fringe Benefits

Mr. Chairman and members of the Subcommittee: I am writing to you in my capacity as Chairman of the Board of First International Bancshares, Inc.

First International Bancshares, Inc. ("First International"), a bank holding company under the Bank Holding Company Act, presently owns all of the capital stock of thirty Texas banks. First International and its affiliated companies employ over 5,000 full and part-time employees who are covered by uniform non-contributory defined benefit pension plans administered under the First International Bancshares, Inc. Retirement Program.

My testimony contained herein is in support of S.1958, a bill to amend the Employment Income Security Act of 1974 ("ERISA") for the purpose of facilitating the investment by certain employee pension benefit plans in qualifying employer real property; and, after some appropriate modifications, to recommend its passage. S.1958 would amend the prohibited transaction restrictions contained in Section 407 of ERISA to permit certain employee pension benefit plans to invest in qualifying employer real property provided certain conditions are satisfied. The conditions are designed to protect the interests of such plans and of their participants and beneficiaries.

Succinctly stated, S.1958 is necessary and appropriate for a number of reasons. First, Section 407 of ERISA provides that no employee pension benefit plan may acquire or hold any employer real property, unless it is qualifying employer real property. The term "employer real property" means real property leased to the employer of employees covered by the plan or to the affiliate of such employer. Qualifying employer real property means parcels of employer real property of a substantial number, dispersed geographically, if each parcel and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use, even if all such real property is leased to the one lessee, and if the acquisition and retention complies with other rules of ERISA. According to the Department of Labor, "qualifying employer real property" precludes the acquisition of a single parcel of employer real property. Subject to exceptions, a pension plan may not acquire or hold any qualifying employer real property or qualifying employer securities if immediately after the acquisition, the aggregate fair market value of both exceeds ten percent of the fair market value of the assets of the plan.

Second, although Section 408(a) of ERISA provides the Secretary of Labor authority to grant administrative exemptions from prohibited transactions, as a matter of policy, I am informed that the Department of Labor will not consider an exemption request by a plan if the underlying transaction is arguably within the scope of Section 414(c)(2) of ERISA, the transitional provision relating to employer real property leases that pre-date ERISA. Under current policy, exemption applicants are required to withdraw their applications. Furthermore, the Department of Labor will not render an advisory opinion that the underlying transaction is covered by the transitional provision. The Department takes the position that such plan should not apply for an exemption application until shortly before June 30, 1984. In most cases, the acquisition and holding of employer real property prior to January 1, 1975, would seem to meet the exemptive conditions contained in Section 414(c)(2) of ERISA.

Third, national banks are subject to examination by the United States Comptroller of the Currency. The bank examiners from the Office of the Comptroller are currently demanding that banks acting as trustee for employee pension benefit plans which hold employer real property immediately apply for and obtain an exemption ruling from the Department of Labor under Section 408(a). As explained above, the Department of Labor will not consider such exemption applications at this time. Thus, although ERISA Section 414(c)(2) may grant a transitional exemption until 1984 with regard to such employer real property, between the demands of the Comptroller of the Currency and the current position on rulings by the Department of Labor, such plans may be left with no realistic alternative but to dispose of such employer real property even though such properties may otherwise have qualified for administrative exemptions or be covered by the transitional exemption of 414(c)(2).

Fourth, the conditions contained in S.1958 are adequate to insure that employer real property transactions which satisfy the conditions are in the interest of employee pension benefit plans and of their participants and beneficiaries and of the rights of such participants and beneficiaries.

In order to alleviate a dilemma of many banks which act as trustee of employee pension benefit plans which cover only their own employees, certain modifications to S.1958 are necessary and appropriate.

First, ERISA Section 407(d)(4)(B) and S.1958 require that each parcel of qualifying employer real property and the improvements thereon be suitable (or adaptable without excessive cost) for more than one use. By applying this requirement conjunctively to both the land and the improvements, this provision effectively excludes many valuable parcels of real estate which were leased by the employee pension benefit plan to the employer on which the employer built and owns the improvements. While the improvements constructed and owned by the employer may not be easily adapted to other uses, the only property of the plan, the raw land, may be suitable for a number of uses. Also, under many such leases, the employer has the right to destroy and remove the existing improvements and construct new improvements thereon without restriction as to type of use.
Thus, by its present language which applies the suitability for more than one use requirement to the land and improvements jointly, without regard to whether the improvements are owned by the lessor, Section 407(d)(4)(B) and S.1958 unnecessarily restrict the definition of qualifying employer real property beyond any safeguards necessary to protect the plan and its participants.

Second, subparagraphs (H) and (I) of Section 407(d)(4) of S.1958 require that the employer real property be held by an "independent professional trustee". It is submitted that this is unduly restrictive in the case of banks and other financial institutions acting as trustees of plans covering only their own employees or those of their affiliated companies. In the original enactment of ERISA, it was recognized that banks and other financial institutions which are supervised by the United States or a State are in a different position than that of an unregulated fiduciary. That is, the supervision and regulation by the United States or State banking authorities practically assure that a bank will not violate any of its fiduciary duties; and thus the rights and interests of plan participants are protected by safeguards not always found in the case of an unregulated fiduciary. Consequently, specific statutory exemptions from the general prohibited transaction rules were enacted; to wit:

1. Section 408(b)(4) allows the investment of part or all of a plan's assets in deposits which bear a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a State, if such bank is the fiduciary of such plan and if the plan covers only employees of such bank or other financial institution and employees of affiliates.

2. Section 408(b)(6) allows a bank or similar financial institution supervised by the United States or a State which is a fiduciary of a plan to provide ancillary services for such plan.

3. Section 408(b)(8) provides that banks and trust companies, subject to the supervision of a State or Federal agency, which maintain common trust funds or pooled investment funds, may invest in such funds with assets of plans of which they act as trustee.

From the foregoing examples, it is clearly evident that the drafters of ERISA considered that the supervision of the United States or State banking authorities over banks and other similar financial institutions to be an adequate safeguard to permit certain statutory exemptions from the general rules regarding prohibited transactions. It is submitted that these same safeguards are equally present and the rights and interests of the plan participants are equally protected in the case of one parcel of employer real property legal title to which is held and which property is administered by a bank or similar financial institution subject to supervision by the United States or a State. By its present language which includes the word "independent" with respect to a professional trustee, S.1958 unnecessarily excludes from the exemption banks or similar regulated financial institutions which are trustees for plans covering only their own employees and those of their affiliated companies. As may be seen from those statutory exemptions already contained in ERISA Section 408(b), discussed above, such exclusion of banks or similar financial institutions is unnecessary for the protection of the rights and interests of the plan participants.

Third, since long before the enactment of ERISA, banks have been very cognizant of the potential for conflicts of interest to arise under doctrines of trust law when a bank acts in a dual role in its fiduciary capacity and in its individual capacity in a single transaction. As a consequence of this awareness and of applicable trust law, in order to avoid the existence or even the appearance of a violation of their fiduciary duty in such instances, many such transactions are required to be or are voluntarily submitted by banks to a State or Federal court of competent jurisdiction for approval by a judgment prior to execution of such transactions.

Subsection 407(d)(4)(G) of S.1958 requires that the annual rate of return on employer real property be at least as favorable as the annual rate if such property was leased to an unrelated third party in an arms length transaction. Furthermore, this comparability must be determined annually by an independent qualified appraiser. Subsection 407(d)(4)(J) requires that a lease of a single parcel of employer real property must be approved by an independent fiduciary unrelated to any party in interest and which has no other interest (other than its interest as trustee or nondiscretionary service provider) with respect to the transaction.

It is submitted that in those instances where the lease of a single parcel of employer real property to a bank by a bank's employee pension benefit plan for its own employees and those of its affiliated companies has been first submitted to a State or Federal court of competent jurisdiction for approval and such approval has been conferred by judgment;

56-943 O - 80 - pt.2 - 20

and, further, that any later amendments and any mandatory rental revision procedures contained therein are subject to the court's control, the court is as effective and adequate to safeguard the rights and interests of the plan participants as an "independent professional trustee" or an "independent qualified appraiser". Such court approval renders the annual determination by an independent qualified appraiser and the approval of such lease by an independent fiduciary, as presently required by S.1958, unnecessary and superfluous.

Based upon the preceding discussion, we propose that S.1958 be amended in the following manner:

1. By striking out subparagraph (B) of subsection 407(d)(4) and inserting in lieu thereof the following:

> "(B) if each parcel of real property and the improvements thereon (except improvements placed thereon by and at the expense of the lessee) are suitable (or adaptable without excessive cost) for more than one use."

2. By striking out subparagraph (H) of section 407(d)(4) and inserting in lieu thereof the following:

> "(H) if, in the event a plan holds only one parcel of employer real property, legal title to such property is held by an independent professional trustee, or by a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is the trustee of such plan and such plan covers

only employees of such bank or other institution and employees of affiliates of such bank or other institution."

3. By striking out subparagraph (I) of Section 407(d)(4) and inserting in lieu thereof the following:

"(I) if, in the event a plan holds only one parcel of employer real property, such property is administered by an independent professional trustee, or by a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is the trustee of such plan and the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution."

4. By adding the following sentence as the last sentence of paragraph (4) of Section 407(d):

"Subparagraphs (G) and (J) shall not apply if such lease is approved by judgment of a State or Federal court of competent jurisdiction in the judicial district in which the employer real property is located."

In addition, in order to avoid a strict or literal construction of subparagraph (ii) of Section 407(d)(4)(E) of S.1958, we recommend striking out such subparagraph (ii) and inserting in lieu thereof the following:

"(ii) which provides that obligations for principal and interest under any mortgage with respect to the property and for liability for tax under section 511 of the Internal Revenue Code of 1954 are to be paid by the lessee or are to be paid fully from rents generated by such property and under which the amount of such rents is sufficient to pay such obligations;"

In conclusion, we would point out that the conditions contained in S.1958 and the foregoing proposed amendments thereto are more restrictive than the existing restrictions contained in the present statute. This does not appear to be warranted when the only difference is that the proposed amendment would permit employee pension benefit plans to hold a single parcel of employer real property. Moreover, the amendments which we have proposed would prevent the unnecessary disposition of parcels of employer real property caused by the aforementioned combined action by the Comptroller of the Currency and inaction by the Department of Labor. The proposed amended conditions more than compensate for any perceived increase in risk to the plan.

I will be pleased to answer any questions, either written or by telephone, that you might have with regard to these comments on S.1958.

Respectfully submitted,

Robert H. Stewart III
Chairman of the Board
First International Bancshares, Inc.

AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION

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THE AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION

Statement on ERISA Improvements Act S. 209 and
ERISA Simplification Act of 1979 S. 1089, December, 1979

The nearly 30,000 members of ASPA have had an on-going interest in our nation's retirement income systems. We have testified on numerous occasions to Congressional Committees studying the public and private retirement programs. We feel that ERISA and the 1977 amendments to the Social Security Act have done much to strengthen both the public and private retirement systems. We are deeply concerned with the preservation of human dignity for our older citizens through provision of adequate retirement income. It has been and is our position that the needed retirement income must be supplied jointly by social security, public reitrement and private retirement plans, and the financial resources of individuals.

Due to present and projected demographic, employment and economic problems, we feel that studying the retirement problem and making needed corrections on an on-going basis will become a relatively permanent challenge for both government and the business community. Although much progress has been made as evidenced by ERISA itself and changes to the Social Security System, we must be in a position to constantly review problems related to retirement and make any necessary changes to existing systems.

The proposed bills - ERISA Improvements Act as submitted by Senators Williams and Javits and ERISA Simplification Act of 1979 as submitted by Senator Bentsen - have many changes that ASPA strongly supports. They are:

- Simplified reporting and disclosure
- Ability to transfer individual pension assets from one fund to another
- Improved survivor protection

The American Society for Personnel Administration

Statement on ERISA Improvements Act S 209 and ERISA Simplification Act of 1979 S. 1089, December 1979 - page 2

- Recommended universal amendment language
- Tax credit for small business retirement plans
- Taxable deduction for employee retirement contributions

As to the individual tax deduction allowance for contributions to retirement plans, we prefer Senator Bentsen's proposal in that it is more liberal than the proposal submitted by Senators Williams and Javits. Also, although we are strongly in favor of other areas of the proposed bills we believe that the individual tax deduction section is probably the single most significant change proposed by these bills. This change would create a statutory environment such as to encourage additional individual retirement savings by individuals. Encouragement in this area becomes increasingly important as individuals have less income to devote to retirement savings due to economic problems brought about by inflation.

Additional individual retirement savings would also tend to give relief to the mounting pressures on both our social security and welfare systems. Also, increased savings would add to capital formation which should then encourage economic growth, increased employment and a broader tax base. This would tend to offset any revenue loss in the long run while giving immediate encouragement to individuals to take an active hand in overcoming problems related to supplying retirement income.

We urge adoption of the aforementioned portions of the proposed bills and are prepared to encourage our membership to take action supporting these bills.

STATEMENT SUBMITTED BY THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS TO THE SUBCOMMITTEE ON PRIVATE PENSION PLANS AND FRINGE BENEFITS OF THE SENATE FINANCE COMMITTEE ON S. 209 AND OTHER PRIVATE PENSION LEGISLATION

December 18, 1979

The AFL-CIO appreciates the opportunity to present our views on various bills that would amend the Employee Retirement Income Security Act (ERISA). The principal bill before the Subcommittee on Private Pension Plans and Fringe Benefits, to which we will direct most of our comments, is S. 209, introduced by Senators Harrison A. Williams and Jacob K. Javits.

It is important to state at the outset that we support ERISA. We feel that the law is beneficial and support its basic provisions. Like most laws, however, ERISA is not perfect and does require change. Therefore, we are making a number of recommendations for changes in the law, particularly with respect to some aspects of its administration. Attached is a statement on ERISA recently adopted by the AFL-CIO convention. We respectfully request that it be included in the record of the hearings.

We would like to mention some of the labor movement's concerns with the law and its administration.

<u>Administration and Enforcement</u>

A major issue during deliberations on the ERISA legislation was whether the Labor Department or Treasury Department was to administer the law. The AFL-CIO strongly supported administration by the Labor Department since the law concerns itself with employee rights and benefits and only peripherally with taxes. What we have, however, is a division of responsibility between the two Departments and also establishment of the autonomous Pension Benefit Guaranty Corporation. Thus, there are numerous possibilities for duplication and overlapping authority.

Actual experience under the law has shown that dual administration is not working well. Matters frequently must be redone, often several times, as the Labor and Treasury Departments attempt to resolve their differences. There is an urgent need to break the log jam in the issuing of regulations. Decisions have still not yet been made on a number of important issues.

The Departments have made considerable progress in improving the administration of the law since they concluded a reorganization agreement. But there can be no real solution to the dual administration problem except administration by one agency or department of government and, in our view, ideally that agency should be the Department of Labor.

S. 209 does not put administration in the Labor Department but it does consolidate the functions of the Labor Department, the Pension Benefit Guaranty Corporation and most of the ERISA functions of the Internal Revenue Service into a single agency -- a new Employee Benefit Commission. The Commission would have the power to certify to the Treasury Department that a plan is qualified for tax exemption status and would develop policy respecting all federal laws which relate to all employee benefit plans.

We would have preferred that the consolidation take place within the Department of Labor. Nevertheless, we are prepared to go along with the bill's approach because it will do much to resolve existing problems and because it is preferable to the problems inherent in dual administration.

Misrepresentation

The Supreme Court recently decided the Daniel case, reversing the lower federal courts which sought to superimpose on pension plans the complex regulations of federal securities laws. We opposed such a concept because it would have subjected many of our collectively bargained pension plans to the threat of bankruptcy -- producing retroactive liability, additional burdens of overlapping regulatory jurisdiction, and vague and undefined misrepresentation standards which would have imposed inequitable obligations on these plans.

Thus, the AFL-CIO strongly supports the provisions of the bill. that confirm the Supreme Court's decision in Daniel. However, we are concerned about vague "misrepresentation" provisions in S. 209 which may cause many of the problems inherent in the threat presented by the Court of Appeals decision in the Daniel case. Such legislation is unwise until a clear need for it is demonstrated. Much more information is needed on the extent of misrepresentations and resulting injuries and on the impact such provisions would have on the operation of pension plans. Consequently, the AFL-CIO recommends that pending a more complete analysis of the extent of the problem, these provisions not be enacted into law. Instead, the Congress should require the Labor Department to undertake an immediate and expeditious study as to the adequacy of protection against misrepresentation under existing law, including ERISA, for pension plans and participants.

Right of Unions to Sue - Part 5, Title I, of ERISA provides for enforcement by a participant, beneficiary or by the Secretary of Labor of certain rights under ERISA and/or the pension plan. It is not entirely clear, however, whether a union may sue in its own name to enforce such rights where it represents the employees involved. The right of a union to sue in its own name is extremely important since many employees would be reluctant for fear of retaliation if they are forced to be named plaintiff in such a lawsuit. The bill should include a provision to insure that a union may sue in its own name to enforce employee rights under ERISA.

Fiduciary

Within the area of fiduciary responsibility, problems relating to prohibited transactions have been the most troublesome. Such problems are particularly difficult for multiemployer plans because there are so many parties involved and they are constantly changing.

Congress could not deal with all the existing arrangements in the employee benefits field and thus made provision for liberal use of exemptions. Congress obviously wanted to protect legitimate actions engaged in by plans which would technically be prohibited by the Act but which could be dealt with under the exemption process. As things now stand, a myriad number of legitimate transactions prohibited by ERISA require individual exemptions. The exemption process is slow and has resulted in a backlog of exemption requests.

S. 209 helps by narrowing the definition of party in interest to remove from that status those persons who are highly unlikely to be in a position to influence the actions of a plan or of plan officials. In addition, transfer of assets between plans which have entered into reciprocity arrangements will receive a new statutory exemption and the Labor Department will be required to report to the President and the Congress on undue delays in deciding exemption requests. Though not resolving all the problems, these modifications would help and we urge their adoption.

Delinquent Contributions - Another needed provision would make the failure to contribute to a pension or welfare fund in accordance with the provisions of a collective bargaining agreement a violation of the law. A fiduciary, who acts in behalf of a plan and brings a successful action under this provision, would be entitled to recover lawyer's fees and other costs from the defendant. We recommend enactment of this provision which would help multiemployer plans with their frequent and difficult task of collecting delinquent contributions.

Socially Useful Investment - ERISA's fiduciary requirements relating to prudent investment have created a substantial amount of uncertainty regarding investment decisions and remain a serious obstacle to investment of pension funds for socially useful purposes and in ways that will benefit our members. The AFL-CIO has long encouraged union pension funds to invest in socially useful purposes such as health facilities, housing projects, etc. We feel that even if there is a slight sacrifice in yield, it can be outweighed by the desirable social and economic benefits of such investment.

Because most pension funds are run by employers and/or delegate investment functions to bankers, investment trusts and other conservatively managed financial institutions, a somewhat anomalous situation has developed. Workers' money is being channeled into all sorts of investments which do not benefit workers or their families. While such projects may be sound from an investment standpoint, pension plan money could be utilized to provide a double benefit -- income to the pension fund and investment in projects and institutions that will be to the benefit of workers and their families.

The passage of ERISA has aggravated this problem, creating a potentially serious adverse impact on socially useful investments and has made efforts to encourage this kind of investment extremely difficult. The Labor Department has recently issued regulations which have helped clear up some of the confusion surrounding the investment of assets under the prudent man rule, but these regulations, in our opinion, do not deal adequately with this problem. The only satisfactory way to deal with it is for Congress to amend ERISA to make clear that socially useful investment which meets standards of prudence is not a violation of the law.

<u>Preemption</u>

The AFL-CIO is convinced that the broad federal preemption provided by ERISA should be continued. Such federal preemption was consciously selected to encourage the growth and development of private pension and welfare plans and to assure uniform national regulation of such plans. We urge the Congress not to limit the preemption provisions of ERISA at this time, as proposed in S. 209 and to permit a longer period of experience under the preemption provision during which the Department of Labor would study its effect -- a study which can serve as the basis for future legislation if the need for it is clearly demonstrated.

<u>Tax Incentives</u>

S. 209 would permit a deduction from taxable income for employee contributions to a qualified plan which would be required to be accepted by the plan. In general, the maximum allowable deduction is the smaller of 10 percent of compensation or $1000. The amount of the allowable deduction would be reduced by any amount contributed to the plan.

The bill attempts to deal with the inherent problems of discrimination in favor of highly compensated employees in such proposals by the use of an "actual deferral percentage" formula similar to the one used for cash or deferred compensation plans.

It is extremely difficult, if not impossible, to accomplish major plan improvements through tax incentives in a non-discriminatory manner. The use of tax incentives inevitably benefits highly paid employees who can afford to take advantage of them because they are in tax brackets that provide greater financial gain.

In our opinion, these kinds of tax incentives which are inherently regressive will not result in significant expansion of private pension coverage. Such proposals would help very few low or middle income workers who live so close to the margin that they are unable to save anything or very little out of their incomes for this purpose. Such a tax deduction is of little value to them. The fairest and most efficient way to provide adequate retirement protection, particularly for those workers not covered by private pension plans, is to improve the Social Security program.

Furthermore, this proposal would present pension funds, particularly multiemployer plans, with formidable administrative problems at the expense of employee benefits. This would be unfortunate since these administrative problems would come at a time when these funds are still confronted with difficult problems of compliance with ERISA.

The bill also grants tax credits to employers who initiate or improve pension plans. Only small employers are eligible for the tax credit for initiating new plans. The allowable tax credit which is on top of the normal deductions for contributions to a plan would be 5 percent of the first year cost, 3 percent of each of the following two years, and 1 percent for each of the next two years.

We oppose this proposal. It would penalize those employers who have done a good job of providing pension protection for their employees and reward those employers who have done a poor job or have provided no pensions at all. The proposal also would be extremely difficult to administer for it would be virtually impossible to write regulations defining what kind of improvements would qualify for a tax credit.

In addition, taken together, the proposals would result in substantial revenue loss running into billions of dollars. Proponents of these proposals should show how this lost revenue is to be recovered or should demonstrate that the loss in revenue will not come at the expense of other more important programs.

Funding

Section 303 of ERISA provides for the waiver of minimum funding standards by the Secretary of Treasury. Section 304 of ERISA further provides that if such a variance is granted, "no amendment of the plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits or any change in the rate at which benefits become nonforfeitable under the plan shall be adopted..." Under this provision the granting of a variance could give an employer a "lawful" justification for refusing to bargain with the union on pension improvements and it is therefore extremely important that the collective bargaining representative of the employees involved be given notice of and the right to participate in the variance process. In this manner the interests of participants and all beneficiaries will be protected. The Subcommittee should include such a requirement in the bill.

Reporting and Disclosure

A major purpose of Section 114 of S. 209 is to reduce the paperwork of small business, and we have no objection to that. Unfortunately, in the attempt to achieve this objective, S. 209 eliminates the Summary Annual Report. Our experience suggests that it is the smaller plans that are most in need of monitoring which cannot be done effectively in the absence of such filings with the Labor Department. We suggest an alternative to the filing of the Summary Annual Report which may be less of a burden for employers: simply require that employers file copies of their pension and welfare plan and amendments with the Department and that such documents be made available for public scrutiny within 120 days of the statutory filing date.

The AFL-CIO is concerned that S. 209 appears to authorize the Secretary of Labor to drop almost any reporting requirement at any time. Though we are confident that the present Secretary of Labor and his staff would use this section wisely, no one can foresee what the future may bring in the way of Secretaries and Administrators. Thus, in the interest of participant protection, the Secretary should be denied this kind of blanket authority.

The AFL-CIO believes that the simplification of ERISA requirements and the reduction of burdens on plan administrators and employers should be a continuing goal of the Congress and the Department of Labor. However, lessened administrative burdens should not be accomplished by compromising participant protection.

Minimum Standards

S. 209 makes revisions in the minimum participation and vesting rules in order to clarify and resolve some of the difficulties experienced with the minimum standards provisions of the law. These proposed changes would relieve many plan problems and help improve adiminstration as well as expand certain participant protections. We particularly urge the Committee to act favorably on those provisions which do the following:

- Prohibit reducation in disability benefits paid under a welfare plan because of an increase in social security benefits. This prohibition already applies to retirement and disability benefits paid through a pension plan and fairness requires that this prohibition also apply to disability benefits paid through a welfare plan. This section also prohibits a reduction in pension benefits as the result of a workers compensation award. We believe such an offset violates current provisions of ERISA but believe clari- is necessary to avoid the litigation that is now developing in the courts over the issue.

- Expand joint and survivors annuity benefits by requiring either an annuity or a lump sum payment for the surviving spouse of a participant who is credited with at least ten years of vesting and who dies before the annuity starting date. This proposal would resolve the complications caused by the present rules on electing joint and survivor coverage at the early retirement age and would improve somewhat the protection for a surviving spouse. We urge broadening of this proposal to protect spouses of disabled participants who have ten years of vesting when disability occurs.

- Clarify arrangements covering the transfer of contributions from the jurisdiction in which the employee is currently employed to the pension and/or welfare fund in which the employee previously participated. Clarification in ERISA is needed so that such arrangements are not considered violations of the law.

- Permit plan participation on a plan-year basis. Most multiemployer plans can function efficiently only if the plan computes service on the basis of plan computation years. Current regulations allow this for all purposes except for determining initial date of participation. This change allows the plan to measure a year of service for purposes of initial participation to use the first day of the plan year so long as rights and benefits are determined on the basis of all an employee's service regardless of the date on which the employee commenced participation. The purpose is to relieve plans of the record-keeping burden which arises when participation must be measured from different dates for employees.

- Establish 125 days of service in the maritime industry as a year of service. This conforms to existing regulations but the present law has a technical error which could subject the regulations to possible legal challenges.

- Allow use of elapsed time as a method of measuring the year of vested service instead of 1000 hours. This service computation method is commonly used by both single and multiemployer plans and current regulations permit its continued use. However, pension lawyers feel this could be subject to challenge in the courts unless the law is clarified.

- Allow plans to use the average of several accrual rates in determining retirement benefits when more than one applies. The purpose is to tie a participant's benefit accrual for a given year of service to the retirement benefit in effect during that year rather than to any one benefit formula.

- Remove incentives which encourage beneficiaries of multiemployer plans to return to work in the same industry, trade or craft, and in the same geographic area and compete with employees of preretirement age who are participants in the same plan -- a practice which tends to create labor relations instability.

S. 1090 and S. 1091

The effect of these bills would be to exempt church-affiliated organizations, such as hospitals and social agencies, from ERISA coverage scheduled for 1983. The argument is made in behalf of these bills that there is an essential difference between business organizations and such institutions because a business can pass on increased costs to the consumer and church-affiliated institutions cannot readily do so.

The fact is that ERISA also covers practically all other private non-profit institutions, most of which have similar economic and compliance problems and these are not asking to be exempted from the law. There is little logic in covering private, non-profit hospitals and agencies by ERISA but exempting identical church-affiliated institutions. Church-affiliated organizations were given special consideration not granted similar private non-profit institutions by having their ERISA coverage delayed until 1983 -- more than eight years after the passage of the law. This is ample time to prepare for and to make any necessary adjustments. We believe coverage should take place as scheduled without further delay.

Conclusion

In our opinion, ERISA was landmark legislation and five years after its passage still stands as a major achievement. A law as complex as ERISA would be difficult to administer under the best of circumstances and problems in implementation and administration were anticipated. Divided administrative responsibility among several agencies helped to create serious additional difficulties. Follow-up legislation to deal with these problems was to be expected. Enactment of S. 209, with the modifications we have suggested, would result in major progress toward a resolution of these problems.

Resolution
Adopted by the
Thirteenth Constitutional Convention
of the AFL-CIO
Washington, D.C.
November 15-20, 1979

Pensions

The Employee Retirement Income Security Act of 1974 (ERISA) has proven beneficial to workers and their families, but it is in need of improvement. Experience has shown that some of its provisions are unsatisfactory and its administration is unwieldy. The inefficiency, duplication of effort, and delay of the present administrative system have often hurt the very people that the program was intended to help.

The AFL-CIO opposes proposals that attempt to deal with inadequate private pension coverage by allowing special tax deductions to individuals and employers. This method of encouraging provisions for retirement security outside the framework of collective bargaining is of no help to low or middle-income workers. Similar proposals for employers reward those who have done nothing or have inadequate pension plans and penalize employers who have done a good job.

Of great concern are the provisions of the law relating to termination insurance for multiemployer plans. Termination insurance was enacted to protect American workers against loss of pension benefits and to encourage the continuation and growth of sound private pension plans. The law is serving this function with respect to participants in single employer plans. However, the multiemployer termination insurance provisions, as now constituted, will not protect the workers or their pension plans. Termination insurance provisions designed with single employer plans in mind simply do not work when applied to multiemployer plans. The special characteristics of multiemployer insurance plans must be taken into account in designing such a program. Otherwise, the law will have a serious, negative impact on the continuation and growth of collectively bargained multiemployer plans.

Therefore, we urge Congress to make the following amendments to ERISA:

1. Place major responsibility for the administration of the law preferably in the Department of Labor or in a new administrative agency.

2. Clarify ambiguous language which poses the danger of harmful interpretations and court decisions and to correct statutory defects revealed during the implementation period.

3. Revise existing cumbersome machinery and authority so the Secretary of Labor can permit beneficial transactions and at the same time, enforce prohibitions of abusive transactions.

4. Enact effective protection for the pension rights of state and local government employees.

Further, we urge the Congress to reject discriminatory tax proposals for individuals and employers as a way of encouraging provisions for retirement security outside the framework of collective bargaining.

Congress must amend the termination insurance provisions of ERISA to take into account the special needs of collectively bargained multiemployer plans. Specifically, we urge the following:

1. Provide a mechanism for assisting dying industry plans which does not increase the premium for healthier plans to a level which would place them in serious jeopardy.

2. Make it possible for plans to reorganize and, if necessary, to secure assistance from the Pension Benefit Guaranty Corporation when the only other reasonable alternative is termination.

3. Establish for collectively bargained multiemployer plans guarantee levels appropriate for and consistent with the best interests of the participants of each plan.

4. Amend the employer liability provisions to provide incentives for employers to continue their participation in multiemployer plans.

STATEMENT SUBMITTED BY

THE NATIONAL ASSOCIATION OF MANUFACTURERS

for

SUBCOMMITTEE ON PRIVATE PENSION PLANS

and

EMPLOYEE FRINGE BENEFITS

SENATE COMMITTEE ON FINANCE

on

S. 209

THE ERISA IMPROVEMENTS ACT OF 1979

and

S. 1089

THE ERISA SIMPLIFICATION ACT OF 1979

DECEMBER 21, 1979

INTRODUCTION

The National Association of Manufacturers welcomes this opportunity to offer its views on S. 209, the ERISA Improvements Act of 1979 and S. 1089, the ERISA Simplification Act of 1979, to the Subcommittee on Private Pension Plans and Employee Fringe Benefits, Senate Committee on Finance. The NAM is composed of over 12,300 manufacturing and related concerns, 80 percent of which have 500 or fewer employees. The NAM represents industrial employers who employ, in the aggregate, over 15 million employees or 78 percent of all employees employed in manufacturing nation-wide. A large number of its members have one or more retirement plans, many of which are by-products of the collective bargaining process.

ERISA has now been in effect for more than five years, and the NAM believes that appropriate measures to simplify its administration, to lessen its paperwork requirements, and to encourage the growth of the private pension system are timely. This statement contains general comments on ERISA and the private pension system and then discusses various provisions of S. 209 and S. 1089.

OVERVIEW

Following the passage of ERISA, there was a substantial increase in termination of single employer-sponsored "defined benefit" pensions plans throughout the country. While the reasons for such terminations are complex, it is clear that the costs of administering plans and the paperwork requirements of ERISA had a significant impact. Recent individual agency actions as well as Reorganization Plan #4, approved late last year by Congress, should lessen the effects of administration and reporting problems.

The NAM believes it is important in considering further substantive changes to ERISA to proceed carefully because of the extremely broad and diverse number of pension plans in this country, many of which are affected by a collective bargaining process which has played and will continue to play a unique role in the development of provisions specifically tailored to meet the needs of individual employers and employees. The NAM at the present time opposes major substantive amendments requiring plan changes or constricting the freedom for plan development to meet individual needs. Such activity would discourage both the expansion of existing plans and the creation of new ones.

Moreover, the impact of the Social Security Amendments of 1977 (P.L. 95-216) and the Age Discrimination in Employment Act Amendments of 1978 (P.L. 95-256), and the transfer of jurisdiction to the EEOC are not clear. Social Security changes will have significant fiscal impact while the new mandatory retirement law changes have created uncertainty not only for their effects on pension plans and other benefit programs but also for retirement policy in general.

Development of numerous advisory commissions such as the one on Social Security authorized by the 1977 Act and the Presidential Commission on Pension Policy whose members were named by the White House will be providing in-depth analysis of retirement policy.

For these reasons, Congress should not act expeditiously in passing major ERISA amendments.

MULTIPLE JURSIDICTION

Title IV of S. 209 would consolidate the administration of ERISA which now involves the Departments of Labor and Treasury as well as the Pension Benefit Guaranty Corporation into a new single agency. The dual jurisidiction between Labor and Treasury has been, in part, responsible for problems such as delays in promulgation of ERISA regulations and excessive duplication of reports. However, there has been and should continue to be improvement in administration because of the concerted efforts of the respective Departments in reducing such duplication, coordinating filing requirements, and implementing other actions to reduce paperwork.

The NAM supported Reorganization Plan #4, to simplify further ERISA administration, as an appropriate action to clarify and refine jurisdictional authority. As part of the process for Congressional approval, the Administration agreed to make recommendations to Congress by January 31, 1980 on any further change in administration. The NAM urges the committee to delay action on major legislative changes with respect to jurisdiction until this reorganization plan has been fully implemented. A full evaluation of this reorganization should be possible by January 31, 1980, and the experience will allow for informed policy decisions if further changes are needed.

REPORTING AND DISCLOSURE

The NAM supports efforts to simplify reporting and disclosure requirements under ERISA and, therefore, generally supports the parts of Sec. 111-117 of S. 209 resulting in simplified reporting, consolidation of forms, elimination of Summary Annual Reports, and simplified disclosure of participant's benefit rights. These revisions will reduce paperwork, improve administration and encourage rather than discourage plan creation.

WORKERS' COMPENSATION OFFSET

The NAM strongly opposes Section 126 which would prohibit the reduction of pension benefits by the amount of workers' compensation awards. Such offsets are entirely appropriate to the concept of integrated compensation/benefit systems, and the elimination or reduction of such offsets is contrary to sound system development and administration.

Historically, employers have been allowed to offset pension benefits from other forms of employer-financed programs. The rationale, most simply stated, has been to insure minimal duplication of benefits, reasonable costs to the employer, and adequate wage loss protection for employees. In the words of one leading authority on workers' compensation, Professor Arthur Larson:

> Once it is recognized that workmen's compensation is one unit in an overall system of wage loss protection, rather than something resembling a recovery in tort or in a private accident policy, the conclusion follows that duplication of benefits from different parts of the system should not ordinarily be allowed. (Emphasis added) 4 Larson Workmen's Compensation Law §97.00

That reductions in private plan benefits are common is recognized by Dr. Larson as well:

> Although avoidance of duplication cannot ordinarily be achieved under the American statutes in these cases by, so to speak, trimming at the workers' compensation end, it is frequently achieved by express language trimming at the private-plan end, that is, by reducing private benefits by the amount of any workers' compensation payment. Id at §97.51

Revenue Ruling 68-243 recognizes the permissability of workers' compensation offsets. This ruling, which predates ERISA by six years and remains virtually unchanged today, focuses on this issue by drawing an important distinction between allowable offsets for benefits payable under workers' compensation and disallowed offsets for damages recovered from an employer in a common law tort action. Under this ruling, it is recognized that an offset of court-awarded damages is inappropriate in that it would result in a pension plan being used to satisfy the employer's proven liability for damages. On the other hand, one can reasonably conclude that the workers' compensation offset is allowed because of the wage loss nature of the workers' compensation system. The fact that an employer is insured under a workers' compensation statute and consequently undertaking a financial responsibility which does not in any way reflect his culpability for injuries incurred by employees, is reason in and of itself to permit the offset. In this context, one must recognize several facts. The principle of workers' compensation, to enable an injured employee to live without being a burden to others, is not undermined by the offset. Also, if an employee were able to recover damages from both workers' compensation and pension benefits, he would receive dual benefits in every instance when the employer was not responsible for the injury.

A number of cases support the premise that sums paid under privte pension plans and workers' compensation statutes constitute duplicative benefits for what is the same basic loss. As Roger Marks pointed out in a recent article of Forum (ABA, Vol. XIV, No. 5, 1979) Bromberg v. United Cigars Whelan Stores Corp. [1] addressed the issue of pension benefits guaranteed not only at normal retirement age but also when the Company's medical staff recommended retirement "for reasons of ill health". The plaintiff suffered a heart attack, ruled compensable under workers' compensation, and also applied for retirement benefits.

1. 14 Labor Cases ¶ 66,203 (1961)

The court denied him these benefits, stating:

> Plaintiff was not retireable for "ill health" within the meaning of the provisions of the plan above quoted. That provision, to make any sense, must be deemed to refer to ill health not compensable under the Workmen's Compensation Law. Otherwise, there is a duplication of benefits.

The court appears to apply an interpretation that avoids cumulation of benefits unilaterally financed in both instances by the employer. (See, also Larson, Workmen's Compensation, Vol. 2, §97.33.)

Similarly, as Marks again pointed out, Parsons v. Granite City Steel Company [2] upheld the distinction of pension payments by a company when an injured employee, well after his retirement, was awarded lifetime monthly workers' compensation payments in an amount larger than the pension. The court ruled for the company when it discontinued pension payments after beginning workers' compensation payments.

It has been argued that an offset results in a divestiture of vested benefits, and consequently should be disallowed. Under IRS Reg. Section 1.141 (a)-3, a plan is not a qualified plan if an employee who has completed ten years of accredited service does not have a nonforfeitable

2. 41 Ill. App. 2d 396, 190 N.E. 2d 644 (1963)

right to 100 percent of his accrued benefit derived from employer contributions. It might, by implication, be consequently interpreted that reducing an employee's benefits because of workmen's compensation is, in effect, divesting the employee of benefits in which he is one hundred percent vested. IRS Reg. Section 1.411 (a)-4(a) states, however, that "nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced to take into account benefits which are provided under the Social Security Act or under any other Federal or State law and which are taken into account in determining plan benefits". Consequently, a workers' compensation offset does not violate ERISA's forfeiture provisions.

The offset question is not new. Congress has been repeatedly called upon to address it, and has yet to express a clear conviction that offsets be disallowed. Rather, the offset has been allowed on the basis of sound public policy. For instance, Congress showed concern over employees receiving both workers' compensation and Social Security disability, a situation that could give rise to receiving two sets of benefits financed by the same employer as well as benefits which exceed his pre-retirement earnings. As a result of this concern, 42 U.S.C. §424a provides that social security disability benefits must be offset by workers' copensation benefits to the extent that the combined Social Security and workers' compensation benefits exceed 80 percent of the employee's previous average monthly earnings.

The policy against duplicative benefits is further found in 42 U.S.C.A. §§402 (k)(2)(B), (k)(3), and 414 (a). Most recently, P.L. 95-216, Section 334(b)(2) of the Social Security Amendments of 1977 requires a reduction of Social Security survivor's benefits for persons receiving Civil Service annuities.

The NAM believes workers' compensation and similar offsets now allowed under Social Security law should be continued for pensions as well. The actions of Congress in this regard have in essence given the go-ahead to employers to prevent overlap and duplication in benefits under private pension plans and workers' compensation. The consequence of reversing these policies and practices are far-reaching and should not be ignored.

56-943 O - 80 - pt.2 - 22

The first is obviously cost. The Hays Associates Report on Pension Plans/Workers Compensation Offsets, which was submitted to the Congress, reaches the conclusion that the number of affected claimants is approximately 2,000 per year and that the estimated increase in annual pension plan contributions will range from $31.7 to 34.1 million. The members of NAM's Subcommittee on Workers' Compensation believe these figures to be extremely low. As a matter of fact, Michigan, far exceeds this number in any given year. They certainly do not take into consideration the increased user participation which would occur from the higher benefits under a "double dip." Such increased utilization resulting from higher benefits is well documented under the Longshoremens' and Harbor Workers' Compensation Act, the Federal Employees' Compensation Act, and Social Security disability. Increased utilization is perhaps most evident when one views the results of prohibiting offsets for collateral benefits under the Black Lung Program. In addition to increased utilization, we also urge the Committee to seriously consider the pyramiding effect of yearly costs which would be cumulative in nature. The

NAM believes that the resulting increases would be inflationary, considerably increasing employers' workers' compensation costs at a time when costs are already rising rapidly because of delays in adopting needed reforms in administrative practices. The absence of such reforms has allowed costly abuses to continue.

Another element that the Committee must bear in mind, one that certainly supports retaining the workers' compensation offset, is the fact that employers are under no legal compulsion to create retirement plans for their employees. The elimination or reduction in the workers' compensation offset may cause employers to become less generous by elminating disability provisions from company plans, refraining from increasing normal retirement pension benefits levesl, or dispensing with the plans in their entirety.

Section 126 would also require that those plans, and their summary plan descriptions, which allow offsets would have to be amended. State laws and accompanying case law would undoubtedly be affected. Finally, as to collectively bargained plans, Section 126 represents an unwarranted intrusion in an area more appropriately handled by the collective bargaining process.

For these reasons, the NAM strongly believes that Section 126 is contrary to sound public policy and should consequently be deleted from S. 209.

JOINT AND SURVIVOR ANNUITIES

Sec. 127 of S. 209 requires a new mandatory benefit for a surviving spouse payable at the death of an employee in the form of a survivor's annuity if the employee has at least 10 years of service. In effect, a new life insurance policy paid for by the employer is mandated. The NAM opposes such a provision because of its potential cost and its impact on established life insurance programs.

At the present time, many employers provide similar coverage through group life insurance policies, and ERISA already allows for an optional benefit similar to this provision. The expense for employers not already providing such coverage will be significant in many cases if this provision is made law. In addition, the mandated benefit would often be coordinated with existing group life policies which will add to complexity of administration. Ultimately such a mandated benefit could result in reduction of other benefits since there is a limit on the amount of funds available to an employer to provide benefits.

FUNDING

Sec. 131 of S. 209 requires employers to take into account all plan provisions including those not yet in force in the employer's funding methods after December 31, 1980. While the actual impact of this provision is unclear, it appears that it could lead to increased costs, could result in undermining the collective bargaining process affecting many benefit plans in this country, and will add to complexity of pension law generally.

As the NAM understands the effects of this provision, an employer after December 31, 1980, for example, would have to begin funding benefit increases although such increases have not yet become effective, may not become effective for some years into the future, and depending on future events may never take effect. Such a provision would adversely affect the flexibility inherent in the collective bargaining process by restricting the use of phased-in benefit increases. Any economic advantage to an employer for a gradually negotiated phase-in rather than an immediate one will have been lost by this provision. The NAM believes the use of ERISA to impact the bargaining process in this manner is inappropriate.

Moreover, the provision allows a funding acccount to be adjusted if the provision scheduled to become effective in the future does not. This adjustment process will add to the complexity of administration of pension plans. New regulations will be required for the handling of such adjustments, and other problems will arise in employer decisions interpreting that part of Sec. 131 which exempts from such funding requirements provisions which are "...adopted but contingent on a future event..."

COST OF LIVING ADJUSTMENTS

Sec. 152 of S. 209 directs the Secretary to conduct a feasibility study related to mandating cost of living adjustments for private pensions plans. The NAM believes such a study is unwarranted and duplicative of other major "studies" currently being conducted in the federal government.

The President's Commission on Pension Policy has been appointed to develop national policies and recommendations for retirement, survivor, and disability programs. Besides the Presidential Commission, various other councils are currently at work to conduct studies of retirement issues, especially in Social Security. Another independent study at this time would be superfluous and an unnecessary expenditure of tax dollars.

FRAUD ISSUES

The United States Supreme Court decision in International Brotherhood of Teamsters v. Daniels, 58 L Ed 2d 808 (1979), on January 16, 1979, has clarified the inapplicability of Federal and state securities laws to interests in pension plans. Since the Daniel decision involved only one type of benefit plan, the NAM supports that part of §154 of S. 209 which would preclude the application of all security laws, both Federal and state, to the interests of an employee in an employee benefit plan.

However, the creation of an entirely new cause of action for misrepresentation under ERISA as proposed in §154(b) is in our view not justified at the present time. As this Committee is well aware, the Daniel litigation would not have occurred had ERISA been applicable to Mr. Daniel's break-in-service. Other ERISA rules as well as its fiduciary requirements provide, we believe, adequate protection to plan participants. We would urge the Committee to delay further action on this provision until more detailed information on the need for and wisdom of creating such a federal cause of action has been demonstrated.

PREEMPTION

§155 of S. 209 makes it clear that a state insurance law requiring a specific benefit be made available in a policy of insurance for an employee benefit plan is preempted by

ERISA and, therefore, not in effect. The NAM believes that such a provision is needed to prevent the continuation of a trend towards development of disparate state laws mandating different benefit coverages in individual states. Different state requirements result in administrative complexity and additional costs for employers required to provide different and/or inconsistent coverages. The NAM, therefore, supports that part of §155 reaffirming the preemption of ERISA in this area.

The NAM is opposed to that part of §155 which would exclude the prepaid health care law of the state of Hawaii and similar laws of other states from the ERISA preemption provisions. Such a provision is inconsistent with the previously discussed affirmation of preemption and is contrary to the intent of ERISA to allow employers engaged in interstate commerce to establish uniform benefit policies.

TAX CODE PROVISIONS

S. 209 contains tax code amendments including a deduction for employee contributions to pension plans

(§203). The NAM supports the principle of tax deductions for employee contributions to pension plans but does not believe that the availability of the deduction should be dependent upon the discrimination standards set out in this section.

MASTER PLANS

A new part 6 would be added to Title I of ERISA by S. 209 allowing for creation of a "special master plan" which employers could adopt without being subjected to many of the accompanying administrative details associated with maintenance of a private pension plan. The NAM supports this approach to encourage the growth of private plans.

S. 1089

The NAM generally supports and does not take issue with Sections 2-4 of the bill. The reductions in paperwork and administrative costs are favorable to our members. Section 5 of the proposal would provide for a booklet that would assist plan sponsors in developing record keeping systems, particularly smaller businessmen. Also published would be information concerning individual retirements accounts.

Eighty percent of the NAM membership have 500 or fewer employees. These booklets would prove to be very helpful to them, and, additionally, would encourage increased participation in IRAs generally. We therefore support Section 5.

The NAM does not support the thrust of Section 6. The Secretary of the Treasury would be authorized to bring civil actions in order to enforce compliance by a plan or a trust with the requirements of the Internal Revenue Code. Not only would this enlarge the enforcement authority of the Internal Revenue Service, but it would also duplicate authority that is now vested by ERISA within the Department of Labor. We do not agree with such a measure and therefore are opposed to this section of the bill.

CONCLUSION

The NAM strongly supports those provisions that are calculated to simplify ERISA administration, reduce costs to employers, and encourage the maintenance and development of private pension systems. Appropriate legislative action can be achieved to accomplish those goals without major disruptions to the pension system. The manufacturing community has a vital interest in ERISA development, and the NAM appreciates the opportunity to discuss these as well as other matters in this field.

A CONFERENCE OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

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December 21, 1979

Mr. Michael Stern
Staff Director
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearings Held by Subcommittee on Private Pension Plans and Employee Fringe Benefits on December 4 and 5, 1979

Dear Mr. Stern:

On behalf of the Association for Advanced Life Underwriting (AALU) and the National Association of Life Underwriters (NALU) we are submitting comments regarding the various bills under consideration and the hearings held on December 4 and 5 by the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Senate Committee on Finance. The bills on which we wish to comment are S.209, S.511, S.989, S.1089, S.1240 and S.1958.

AALU is a national association of approximately 1,100 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 NALU, the largest life insurance industry field force organization in the United States. NALU has a membership of approximately 140,000 life insurance agents.

We will group our comments regarding each of the bills on which we intend to comment separately.

I. <u>S.209</u>

In the announcement regarding the hearings held by the Subcommittee, it was stated that comments should not be made regarding sections 201 through 205 of S.209. Consequently, we will omit all comments relating to those provisions which refer to amendments to the Internal Revenue Code of 1954.

We will group our comments regarding S.209 according to the subject groupings used in that bill.

A. Reporting and Disclosure Requirements

Part I of Title I of S.209 contains the reforms relating to reporting and disclosure. AALU supports those reforms. In particular, AALU supports sections 112 and 113 of the legislation which would provide greater flexibility to modify the reporting and disclosure requirements and repeal the summary annual report requirement, respectively. We believe that this added flexibility in the reporting and disclosure area and the elimination of the unnecessary summary annual report would be a significant improvement in the administration of plans, especially for small employers. AALU also supports the provisions of section 111 relating to employee benefits statements to participants. We believe this will provide a very workable, highly useful and administratively feasible requirement concerning employee benefits statements.

We submit that the reporting and disclosure provisions of S.209 would be improved by further modifications. In particular, we would suggest the following:

1. <u>Summary Plan Descriptions</u>

The legislation proposed last year (S.3017) by Senators Williams and Javits contained two provisions concerning summary plan descriptions that have not been included in S.209. Those provisions included a provision that summary plan description updates did not need to be provided until every tenth year (instead of every fifth year) and a requirement that summary plan descriptions need not be amended until 210 days after the close of the plan year in which the amendment occurs. Both of the changes in the 1978 legislation would have reduced administrative costs without significantly affecting the rights of participants. As a consequence, AALU feels that these deleted provisions should be reconsidered and restored to S.209.

2. Actuarial Certification

The cost of the required actuarial certification for annual reports 1/ is a significant burden for smaller employers. For small employers, the administrative cost of obtaining actuarial certification may be extremely high in relation to the contributions and benefits provided under the plan. As a consequence, this administrative cost is a substantial deterrent for small employers to adopt and maintain retirement plans. As a consequence, AALU submits that relief from the annual requirement of actuarial certification should be provided for smaller plans such as plans with fewer than 100 participants. This relief could be provided by only requiring actuarial certification every three years in accordance with the Labor Department's announcement of proposed three year cylical filing requirements for small plans. It is our understanding that the Labor Department has not yet determined whether the cylical filing requirements would also apply to

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1/ See ERISA §103(d).

the actuarial certification or whether the actuarial certification would continue to be required on an annual basis. We suggest that the legislation be modified to resolve this problem and make it clear that actuarial certification is only required every third year.

In addition, actuarial certification should be excused for certain types of plans in which actuarial certification is essentially unnecessary. This is analogous to the exemption for insurance contract plans 2/ already contained in ERISA. In these types of plans the actuarial calculations do not require the need for an enrolled actuary and those plans should be permitted to save this unnecessary administrative cost. The type of plan to which this exception would apply would be defined benefit plans with fewer than 100 participants and that satisfy the following six requirements:

2/ See ERISA §301(b).

(1) The plan is funded exclusively by assets guaranteed by an insurance company, a bank, a savings and loan association or a similar institution against market fluctuations.

(2) Contributions to the plan are based on the individual level premium funding method using a reserve basis specified by IRS regulations.

(3) The value of the retirement benefits provided by the plan at normal retirement age is equal to the reserves at normal retirement age. All ancillary benefits in excess of the reserve for an individual are insured by an insurance company.

(4) All contributions necessary to meet the reserve requirements have been made during the plan year.

(5) No rights under any plan assets have been subject to a security interest at any time during the plan year.

(6) There are no policy loans outstanding against any plan assets at any time during the year.

B. Fiduciary Responsibility

Section 102 and Part IV of Title I of S.209 contain reforms relating to the fiduciary responsibility provisions of ERISA. AALU supports these reforms and especially supports the concept of simplifying the ERISA fiduciary requirements. The uncertainty in the application of the fiduciary rules of ERISA has created substantial problems by making plans unsure of what actions are proper. These restrictions have produced overly conservative reactions by many plans. A clarification and narrowing of the application of these rules would be in the best interest of plans and plan participants. AALU especially supports the concept of narrowing the definition of "party-in-interest" under ERISA, 3/ limiting co-fiduciary

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3/ §102 of S.209.

liability to the extent possible 4/ and clarifying the status of assets in a life insurance company's general account. 5/ AALU submits, however, that two modifications of these proposals would be appropriate.

1. Party-in-Interest Refinements

The definition of "party-in-interest" as contained in S.209 is still broader than is necessary to accomplish the purposes of ERISA. To that end, we recommend that the terms "counsel" and "person providing . . . services" be deleted entirely from the definition of party-in-interest in section 102.

2. Investment Advice

The definition of "fiduciary" 6/ in ERISA should be amended to provide that normal sales

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4/ §143 of S.209.

5/ §141 of S.209.

6/ See ERISA §3(2)(A)(ii).

presentations and recommendations by an agent or broker to a plan does not constitute rendering investment advice unless the agent or broker holds himself out as an impartial advisor. In this situation, an agent or broker should not be expected to operate in a fiduciary capacity since the agent or broker is clearly operating in a sales capacity. Clarification is needed here because the issue has been left unresolved by the Department of Labor and because the issue is not adequately clarified in Prohibited Transaction Exemption 77-9.

C. Special Master and Prototype Plans

Title III of S.209 contains provisions authorizing special master and prototype plans. AALU very much supports the concept of special master and prototype plans. These plans would help alleviate the burden on small employers by reducing the administrative cost to small employers in adopting and maintaining plans. To that end, AALU notes that if plan sponsors are unduly burdened with administrative requirements and fiduciary responsibilities there may be less incentive for sponsors to provide special master and prototype plans or the cost of adopting these plans may be higher. As a consequence, AALU strongly recommends relieving the plan sponsors from fiduciary responsibilities and administrative requirements to the extent possible without shifting those back to the adopting employer. In short, AALU proposes that in these types of plans, as many administrative requirements and fiduciary responsibilities as possible be made inapplicable.

AALU suggests the expansion of the special master and prototype program to permit plan consultants to be sponsors as well as investment advisors, banks and insurance companies. Plan consultants can presently sponsor field prototype plans and their having involvement in the pension field makes them particularly suitable as sponsors. 7/

7/ §204 of S.209.

D. Minimum Standards

Part II of Title I of S.209 contains numerous modifications of ERISA relating to minimum standards. AALU particularly supports the provisions of section 127(a) permitting pension plans to provide a normal form of benefit in a form other than an annuity and the provisions clarifying the use of the elapsed time method.

AALU also supports the concept of simplifying the administrative rules as contained in section 123 of S.209, regarding commencement of participation in the plan. For insured plans especially, the administrative difficulty of maintaining dual entry dates is burdensome. As a consequence, this change to permit a single entry date for plans based on plan years of employment is a very worthwhile and laudable improvement in ERISA. AALU does not feel, however, that is is appropriate to require vesting and benefit accrual on the basis of total employment as a condition of this simplification of the eligibility standards. AALU submits that the improvement in the eligibility requirements is a worthwhile improvement in ERISA and that the additional complication of requiring vesting and benefit accrual rules that may be detrimental to a particular employer will undercut the purpose of improving the administerability of ERISA.

Section 127 of S.209 contains provisions requiring survivor annuities in the event an employee dies with ten years of credited service for vesting purposes. The expansion of the survivor annuity requirements in ERISA would be acceptable to protect surviving spouses if the provision were modified to add an age requirement in addition to the requirement of ten years of service. At present, ten years of service could be achieved at a very young age and the administrative cost of this provision could far outweigh the benefits to be provided. If the provision were modified to include a minimum age in the range of ages 45 to 50, the provision would provide a more meaningful benefit in relation to the administrative cost involved in monitoring and providing the survivor benefit.

E. Funding

Section 131 of S.209 provides for changes in the funding rules to take into account future plan modifications. AALU supports this change but recommends that the provision be modified to permit plans to also take into consideration projected cost-of-living increases in funding benefits. This provision would simplify the funding of plans and permit the more realistic funding of plans. At present, plans must arbitrarily assume the cost-of-living increases that can be reasonably projected will not occur.

F. Dual Jurisdiction

Title IV of S.209 proposes the creation of a new single agency -- the Employee Benefits Commission -- to solve the dual jurisdiction problem created by ERISA. AALU submits that the dual jurisdiction problem is presently not a substantial problem and that the administrative confusion and costs of consolidating agencies is currently not justified. AALU therefore recommends that the provisions relating to the Employee Benefits Commission be deleted from the legislation at the present time, especially in view of the apparent success of Reorganization Plan No. 4 in solving the dual jurisdiction problems created by ERISA.

G. Small Business Seat on Advisory Council

AALU strongly supports section 151 of S.209, which requires that a seat on the Labor Department Advisory Council be allocated for a representative of small business. AALU believes that small business has not received adequate representation with respect to ERISA and that it is highly important that the views of small business plans be represented in the future. Creating this seat on the Advisory Council will help provide input for the small business retirement plans.

II. S.511

S.511, introduced by Senator Matsunga on March 1, 1979, would include tax-exempt organizations, i.e., organizations exempt from income tax under section 501(a), under the deferred compensation rules provided for state and local governments under section 457 of the Internal Revenue Code. In general, section 457 imposes restrictions on the provision of deferred compensation to employees.

The Revenue Act of 1978 adequately addressed the perceived abuse that was occurring with respect to the use of deferred compensation. Recognizing that there was no problem with private employers who provide deferred compensation, Congress provided different rules for private taxable employers. 8/ The Senate likewise recognized that tax-exempt organizations (other than state and local governments) did not contribute to the perceived abuses that Congress was addressing with section 457 of the Internal Revenue Code. Consequently, it provided for treatment of tax-

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8/ See §132 of the Revenue Act of 1978.

exempt organizations in the same manner as private taxable employers. Unfortunately, this provision was dropped in conference.

While we do not have any economic projections, we believe that the revenue effect of modifying the rules concerning deferred compensation agreements for employees of tax-exempt organizations would be insignificant. As a consequence, it is unlikely that revenue plays any material role in any decision regarding the treatment of deferred compensation by tax-exempt organizations.

As the Senate recognized in considering the Revenue Act of 1978, we also believe that the purpose of tax equity will be significantly harmed by the creation of separate rules for employees of tax-exempt organizations, especially where those rules are not justified by any perceived abuse. From an employee's viewpoint, deferred compensation agreements should not differ in their tax result because of the tax status of the employer. A deferred compensation agreement for an employee of a private taxable employer should produce the same tax result for the employee as a similar deferred compensation agreement for an employee of a charitable organization. Separate rules exist for state and local governments but these were specifically addressed at perceived abuses and should not be extended beyond those situations.

Consequently, AALU supports an extension of the provisions of section 132 of the Revenue Act of 1978 to apply to tax-exempt organizations but feels that the approach taken in section 511, i.e., to include tax-exempt organizations under section 457 of the Internal Revenue Code, is inappropriate and will lead to unnecessary complexity in the tax laws.

III. S.989

S.989 corrects an inadvertent error in the lump sum distribution rules applicable to distributions from qualified plans by permitting single sum distributions from money purchase plans to qualify for rollover treatment even though the employee is not receiving his entire account balance from a profit sharing, stock bonus or defined benefit pension plan at the same time.

AALU strongly supports the change made by S.989. AALU recommends, however, that the approach in S.989 be expanded so that it applies to the lump sum distribution treatment of single sum distributions from money purchase pension plans as well as rollover treatment. If such distributions from money purchase plans will qualify for rollover treatment they should also qualify for favorable income tax treatment without regard to whether full distribution is made from other plans of the employer as well.

IV. S.1089

S.1089, the ERISA Simplification Act of 1979, is intended to accomplish several reforms in the reporting and disclosure area. S.1089 would eliminate the PBGC premium form and the summary annual report. It would provide taxpayers the option of filing any ERISA forms with their annual tax return and would require the Treasury and Labor Departments to provide a bookkeeping guide to assist small business in complying with ERISA. S.1089 would also permit the Secretary of Treasury to bring civil actions to enforce compliance by a plan with the Internal Revenue Code requirements of ERISA.

AALU strongly supports the provisions of S.1089 insofar as they reduce the reporting and disclosure requirements created by ERISA. The reporting and disclosure requirements are one of the most substantial burdens and least beneficial aspects of ERISA. They increase plan operational costs substantially without providing comparable benefits to participants or beneficiaries. The repeal of the summary annual report would be especially beneficial and should be enacted promptly.

AALU also strongly supports the concept of assisting small business in complying with ERISA by requiring the Treasury and Labor Departments to provide guides in developing recordkeeping systems in order to comply with ERISA.

V. S.1240

S.1240, the Employee Stock Ownership Improvements Act of 1979, contains numerous provisions relating to "tax credit employee stock ownership plans" and to "employee stock ownership plans." Because most practitioners and others familiar with employee benefits commonly refer to these two plan entities as "TRASOPs" and "ESOPs," respectively, AALU strongly suggests that in order to bring harmony to the terminology in this field, the statutory provisions be amended to comply with what has become common useage. Consequently, AALU suggests that the terms "TRASOP" and "ESOP" be codified rather than the terms "tax credit employee stock ownership plan" and "employee stock ownership plans."

AALU also supports the concept of broadening the availability of TRASOPs by extending the base on which the TRASOP contribution is made to one percent of participant's compensation rather than one percent of investment credit. While AALU appreciates the projected revenue affect of such a change, we believe it is inappropriate and unfair to limit the benefits of TRASOPs to individuals who happen to be employed by capital intensive companies. The equitable solution to this problem is to extend the benefits of TRASOPs to all employers, whether capital or labor intensive.

AALU also supports the concept 9/ of providing that dividends paid on securities held by a TRASOP or an ESOP should be deductible by the corporation. This concept helps alleviate the double taxation problem that currently exists in the present law with respect to taxation of corporate earnings. Further, AALU supports the concept of allowing deductible charitable bequests to ESOPs and TRASOPs. Providing this additional incentive will

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9/ §4 of S.1240.

help foster the goal of TRASOPs and ESOPs, i.e., diversified capital ownership by workers.

AALU also supports the provisions of S.1240 10/ repealing the voting rights pass-through requirement proposed under existing law. AALU believes that a mandatory pass-through of voting rights is inappropriate for qualified plans and will cause unnecessary complication in the administration of plans. Additional deterrents to the adoption of qualified plans are not needed and should be alleviated unless substantial abuses will result. Experience has indicated that there is no significant abuse by permitting trustees to vote stock held in a qualified plan. Consequently, AALU supports the concept of repealing the voting rights pass-through requirement.

AALU further supports the provisions in S.1240 11/ providing for special credits for small

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10/ §7.

11/ §11.

employers that establish ESOPs. Small employers are frequently victimized by their discriminatory tax treatment and are often economically unable to afford the cost of establishing plans. The provisions in S.1240 are designed to counteract this economic bias by providing a tax credit to small employers. AALU feels that this credit is particularly beneficial and should be enacted.

VI. S.1958

S.1958, introduced by Senator Matsunaga on October 30, would modify the requirements for plans holding employer real property. In particular, S.1958 would permit qualifying employer real property, i.e., real property leased to the employer, to be held by a qualified plan even if the plan only holds one parcel of such property. Present law apparently requires that in order for a plan to hold qualifying employer real property it must hold more than one such parcel.

AALU supports the concept of permitting plans to hold qualifying employer real property even if only one such parcel is held. The effect of the present rules is to discriminate against smaller plans that are financially unable to hold more than one parcel of qualifying employer real property or that were established by a smaller employer that does not have more than one parcel of property. Since qualified plans are subject to general diversification rules anyway, AALU submits that specific rules on diversification of real property are unnecessary. Consequently, AALU suggests that special diversification rules are not necessary when qualifying real property is held.

Respectfully submitted,

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Gerald H. Sherman,
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GHS:SML/cah

association of american medical colleges

JOHN A. D. COOPER, M.D., PH.D.
PRESIDENT

202. 828-0400

December 21, 1979

Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Written statement for submission to the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Committee on Finance, United States Senate, in connection with the hearing on December 5 with respect to S.511 introduced by Senator Matsunaga relating to deferred compensation plans maintained by tax exempt organizations

Dear Mr. Stern:

The Association of American Medical Colleges (AAMC) serves as the national voice for all of our nation's 125 schools of medicine, public and private, more than 400 of the major teaching hospitals and over 60 academic and professional societies.

AAMC endorses the written statement filed on behalf of the American Council on Education and the National Association of Independent Colleges and Universities filed in connection with these proceedings. For the reasons stated therein, we strongly urge that S.511 be modified to confirm that a deferred compensation plan or agreement maintained by a tax exempt organization be governed by the same rules as the deferred compensation plans maintained by taxable employers. This should be done by amending Section 132 of the Revenue Act of 1978 (Public Law 95-600) to include deferred compensation plans or agreements maintained by tax exempt organizations. Under that section, the tax aspects of such plans are to "be determined in accordance with the principles set forth in regulations, rulings and judicial decisions relating to deferred compensation which are in effect on February 1, 1978." This means that the basic rules with respect to the taxation of deferred compensation agreements will be those set forth in Revenue Ruling 60-31, 1960-1 C.B. 174, a "discussion of the application of the doctrine of constructive receipt to certain deferred compensation arrangements." Revenue Ruling 60-31 was in turn based upon a number of decided cases. Some twelve of these, the earliest of which was handed down in 1921, were cited in the ruling itself. The validity of this ruling, which has been in effect for nearly twenty years, has been uniformly upheld by subsequent decisions of a number of courts.

The colleges and universities, as employers, are quite willing to live within the restrictions of Revenue Ruling 60-31. These generally hold that there is no constructive receipt where the employee is relying entirely on the promise of the institution and has no claims except as a general creditor for the retirement payments when and as they become due, whether or not the institution protects itself against the obligation by setting up a reserve or some other security which is part of the general assets of the institution. Inclusion of tax exempt organizations within the purview of Section 132 of the Revenue Act of 1978 will eliminate the necessity for lengthy litigation involving deferred compensation agreements of tax exempt organizations. Such litigation will undoubtedly result if the Internal Revenue Service, as it seems determined to do, imposes on tax exempt organizations alone the proposed modification of Regulations 1.61-16(a) published in the Federal Register on February 3, 1978, and discussed in Information Release 2135 on June 11, 1979. These proposed regulations stimulated the enactment in the Revenue Act of 1978 of Sections 131 dealing with the deferred compensation plans of state and local governments, 132 dealing with certain private compensation plans and 133 dealing with deferred compensation payments to independent contractors. It should be noted that the Senate approved the inclusion of tax exempt organizations in Section 132 when it passed H.R. 13511 in the 95th Congress but the provision was dropped in conference.

All of the circumstances described in the statement of ACE and NAICU obtain in our member medical colleges and associated teaching hospitals. As in private industry, the use of deferred compensation agreements is an important aspect of our recruitment of especially talented administrators and senior academic officials. In many cases, we are in competition with private industry for such individuals. Many of these are physicians who have available to them the alternative of private practice in professional corporations where financial rewards are far greater than our institutions can afford to offer. We believe that the inability to provide deferred compensation arrangements similar to those which the statute confirms can be awarded in the private sector will deprive us of the teaching, research and patient care services of unusually able individuals that we need to provide the leadership so crucial to the continuing excellence of our medical colleges and teaching hospitals.

We are especially concerned at the potential loss of talented clinical faculty that is likely to result from the promulgation of the proposed regulations. In this connection, it should be noted that the Flexner Report in the early 1900's revolutionized the American medical education system which had reached a distressing state by that time in this country. One of the principal changes the Flexner Report effected is the heavy reliance that the medical schools assign to fulltime faculty for teaching. This is especially important in the clinical area where the faculty are expected to be the brightest and best: the role models that students can emulate by virtue of their renown as practitioners in a discipline or field of medicine while still deeply committed, through fulltime employment, to teaching and research. Much of the remarkable development of medicine over the past fifty years is attributable to the continuous day-to-day involvement of clinicians with students in the teaching and research of our medical colleges and associated teaching hospitals.

Our deans are gravely concerned that, if they are denied the opportunity to offer deferred compensation arrangements (particularly to their clinical faculty), many of their most talented people will opt for the private sector and as a result be available for teaching and research only as a sideline to their primary activity -- the practice of their specialty. This could have a very retrogressive and detrimental effect on medical education.

This possibility stems in part from the development of the professional corporation which is available to such practitioners and offers substantially greater financial opportunities than our institutions can provide. In some of the clinical specialties, the compensation which our institutions offer is one-half or one-third of what physicians could expect to generate in income by confining their activities to private practice. Moreover, in the private sector, they could have available incentives, in addition to deferred compensation arrangements, which we do not provide, including much more generous pensions.

Moreover, the institutions would be faced with the significant loss of the income generated through the practices of those faculty members in the clinical departments, a significant part of which is used to sustain the research and educational activities of preclinical or less well-supported clinical departments and the other operations of the medical school. This latter source of revenue has become an increasingly important factor in the support of medical schools, as the direct grants from Federal and state sources have seriously diminished and the support of research from the same sources has become increasingly scarce. However, the principal effect would be upon medical education. Even if the physicians were available on a part time basis, our deans feel that it would in no way be a substitute for the present practice of employing faculty on a fulltime basis to teach, do research, perform surgery and take care of teaching cases. In sum, we believe that the change generated by the proposed regulations may be irreversible and do irreparable damage to medical education, even if, as we believe, it will eventually be found to be invalid by the courts.

Several examples might suggest the problems which adoption of an individual option rule have on the recruitment of especially gifted people for special situations. These are based upon fact situations which have existed although they do not precisely describe the circumstances involved.

(1) "A" is a clinical professor at "X" university's medical school. Although his salary reflects in some part the revenue which his clinical activity generates for the teaching hospital where he served, it is considerably less than he could expect to realize if he were in professional corporation 'M', which consists of a number of doctors, or proprietary hospital 'H." Moreover, professional corporation 'M' and proprietary hospital 'H' have generous qualified pension plans which would afford him a pension upon his retirement, which is far greater than "X" can provide. In addition, 'M' and 'H', to attract "A", might be willing to enter into a deferred compensation arrangement which would further supplement that retirement income. For a number of reasons, he would prefer to retain his status as a full professor primarily because he is a fulltime teacher and has devoted his professional life to that calling. If "X" can offer him a deferred compensation agreement, he would be happy to stay in his present capacity. If it cannot, he may well feel obliged, in the interest of protecting his family, to join professional corporation 'M' or proprietary hospital 'H' and do teaching on the side. Indeed, "A" and his other colleagues may determine to form their own

professional corporation because the same financial considerations apply to at least some of his colleagues of the fulltime faculty at "X" university's medical school.

(2) The medical school of "Y" university is very desirous of obtaining as a fulltime professor "A", who is now teaching at "Z" state university. "A" is very interested in making the change and believes that he can make a significant contribution to "Y's" medical school program. In addition, "A's" salary will increase significantly. However, under the pension plan of "Z" state university, "A" will receive no benefits from the state retirement system other than a return of his own contributions, with modest interest. Because of the limitations of the 403(b) program maintained at "Y" university, which are based on employment with the same employer, "Y" university, which would be willing at least to bring "A's" retirement up to minimum standards, cannot do so. Only if "Y" university is able to enter into a deferred compensation agreement will "A" be able to make the change which, in the opinion of its faculty, will greatly benefit "Y's" medical teaching program. (A similar problem would exist if, as in the case of some states, "A" would be required to begin receiving retirement payments when he makes the change, albeit said retirement payments are much less than would have been available if he stayed with "Z" until his retirement.)

(3) The medical school of "X" university is desirous of persuading "A", a highly renowned doctor-scientist to become its dean. "A" who has recently resigned from a high government post has been offered a lucrative position in private corporation "M" where there is also available to him a

deferred compensation program for highly compensated employees. "A" is anxious to accept the dean's post. However, not only is the compensation significantly lower than he would receive from 'M' but, without a deferred compensation agreement, he will not have an adequate retirement income because of the limited number of years left for gainful employment and because of the limitations of IRC Section 403(b). "A" feels that he cannot take the employment with 'X' unless he, his wife and family are adequately protected after his retirement. This is possible only if a deferred compensation agreement can be made.

(4) "A", an individual who is near retirement, is importuned to take on the task of interim dean of his institution pending the selection of a new dean, a process which may take as much as two years. Although he would like to fulfill this task, the financial benefits are so limited that he is unwilling to do so unless his retirement benefits can be significantly increased. The maximum increase from a deferred compensation arrangement will not increase his overall retirement to more than 55 percent of his present pay. The advantage to the institution of having this particular individual act as an interim dean is very great since he is intimate with the details of the institution in its operation and is acceptable to the faculty. Under these circumstances, he may feel that it simply is not to his advantage to extend his retirement for two years with all of the efforts that this involves without the benefit of deferring some of the compensation and, thus, increasing his retirement benefits.

(5) The medical school at 'Y' university is particularly anxious to recruit "A", an administrator from private industry. It believes

that A's talents will be especially beneficial to the institution in the ten years which remain of his active professional life. "A" is anxious to make this career change and thinks he can make a special contribution to "Y." However, he feels he cannot afford to do so unless he has a significant increase in his retirement benefits, some of which he may lose by leaving his present employment. In such case, he may decide that, despite his interest, he cannot really afford to take the cut in salary to assume that new obligation without some supplement to his retirement benefits.

(6) "A" is a particularly talented faculty member of "Y" medical school who is a renowned scientist. As such, he has opportunities to go into private enterprise for a significantly increased salary with excellent pension benefits which fully vest after a ten-year period under a qualified pension plan. In addition, he will be eligible for a deferred compensation agreement which will increase those benefits so that his retirement will be 50 percent of his expected final salary at "Y" university. He wants to stay with the university and recognizes that, under its policy, the university cannot increase his salary significantly because of their fairly rigid schedule. In order to keep him, the university is willing to provide him with additional retirement benefits through a deferred compensation agreement. If such an agreement is not available, he feels that his obligations to his family are such that he must accept the new employment.

(7) "A" is an especially gifted faculty member who has demonstrated not only unusual scholarly qualities but administrative ability. He and his wife have significant current outside income which is based on a

wasting asset which will not be available to him at retirement. "Y" university would like to employ him as a dean at the institution which he would like to accept. Because of his outside income, the increase in salary will not generate sufficient real income to make much difference unless he could defer a portion of the compensation and apply it towards his retirement which will otherwise be relatively modest. In the absence of such a program, he may decide not to undertake the arduous administrative tasks which the new position requires as compared to his present activities.

Conclusion

For these reasons and for the reasons set forth in the statement of the American Council on Education and the National Association of Independent Colleges and Universities filed herein, we urge that S.511 be modified to include the deferred compensation plans maintained by tax exempt employers with those of private industry as provided in Section 132 of the Revenue Act of 1978.

We would also urge that, for the purpose of deferred compensation plans, state universities, colleges and teaching hospitals be treated as tax exempt organizations. They are in precisely the same position as private medical schools and teaching hospitals with respect to this issue. They are in competition with private industry for especially talented individuals and should have the same opportunity to offer deferred compensation plans in those instances where it may be crucial to their ability to recruit such individuals for their faculty or administration.

In this connection, it should be noted that, if this is not done, there will be confusion confounded. Many state universities can and have qualified as institutions exempt under Section 501(c)(3). (See Estate of Leslie E. Johnson, 56 TC 944 at 950 (1971), and Revenue Ruling 60-384, 1960-2 C.B. 174.) Thus, many state institutions already are or could be treated as tax exempt institutions.

Moreover, as to those institutions which cannot qualify for 501(c)(3) status, Section 457 imposes strict requirements on the deferred compensation plans of state and local governments, providing virtually no relief in precisely those circumstances where the deferred compensation plan may be the crucial element in attracting qualified individuals to serve on the medical faculty. This is particularly true of those state universities and colleges (of which there are a large number) whose sole pension plan is a program of purchase of 403(b) annuities. Under these programs, the basic annuity is provided with no option on the part of the employee. Nonetheless, under Section 457, the modest $7,500 a year limitation on deferred compensation plans of such state institutions must offset the $7,500 with the entire 403(b) annuity payment regardless of the fact that in most cases the entire payment toward the purchase of an annuity is made with no option on the part of the employee and is the equivalent of a qualified pension plan under Section 401(a). For this reason alone we would be strongly opposed to the enactment of S.511 as currently drafted since it would place private colleges and universities, including medical schools and teaching hospitals, in the same unfair straitjacket.

Sincerely,

John A. D. Cooper

John A. D. Cooper

STATEMENT OF THE

ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC.

ON THE ERISA IMPROVEMENTS ACT OF 1979

(S. 209)

SUBMITTED TO

SUBCOMMITTEE ON PRIVATE

PENSION PLANS AND EMPLOYEE

FRINGE BENEFITS

SENATE FINANCE COMMITTEE

DECEMBER 19, 1979

AGC is:

* More than 8,000 of America's leading general contracting firms;
* 113 nationwide chapters;
* Over 20,000 affiliated firms;
* 3,500,000-plus employees;
* A $100 billion market;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal utility facilities;
* Over 50% of the construction performed abroad by American firms.

The provisions of S.209 appear to implement the declared policy of the Act as set forth in Section 3, Findings and Declaration of Policy. Accordingly, the Associated General Contractors generally favors its enactment.

The Association, however, maintains that any amendment to ERISA must be considered in total. Contingent employer liability, minimum funding and plan termination as well as the issues of S.209 must be taken into consideration to avoid a piecemeal and disjointed approach to an already complex and often unworkable piece of legislation.

There are a few sections on which we shall make specific comment.

1. Section 121, Reciprocal Agreements

Since the lack of reciprocity between and among pension and welfare plans is an impediment to worker mobility in construction, we are in favor of "facilitating" reciprocal agreements. However, the last sentence of Section 121 states, "The Secretary may by regulation establish additional conditions, and such variances and exemptions as are consistent with the purpose of this Act, in order to facilitate such transfer arrangements in the interest of portability and to protect the pension and welfare benefits of employees who become employed under two or more collective bargaining agreements associated with different pension or welfare plans."

Our experience has repeatedly been that regulations to facilitate soon become regulations to require. Reciprocity between and among funds is a complex matter. Some of the issues which require careful study on a fund by fund basis include the following:

a. When funds were established it was assumed that a certain percentage of the contributions would be made on behalf of temporary employees who would not become eligible for benefits. These monies have been built into actuarial assumptions.

b. The trustees and administrators of funds with a large regular inflow of new employees are reluctant to enter into reciprocal agreements with funds which do not enjoy this situation. This could discourage mergers.

c. Funds vary in contribution rates, benefit levels and administrative costs. A fair and equitable reciprocal agreement must recognize those variables and requires careful negotiation by persons with a thorough knowledge of each fund. General regulations simply cannot do this job, and may inhibit its accomplishment.

d. Funds have different levels of unfunded obligations as a result of differences in administration, contribution levels and other variables. These variables will impact the feasibility of equitable reciprocity and portability between plans with regard to the employee's welfare.

2. <u>Section 152, Impact of Inflation on Retirement Benefits</u>

The study to be conducted by the Secretary of Labor seems pointed toward a conclusion that private pension plans should be required to increase pension benefits through cost of living adjustments. Many multi-employer funds in our industry, in this event, would flounder and die. This association has opposed and will again oppose any legislative proposal which requires that employers be required to bargain for benefits for previous employees who have retired.

When most of the multi-employer pension benefit plans were initiated, past service liability was and continues to be a great cost. That liability is funded for a period of 40 years. In a number of areas where construction industry funds are located the growth of construction by contractors operating without collective bargaining agreements has increased dramatically. As a result, contribution levels have fallen and many must be viewed as declining plans. Such declining plans simply cannot, in the forseeable future, bear the burden of built-in cost of living escalators.

3. Section 154(b), Misrepresentation

S.209 attempts to introduce the anti-fraud requirements of the federal securities laws to ERISA. The existing ERISA disclosure and fiduciary requirements are adequate safeguards for benefit plan participants. Further, the introduction of anti-fraud rules to ERISA will only complicate an already complex system now imposed on those who administer employee benefit plans.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS OF THE SENATE FINANCE COMMITTEE ON S. 209, S. 1089 AND S. 511

December 21, 1979

The Investment Company Institute* is pleased to present its views with respect to many of the proposed provisions in S. 209, S. 1089 and S. 511. The Institute has historically supported and continues to support the basic concepts and objectives of ERISA. We do not share the view of some who claim that ERISA is counter-productive; we believe that it is a necessary measure for the protection of the rights of millions of American workers and retirees. At the same time, we realize that any major piece of legislation, such as ERISA, will need continuing review and corrective legislation. We, therefore, applaud the continuing efforts of this Subcommittee in this regard.

Our comments will focus on those parts of S. 209 and S. 1089 concerning reporting and disclosure and special master plans. We will also state our views on the changes S. 511 proposes to make to non-qualified defined compensation plans offered by tax-exempt organizations. In addition, we have set forth suggested changes to be made in ERISA and the Internal Revenue Code** which we believe will benefit qualified plan participants and beneficiaries and should be part of any major pension reform legislation.

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* The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 490 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $70 billion, accounting for about 90% of industry assets, and have approximately seven million shareholders.

** All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

At the outset let us state our opposition to the American Bankers Association testimony calling for an amendment to S. 209 which would exempt bank-sponsored pooled investment funds for Keogh plans and Individual Retirement Accounts from regulation under the federal securities laws. Similar provisions were contained in S. 3017, the ERISA Improvements Act of 1978, and S. 209 as originally proposed. The provisions were vigorously opposed by the Securities and Exchange Commission and the Department of Labor and were deleted by the Senate Labor and Human Resources Committee in mark-up.*

I. Reporting and Disclosure

The Institute supports the general concept of those provisions of S. 209 and S. 1089 which are intended to simplify compliance by employee benefit plans with various reporting and disclosure requirements of ERISA. In particular, we support the elimination of the summary annual report. The summary annual report requires an employer to report to his employees the aggregate assets, expenses and contributions to the plan and the total change of net assets of the plan. Assets of participants of defined contribution plans (including target benefit plans) funded with mutual fund shares are held in segregated custodial accounts. Since employees have no claims on the assets held for the benefit of other participants, summary annual reports are of little value. Therefore, the summary annual report should be eliminated, at least under those circumstances where each

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* Attached hereto as Appendix A is a copy of the letter which the Institute previously sent to Senator Bentsen setting forth a more detailed analysis of this proposal and its legislative history.

participant is provided an annual statement concerning his individual account.

II. Special Master Plan

Title III of S. 209 proposes to establish a special master or prototype plan program. The program is designed to shift many of the statutory burdens from the employer to the program sponsor. While this seems to be a laudable attempt to encourage small employers to establish plans, we believe that this program should also reduce the paperwork and other adopting and operating difficulties of these plans rather than simply shifting responsibility to the sponsor. We feel, therefore, that this new program will be more successful if certain modifications are made.

A. Investment Responsibilities

Title III defines sponsors of a special master plan to be investment managers and named fiduciaries. We strongly oppose this over-simplistic view for two reasons. First, making a sponsor a named fiduciary may make the sponsor responsible for the daily operation of the plan. This is clearly unfeasible since a sponsor cannot possibly monitor on a day by day basis all the plans which adopt its special master plan. Further, many financial institutions may elect not to become sponsors if they, by definition, will automatically become investment managers and named fiduciaries.

Second, many employers may wish to make their own investment decisions, especially in the case where the sponsor offers various types of funding vehicles. Additionally, an employer may want to adopt a plan which permits his employees to direct their own investments. Thus, we recommend that the special master plan provisions incorporate current Section 404(c) of ERISA. Section 404(c) is based on Congress' recognition of the fact that participants and beneficiaries in an employee benefit plan may have different investment objectives. This section also reflects Congress' recognition that many employers realize that they have no greater investment expertise than their employees and therefore do not want the responsibility for investing plan assets.* We believe that the combining of the special master plan with Section 404(c) of ERISA will make the special master plan program very attractive to small employers.

We suggest, therefore, that the special master plan program allow sponsors and employers to decide between themselves who will have the investment powers, thereby broadening the program.

B. Administrative Responsibilities

The sponsor's responsibilities should be limited to a modified and reduced level of reporting, disclosure and recordkeeping. It should be made clear that the employer cannot completely abdicate all responsibilities. Thus, for example, while a sponsor may be responsible for preparing summary plan descriptions, the employer must remain responsible for distributions to employees.

C. Bonding

Section 412 of ERISA requires that every person who handles funds or other property of a plan be bonded. The bonds have to cover a certain percentage of each plan's assets. We feel that the bonding

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* Attached hereto as Appendix B is a copy of the Institute's letter to the Department of Labor setting forth our views on what the regulations under Section 404(c) of ERISA should contain.

requirements should not be made applicable to special master plans due to their restrictive nature. However, if bonding must be provided, we believe that a sponsoring organization should be permitted to get one bond which would cover all plans under this program. Coverage should be reasonably determined on the basis of the risk of loss of the total amount of plan funds handled rather than on a plan by plan basis. Additionally, employers which adopt special master plans should be given total exemptions from the bonding requirements.

III. Additional Suggestions for Amendments to ERISA and the Code

A. Keogh Plans

1. Notice to Interested Parties Upon Adoption of a Keogh Prototype Plan

At present, each employer which adopts a Keogh master or prototype plan (prototype plan) must notify all interested persons in the same manner as if an application for a determination letter were being submitted for approval, except that the time for giving notice is to be determined by reference to the date of adoption rather than the date of application. (See Sec. 3.05 of Rev.Proc. 75-51, I.R.B. 1975-49). Notice must be given interested parties not less than 7 days nor more than 21 days prior to the date the application for a determination letter is made. (See Sec. 3.02 of Rev.Proc. 75-31, I.R.B. 1975-27). Thus, each Keogh employer, before adopting a prototype plan, must notify his employees of his intent to adopt 7 to 21 days before actual adoption. We believe that in the case of small businesses owned by self-employed individuals, this notice requirement is unrealistic, provides no protections and may cause needless disqualifications of otherwise legal Keogh plans.

The purpose of the notice requirement is to provide employees an opportunity for comment on whether an individual plan will be discriminatory in operation. However, a prototype Keogh plan has already been approved by the Internal Revenue Service as to form and there is no procedure for the adopting employer to request IRS advance determination for qualification. One reason for this is the strict parameters for his available options. Thus, the opportunity for abuse is minimal, if existing at all, in the prototype area.

Since a Keogh plan must be established before the end of the business' taxable year, the notice requirement may prevent employers from establishing Keogh plans near year-end. Typically, it is at this time of year when most employers think about establishing retirement plans. Further, it is not until the employer decides to adopt a plan and chooses a funding vehicle that he learns of the notice requirement. Therefore, the notice requirement has the unintended effect of shortening an employer's year by at least 7 days and may result in some plans not being formed.

Due to the failure to comply timely with notice procedure, Keogh plans now in existence may be disqualified upon audit. We believe that this is incongruous with the overall intent of ERISA and the prototype plan program. In addition, we note that under a Simplified Employee Pension Plan which can be an almost identical program, such notification is not necessary.

We suggest that the IRS be instructed to amend the Keogh prototype procedure to allow adopting employers to notify employees of the adoption of the plan within a reasonable time after actual adoption and suggest that the summary plan description be used for this purpose.

2. <u>Keogh Plan Contribution Limits</u>

Consideration should be given to whether or not the contribution limits for Keogh plans have become outmoded due to inflation. The advent of the professional corporation has allowed the self-employed to avoid Keogh plan contribution limits by incorporating. Defined benefit Keogh plans enable a self-employed person to exceed the $7,500 annual contribution limit even though contributing less than 15% of compensation for other plan participants. Hence, consideration should be given to legislation which would raise Keogh defined contribution plan contribution limitations.

3. <u>10-Year Averaging</u>

As a result of Section 402(e)(4)(H) the 10-year income averaging rule cannot be used for the ordinary income portion of a lump sum distribution unless the employee has been a participant in the plan for five or more taxable years before the taxable year in which such amount is distributed. However, capital gain treatment is accorded to that portion of the distribution allocable to pre-1974 participation. The Conference Report for ERISA stated that the ordinary income portion was taxed separately from other income because it was anticipated that "most distributees will have little or no other taxable income in the years following their retirement." The 10-year period was used since that purportedly "represents the approximate life expectancy of a person age 65 and therefore is approximately the period over which the income would be spread if not received in the form of a lump sum distribution."

It seems arbitrary to allow the 10-year averaging for a lump sum distribution where an employee has been a participant 5 years, but not 4 years. We believe the same tax benefit should be granted an employee no matter how long the employee was a participant.

4. Keogh Rollovers

Section 402(a)(5) and Section 408(d)(3)(A)(ii) prohibit the rolling over of a lump sum distribution by a self-employed individual from one Keogh plan to another Keogh plan. However, such distributions may be transferred from a Keogh plan to an Individual Retirement Account. Further, the IRS has ruled that the trustee or custodian of one Keogh plan may transfer assets of that plan directly to another Keogh plan. For convenience, we believe the IRA-type rollover provisions should be extended to allow a self-employed individual to receive a lump sum distribution from one Keogh plan and roll it over to another Keogh plan within 60 days without the premature distribution 10% penalty under Section 72(m)(5)(B) or the prohibition of making contributions for 5 years under Section 401(d)(5)(C). This becomes particularly important, for example, for a self-employed individual under Section 401(c)(1) who is not an owner-employee.

5. Mini Keogh Plans

Section 404(e)(4) provides for "mini Keogh" plans under which a self-employed person may contribute the lesser of $750 or 100% of earned income. This provision does not apply to a self-employed individual whose adjusted gross income exceeds $15,000. The $15,000 adjusted gross income limitation places an arbitrary restriction on the use of mini Keogh plans. Compliance causes complex recordkeeping and administrative problems. The $15,000 limitation discourages the establishment of Keogh plans where self-employed income is small. A person with, for example, $15,000 of adjusted gross income from services not eligible for retirement plan contributions and $1,000 of self-employed income will be unlikely to establish a Keogh plan if limited to a contribution of only $150. We, therefore, suggest that the $15,000 limitation be eliminated or substantially increased.

B. Individual Retirement Accounts (IRAs)

1. IRA Contribution Limits

We have previously urged that Keogh plan contribution limits be raised due to the effects of inflation. We believe that consideration should also be given to raising the IRA contribution limits as well. Inflation has decreased the real worth of the $1,500 maximum contribution by over 40 percent. Clearly, therefore, if IRAs are to play a meaningful part of our retirement system, the contribution limitations should be adjusted.

2. Spousal IRAs

Section 220 allows a contribution by a married person to an IRA on behalf of his or her non-working spouse. This concept should be extended to all non-working spouses, not only those of individuals who participate in IRAs. We, therefore, support the concept of a "housewife" IRA.

3. Limited Employee Retirement Accounts

An individual is eligible to establish an IRA if he or she is not an active participant in a tax qualified retirement program or a government retirement program. This is an "all or nothing" requirement and does not take into account levels of participation in other plans. Participation in a plan where even a small retirement benefit is accrued will disqualify a person from establishing an IRA even though he or she may be able to accrue a larger benefit under an IRA than his or her employer provides. The obvious inequity of this approach was corrected to some degree by the adoption of Section 219(c)(4)(A) and (B) permitting IRA participation by members of armed forces reserves and by volunteer firemen; their coverage under governmental plans previously would have disqualified them from establishing IRAs.

Improvement is needed in areas where employees are covered by other retirement programs that are not as large as would be possible under an IRA. For example, a defined contribution plan could establish a percentage contribution of less than 15 percent or $1,500 for an employee's retirement benefit. A defined benefit plan could fund a retirement benefit that would provide a smaller benefit than would be obtained by IRA-size contributions. Additionally, employees may not derive the benefit of contributions if they terminate employment before they are vested, either partially or fully.

In each case an employee may believe that he or she would be better off with an IRA rather than with an employer sponsored plan. In order that employees' desires for retirement security not be frustrated, the IRA provisions should take into account employees who are covered by other plans, but not to the extent provided by the IRA. We, therefore, support the concept of a limited employee retirement account.

4. Rollover Into an IRA After Age 70-1/2

Distributions from an IRA must begin in the year in which a participant reaches age 70-1/2. A question exists whether an IRA may be established through a rollover after age 70-1/2. The IRS has issued several letter rulings permitting such a rollover as long as distributions, including make-up distributions, begin within that year. We believe that these rulings should be codified through legislation.

5. IRA Reporting

Section 408(i) requires trustees (including custodians) of IRAs to make reports regarding such accounts to the IRS and to the individuals for whom the accounts are maintained. The reports must reflect information with respect to contributions, distributions and such other matters as the IRS may require by regulations. As of this date, no final regulations have been promulgated.

Prior to August 17, 1977, reports were to be made on Forms 5498 and 5499. In August 1977, the IRS issued News Release Number IR-1873 which provided IRA plan sponsors with a suggested format for the reporting activity in an IRA. The release also stated that IRA distributions for the 1977 tax year must be reported on Form 1099-Misc.

While the new format will provide IRA participants with more information about their accounts than was provided on Forms 5498 and 5499, IR-1873 has created much concern. For instance, the new summary report is to be delivered by June 30 of the year following the close of the participant's tax year. However, IRA participants must file their tax returns by April 15 if they are on a calendar tax year basis. Thus, the new report will not arrive in time to help them prepare their returns. Further, if the June 30 summary report does not agree with what some participants claim, it appears that these participants may be required to file amended returns.

In addition, a custodian or trustee cannot actually determine the dollar amount of contributions for specific tax years in the case of after-year contributions, especially when the participant contributes on a more frequent basis than annually. Thus, the structure of the current suggested form inherently leads to the possibility of error, since it asks the custodian or trustee to determine for which tax year a contribution was made. When the participant realizes an error, he will normally request a corrected form from the trustee or custodian; a procedure which will obviously lead to increased operational costs for the custodian or trustee and probably higher fees to the participant.

We, therefore, request that the IRS be asked to issue regulations which would not require individual summary reporting by trustees ~~or~~ custodians in cases where specific transaction confirmations are provided to the individual participants following each transaction.

6. Survivorship Rights

(a) Internal Revenue Service News Release 1809 indicates that "survivorship accounts" will be permitted following the issuance of regulations. Present regulations do not provide for "survivorship accounts" nor do they permit the continuance of an IRA at the participant's death, but require distribution to the beneficiary regardless of age. We believe that legislation should provide for "survivorship accounts", thus enabling the surviving spouse to continue the account until age 70-1/2.

(b) The Code was amended by the Revenue Act of 1978 to permit lump sum distributions paid because of the death of an employee covered by a pension or profit sharing plan to be rolled over to an IRA. Once the funds are in an IRA, the surviving spouse is unable to receive a distribution from the IRA without a penalty until age 59-1/2. This can be a distinct hardship to the surviving spouse. If the surviving spouse had elected to leave the funds in the pension or profit sharing plan, he or she would not be so restricted. We, therefore, recommend that the Code be amended so that distributions may be made from an IRA established pursuant to Section 402(a)(7) prior to age 59-1/2.

(c) Similarly, we believe that the surviving spouse in a spousal IRA should be able to withdraw funds from his or her own account. Under current law, the surviving spouse in a spousal IRA receives the account of the deceased spouse as a death benefit. However, the surviving spouse may not withdraw funds from his or her account without penalty until the attainment of age 59-1/2. This restriction on withdrawals comes at a time when the surviving spouse may desperately need additional funds. We, therefore, recommend that the Code be amended to permit distributions to a surviving spouse from that individual's own portion of spousal IRA.

7. Distribution Option at Age 70-1/2

Section 1.408-2(b)(6)(v) of the proposed regulations provides that if an individual begins receiving distributions at age 70-1/2, he or she cannot annually recalculate his or her life expectancy for determining contributions. Consequently, the participant is limited to a term certain payment over a designated period of years or the custodian or trustee may purchase and distribute a single life or joint life annuity. For example, a man who reaches age 70-1/2 may be calculated to have 11 years of life expectancy. His IRA distribution is then calculated to make payments to him for 11 years. If the man lives to age 81, his IRA is exhausted and he must turn to other sources to provide a retirement income. If the man were a Keogh or corporate plan participant, however, he would be allowed to recalculate his life expectancy annually.

In addition, present regulations enable an IRA participant to request periodic distribution where such distribution is recalculated annually based upon his life expectancy provided that the request is made prior to the tax year in which the participant attains age 70-1/2. However, once the participant reaches age 70-1/2 and thereafter requests distribution, periodic recalculation of life expectancy is no longer permitted. We can see no public policy reason for discriminating against the IRA participant. We believe that legislation should permit periodic recalculation of the life expectancy in IRA accounts.

8. W-2 Form

The W-2 Form asks in Box 5: "Was employee covered by a qualified pension plan, etc.?" However, the proposed regulations for eligibility rely on whether the employee is an "active participant" as defined in regulation Section 1.219-1(c)(I)(ii), rather than if an employee is "covered" by a plan. Thus, the W-2 Form can be particularly misleading when, for example, an individual is covered by a plan, but that plan has discontinued making contributions. In such a situation, the individual may be technically "covered" by a plan, but nevertheless, he may establish an IRA. Therefore, the W-2 Form should be revised to ask the question, "Was employee an 'active participant' in a qualified pension plan, etc.?" The instructions should then provide guidance as to who is an "active participant."

9. Taxation of Benefits

Section 408(d) provides that retirement benefits received under an IRA generally are to be taxed as ordinary income, with no special averaging rule. In contrast, ERISA amended the Code to provide that in the case of a lump sum distribution from other types of retirement plans, the amount attributable to participation before 1974 will be taxed as long-term capital gain, and the amount attributable to participation after 1973 will be taxed as ordinary income under a special 10-year averaging rule. We see no valid reason for not providing 10-year averaging treatment to IRA participants and recommend the enactment of legislation to achieve this result. Further, this disparity in treatment may limit the use of IRAs to achieve portability - an individual who receives a lump sum distribution from a plan may decide to pay the tax determined under the special 10-year averaging rule, rather than rolling it over into an IRA, since the ultimate distribution from the IRA will be subject to normal ordinary income tax without 10-year averaging.

10. Rollovers From Keogh Plans

Section 72(m)(5) provides that a qualified Keogh plan must prohibit an owner-employee from receiving a distribution from the plan before age 59-1/2, except in the case of disability. The consequence of a premature distribution to an owner-employee include a penalty tax and disqualification from the plan for 5 years. Under current law, Rev.Rul. 78-404, (I.R.B. 1978-46, Nov. 13, 1978), upon the termination of a Keogh plan, an owner-employer who is under age 59-1/2 and not disabled may rollover his funds tax-free into an IRA. However, if an owner-employee severs employment before he reaches age 59-1/2 he cannot receive a distribution. Consequently, he or she is not permitted to rollover the account into an IRA. Yet, in a corporate plan situation, the same individual would be eligible to rollover into an IRA. We, therefore, urge enactment of legislation which would permit an owner-employee upon plan termination or severance of employment before reaching age 59-1/2 to rollover assets in his or her Keogh plan to an IRA.

11. Withdrawal From Spousal IRAs

Section 220 permits a husband and wife to adopt a "spousal IRA". It is clear from Section 408(f) that neither party can make a withdrawal before age 59-1/2 without incurring a penalty tax. The spouse who reaches age 59-1/2 can begin to withdraw from his or her account, but the younger spouse, who is less than 59-1/2, is precluded from making withdrawals. Thus, a couple may find themselves in a situation where for several years they can withdraw substantially less than they had planned. We believe that the law should permit the younger spouse, regardless of age, to withdraw funds from the spousal IRA when the older spouse begins to make his or her withd~~rawals~~ after age 59-1/2.

12. 5-Year Payout at Death

Section 408 and proposed regulation 1.408-2(b)(7) thereunder limits a custodial or trusteed IRA (similar provisions also apply to Keogh plans) to the making of a full distribution to the beneficiary within 5 years after the participant's death. If the beneficiary desires distribution over a period greater than 5 years, the custodian/trustee must acquire and distribute an immediate annuity contract. (See IRS Private Letter Ruling No. 7912069, December 20, 1978, which states that amounts payable for a term certain not extending beyond the life expectancy of a beneficiary constitute an annuity within the meaning of Section 408(a)(7)). Thus, the beneficiary is faced with the problem of redeeming his assets in order to purchase the annuity. Such a requirement forces short-term liquidation of assets, which may not be equitable to the beneficiary. We believe that the Code should be amended to enable the beneficiary to request the same forms of distribution which the plan provides to the participant. This would enable the beneficiary to request distribution from the custodial account over his or her life expectancy.

13. Rollovers Over Two Taxable Years

Section 402(a)(5) provides, in part, that in the case of an employees' trust described in Section 401(a) which is exempt from tax under Section 501(a), if the balance to the credit of an employee is paid to him in a lump-sum distribution, he must, within 60 days of receipt, rollover such distribution into an IRA. The Internal Revenue Service recently ruled that where a plan was terminated and distributions were made to a participant during one taxable year but at two different times, the participant is eligible for tax-free rollover treatment and the distributions are not included in his or her gross income for the year in which paid, even though the rollover occurred 60 days following the second distribution.

We believe, however, that under the present law when a lump-sum distribution is made to an employee and in the following taxable year the plan makes a subsequent distribution (as a result of recomputing earnings, contribution adjustments, forfeitures, etc.) the second distribution may not qualify as a lump sum distribution and might not be, therefore, a tax-free rollover. Further, due to the fact that a second distribution is made in the subsequent tax year, the first distribution rolled over may no longer qualify for the tax-free rollover treatment since it may no longer technically qualify as a lump sum distribution.

Therefore, we suggest that the Code be amended to provide that distributions which are intended to be lump sum distributions but which are made over more than one taxable year should be eligible for rollover treatment. Such eligibility would be consistent with the intent of Congress in authorizing rollovers to permit portability of pension benefits.

14. Election Not to Participate in a Qualified Plan

Internal Revenue Service Publication 590 (page 1) indicates that if an individual elects not to participate in a qualified retirement plan he may establish an IRA. This approach, while benefitting the individual, has created a problem of maintaining plan qualification under Section 410(b)(1), where a number of individuals in a small plan make such elections. For example, if a plan covers ten persons, but four elect not to participate, the plan may be deemed discriminatory pursuant to Section 410(b). Section 410(b)(2) provides that certain employees may be excluded without subjecting the plan to the anti-discriminatory provisions of Section 410(b)(1). We suggest that Section 410(b)(2) be amended to include employees who voluntarily elect not to participate in the retirement plan as a group of employees who can be excluded.

C. Fiduciary Matters

1. Non-bank Custodians

At the suggestion of the Institute, the Code was amended by ERISA to permit the use of appropriate non-bank entities to serve as trustees and custodians for Keogh plans, IRAs and programs established under Section 403(b)(7). Our suggestion was based on the desire of a number of mutual fund complexes to utilize their non-bank transfer agents as passive trustees and custodians for these plans in order to reduce administrative costs and delays, particularly since banks are increasingly reluctant to serve as trustees and custodians for small plans at reasonable fees.

The IRS has issued regulations relating to non-bank trustees and custodians which contain high net worth requirements (the greater of $100,000 or 2% of their accounts with no maximum). These requirements may prevent many mutual fund non-bank transfer agents from serving as trustees and custodians. While most non-bank transfer agents can meet the $100,000 figure, many cannot satisfy the open-ended 2% requirement. In our submissions to the IRS, we pointed out that the net worth requirements serve no valid purpose in the case of mutual fund non-bank transfer agents which are registered with and regulated by the Securities and Exchange Commission.

We suggest that the Code be amended to provide an exemption from the net worth requirements for an entity within a mutual fund complex which serves as a passive trustee or custodian, provided that it is registered as a transfer agent with the Securities and Exchange Commission under Section 17A of the Securities Exchange Act of 1934.

2. <u>Passive Custodians and Trustees</u>

As indicated above, many mutual fund complexes have internalized the trustee/custodian function. This may raise certain questions with respect to the prohibited transaction provisions of ERISA. We filed for interpretive, or in the alternative, exemptive, relief with the Department of Labor on March 18, 1976. In particular, we urged that a passive custodian or trustee not be considered a fiduciary since passive custodians or trustees have no investment discretion and simply act as recordkeepers. The Department of Labor has not acted on our request, and we ask that the Subcommittee consider recommending appropriate legislation.

3. Master and Prototype Sponsors

The Institute has submitted interpretive requests to the Department of Labor and IRS asking for a ruling that a sponsor of a master or prototype plan is not a fiduciary. We have also asked for exemptive relief from the prohibited transaction sections of ERISA because a sponsor, even if not a fiduciary, may be considered a service provider. The agencies have responded to our exemptive request by issuing Prohibited Transaction Exemption 77-9. However, they have not addressed the substantive question of the sponsor's possible status as a fiduciary. We ask that the Subcommittee consider legislation making it clear that a master or prototype plan sponsor is not a fiduciary.

4. Fixed Commission Salesmen

Currently, the Department of Labor and IRS view any person who renders regular investment advice to a plan and receives a sales commission as a fiduciary. We believe that a salesman who receives a fixed sales commission which is not dependent upon the amount of advice rendered should not be considered to be a fiduciary. The agencies' current interpretation has created much confusion and has produced two very complicated prohibited transaction exemptions, 75-1 and 77-9. We urge that the Subcommittee consider appropriate legislation in this area.

5. Bonding

(a) Section 412 of ERISA requires that every person who handles funds or other property of a plan be bonded. The bonds have to cover a certain percentage of each plan's assets. We suggest that an institutional investment adviser be permitted to obtain one bond which would cover all plans for which it handles funds or other property. Coverage should be reasonably determined on the basis of risk of loss of the total amount of plan funds handled, rather than on a plan by plan basis. We ask that appropriate legislation be considered.

(b) The question has arisen of whether a Keogh master or prototype plan adopted by a self-employed individual funded in whole or in part with mutual fund shares and covering employees as well as principals operates in such a manner that the employer will be considered to be "handling funds or other property of the plan" within the meaning of Section 412 of ERISA. We believe that ERISA should be amended to clearly exempt a Keogh employer from bonding provided that (1) the employer adopts a master or prototype plan and (2) distribution checks are issued only to plan beneficiaries.

D. Miscellaneous

1. 403(b)(7) Reporting

Regulation §301.6058-1 requires that for each funded plan of deferred compensation an annual report must be filed (Form 5500 series) by either the employer maintaining the plan or the plan administrator. 403(b)(7) mutual fund custodial accounts are subject to this regulation, but their sister plans, 403(b) annuities, are specifically excluded. (See Reg. §301.6058-1(a)(2)).

A review of the legislative history of Section 403(b)(7) gives no indication that Congress wished to impose conditions on Section 403(b) plans funded through mutual fund shares which would not be required if they were funded through annuity contracts. Congress simply sought to provide greater investment flexibility to those persons eligible for 403(b) annuities by adding Section 403(b)(7). The Senate Finance Committee report explained the new provision as follows:

> "Section 403(b) annuity plans. Under present law, the proceeds of a section 403(b) annuity plan, for the benefit of teachers or employees of tax-exempt organizations, may be invested only in insurance contracts. The committee believes that it would be desirable to provide more flexibility in this area, and, accordingly, the committee bill provides that the assets of these accounts may also be invested in mutual funds, under appropriate custodial restrictions." (S.Rept.No. 93-383, p. 137, Aug. 21, 1973).

The House Ways and Means Committee similarly stated: "The Committee believes that it would be desirable to provide more flexibility in this area, and, accordingly, the committee bill provides that these contributions may also be placed in qualified custodial accounts if those funds are to be invested in mutual funds." (H.R.Rept. No. 93-807, p. 162, Feb. 21, 1974).

The burdens of reporting may make mutual fund shares so unattractive to those eligible for 403(b) programs that it may dissuade mutual fund organizations from entering the market. Further, it would likely discourage the purchase of mutual fund shares by eligible employees. Thus, the investment flexibility Congress sought to achieve by providing for an alternative investment product would be frustrated.

We note that Congress has been sensitive to competitive disadvantages in this area. In the Revenue Act of 1978, Congress reacted to proposed Treasury regulations by amending Section 403(b)(7) to provide through legislation the circumstances under which a participant may withdraw funds from a custodial account. The Senate Finance Committee explained its position by stating: "The committee believes that the more restrictive rule for distributions of stock of a regulated investment company has imposed an undesirable competitive disadvantage on regulated investment companies." (S.Rept. No. 95-1263, p.95, Oct. 1, 1978).

We urge the Subcommittee to consider legislation providing for equal reporting requirements for 403(b) custodial accounts and annuities. Legislation is warranted because the reporting requirement is so burdensome that it places the mutual fund industry at a severe competitive disadvantage and thereby thwarts the intent of Congress. The legislative history of Section 403(b)(7) demonstrates that Congress plainly intended that those persons eligible for 403(b) annuities should be permitted to use an alternative funding vehicle and that all such vehicles should be treated in pari passu.

2. Voluntary Contributions

The Institute supports any constructive stimuli which will induce persons to make or increase voluntary contributions. Some legislative proposals attempt to do this by way of a tax deduction. While we support these efforts, we believe that a tax credit may be a more effective stimulus than a tax deduction.

If the Subcommittee wishes to encourage voluntary contributions, we believe that it should consider allowing all persons, including active participants in plans, to establish IRAs. Conceptually this should accomplish the same goals as voluntary contributions, increase retirement benefits and eliminate the need to define and police "active participation" or monitor voluntary contribution amounts for tax purposes at distribution. It will, however, ensure that individuals can keep control of their funds, and reduce administrative costs for employers.

3. Nonqualified Deferred Compensation Plans

The interaction of ERISA (Sections 211(b), 306(c), and 1017(a) and (b)) and the Revenue Act of 1978 have left the nonqualified deferred compensation plans of tax exempt organizations in a vacuum. First, the Department of Labor has not as yet defined the term "primarily for a select group of management or highly compensated employees," thus leaving to speculation which deferred compensation plans might be subject to ERISA. Second, Congress, in the Revenue Act of 1978, provided one set of guidelines for nonqualified plans of taxable entities and another set for state plans. Since tax-exempt organizations were not covered by the Revenue Act of 1978, they will be subject to a third set of guidelines, namely Treasury regulations. Nonqualified deferred compensation plans have obviously become a needlessly complex area. We believe, therefore, that since S. 511 will significantly simplify the rules governing these types of plans, it deserves support.

Additionally, we support S. 511 because it will ensure that tax-exempt organizations will become competitively equal to state and local governments in the area of recruiting and retaining qualified personnel. Clearly, deferred compensation is an important part of any compensation package offered to prospective employees. We see no reason why tax-exempt organizations should be restricted in this area as a matter of legislative policy.

Further, we have noted that during testimony given before this Subcommittee, it has been suggested that the compensation formulas under both Section 403(b) and deferred compensation programs be amended to provide a limit of 25 percent of gross income, with no make-up or catch-up provisions. The Institute would not object to such an amendment since the current contribution rules are needlessly complex and often result in inadvertent administrative error.

APPENDIX A

Investment Company Institute

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202 293-7700

MATTHEW P. FINK
GENERAL COUNSEL

December 10, 1979

Honorable Lloyd Bentsen, Chairman
Subcommittee on Private Pension Plans and
Employee Fringe Benefits
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

On December 5, 1979, the American Bankers Association testified before the Subcommittee on Private Pension Plans and Employee Fringe Benefits on S. 209, the ERISA Improvements Act of 1979. In its testimony (copy attached as Exhibit A) the ABA called for the amendment of the bill so as to exempt bank-sponsored pooled investment funds for Keogh plans and Individual Retirement Accounts from regulation under the federal securities laws. The proposal has already received two full hearings and has been thoroughly discredited.

We are writing to express our strong objection to the ABA's proposed amendment and to advise you that it has also been vigorously opposed by the Securities and Exchange Commission and the Department of Labor. In addition, Senators Proxmire and Garn, the Chairman and the ranking minority member of the Senate Committee on Banking, Housing and Urban Affairs, have requested referral of any such provision to that Committee since it would amend the federal securities laws and the federal banking laws.

The original bill introduced by Senators Williams and Javits, S. 3017, contained a provision, supported by the ABA, which would have exempted bank and insurance company-sponsored pooled investment funds for Keogh plans and IRAs from the federal securities law.

This proposal was opposed by both government agencies having an interest in the matter.

The provision was opposed by the Securities and Exchange Commission which stated that "unsophisticated persons, at whom the sales efforts of the banks would be directed, would be faced with the prospect of making perhaps the most important investment decision of their lives without the protection of the disclosure in a statutory prospectus and without the benefit of the anti-fraud provisions of the securities laws."*

The provision was opposed by the Department of Labor which stated "we are not aware of any study which shows that the application of the securities laws has discouraged services to plans or that this proposal remedies any detrimental effect of the securities laws. On the other hand, the proposal would deprive many plans of existing and longstanding protections of securities laws traditionally applied to anyone (including small plans) in the comingled fund."**

The Investment Company Institute testified in opposition to the provision*** on the grounds that it would implicitly repeal the Glass-Steagall Act which prohibits commercial banks from distributing securities, and would deprive hundreds of thousands of employee benefit plans of protections afforded by the federal securities laws -- protections which are not provided by ERISA. Specifically, we pointed out that enactment of the provision: (1) would permit bank sponsors of pooled investment funds to run misleading advertisements of the type attached as Exhibit B aimed at Keogh plans and IRAs with no restraints

* Statement of the Securities and Exchange Commission, Hearings on S. 3017 Before the Subcomm. on Labor of the Senate Comm. on Human Resources and the Subcomm. on Private Pension Plans and Employee Fringe Benefits of the Senate Comm. on Finance, 95th Cong., 2d Sess., 320 at 348 (1978). [Hereinafter cited as "Hearings on S. 3017"].

** Department of Labor Analyses of Proposals, Hearings on S. 3017, 152 at 160.

*** Statement of the Investment Company Institute, Hearings on S. 3017, 798.

whatsoever imposed by ERISA*; (2) would free bank sponsors of pooled investment funds from providing Keogh plans and IRAs with prospectuses and would allow them to use any type of sales materials they desire; and (3) would deprive all employee benefit plans of the right to bring actions under the federal securities laws in connection with their purchases of interests in pooled investment funds -- rights which are not provided by ERISA.

The provision was strongly supported by the American Bankers Association. Congress adjourned before there was time for Committee mark-up on S. 3017.

On January 24, 1979, Senators Williams and Javits reintroduced the bill as S. 209. In response to the objections which had been raised by the SEC, the Department of Labor and the Institute, the provision was substantially revised. While it would have removed SEC jurisdiction over bank and insurance company pooled investment funds for Keogh plans and IRAs, it would have mandated the Department of Labor to prescribe regulations establishing disclosure, advertising and other standards for all bank and insurance company pooled pension funds.

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* At present bank-sponsored pooled investment funds for corporate retirement plans are exempt from regulation under the federal securities laws. Banks have taken advantage of this exemption to run advertisements of the type attached as Exhibit B. Enactment of the ABA's proposed amendment would permit banks to run similar advertising campaigns aimed at Keogh plans and IRAs.

After viewing bank advertisements aimed at corporate plans, Senator Proxmire stated "It's astonishing that they can do this and the SEC has no authority, no jurisdiction...." Hearings on S. 72 Before the Senate Comm. on Banking, Housing and Urban Affairs, 95th Cong., 2d Sess. at 348 (1978). The SEC recently called for legislation to subject bank-sponsored funds for corporate plans to regulation under the federal securities laws. Statement of the Securities and Exchange Commission on H. R. 1539, H. R. 2747 and H. R. 2856 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Insurance, Oct. 17, 1979, at 16-17.

The SEC testified in opposition to the provision, stating that "the Commission believes that when employee benefit plans invest their assets in banks and insurance company collective investment media, the plans and their participants should continue to be afforded the protections of the federal securities laws, in the same manner as when they invest in other securities. We are unaware of any problems that require a change in the law which would result in a loss of investor protection and a dilution of the important principle of equal regulation of collective investment media."*

The putative beneficiary of enlarged jurisdiction, the Department of Labor, stated that since the Department lacked expertise in this area and the SEC had more experience with these types of regulatory and disclosure issues, any provision in this area should warrant more study. **

A critic of SEC advertising regulation, Roy A. Schotland, Professor of Law, Georgetown University Law Center, testified in opposition to the provision, and, although critical of the SEC, stated "If I had to come up with an answer today, I would say give the Section 516 authority to the SEC. . . ."***

The Investment Company Institute reiterated its view that the pension reform legislation should not be the vehicle for encouraging activity which violates the Glass-Steagall Act. In addition, we stated that, having recognized that interests in these bank-pooled funds are securities and having imposed securities-type controls over them, the transfer of jurisdiction from the SEC to the Department of Labor was an obvious anomaly. ****

The provision was also opposed by the American Bankers Association and the American Council of Life Insurance.

* Statement of the Securities and Exchange Commission, Hearings on S. 209 Before the Senate Comm. on Labor and Human Resources, 96th Cong., 1st Sess., 653 at 667 (1979). [Hereinafter cited as "Hearings on S. 209"].

** Department of Labor Views, Hearings on S. 209, 154 at 199.

*** Statement of Professor Roy A. Schotland, Hearings on S. 209, 319 at 338.

**** Statement of the Investment Company Institute, Hearings on S. 209, 711.

On April 2, 1979, Senators Proxmire and Garn sent a letter to Senators Williams and Schweiker, attached hereto as Exhibic C, requesting that the provisions in question be referred to the Senate Committee on Banking, Housing and Urban Affairs since they would amend the federal securities laws, amend the Glass-Steagall Act and shift regulation over securities matters from the SEC to the Department of Labor.

At its mark-up on S. 209, the Senate Committee on Labor and Human Resources deleted the provisions from the bill.

In short, the issues raised by the ABA's proposed amendment were the subject of two sets of extensive hearings before the Senate Committee on Labor and Human Resources. The ABA's proposal to exempt bank-sponsored pooled investment funds for Keogh plans and IRAs were vigorously opposed by the SEC, the Department of Labor and academic experts. Senators Proxmire and Garn made clear that the ABA's proposal not only would repeal the federal securities laws, but also would effect a repeal of the Glass-Steagall Act. After these two sets of extensive hearings, the Committee on Labor and Human Resources determined not to adopt the ABA's proposal.

We therefore respectfully urge the Subcommittee on Private Pension Plans and Employee Fringe Benefits to reject this latest attempt by the ABA to achieve repeal of the federal securities laws and the Glass-Steagall Act through the guise of pension reform legislation.

Very truly yours,

Matthew P. Fink

Matthew P. Fink
General Counsel

Attachments
cc: Senator Spark Matsunaga
Senator Robert Dole
David Allen
Edward Ing
Jack Curtis
John Daniels
Ralph Ferrara (SEC)
Sydney Mendelsohn (SEC)
Martin Lybecker (SEC)
Robert Pozen (SEC)
Ian Lanoff (Department of Labor)
Monica Gallagher (Department of Labor)
Morton Klevan (Department of Labor)

EXHIBIT A

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS OF THE
SENATE FINANCE COMMITTEE
ON THE
ERISA SIMPLIFICATION AND ERISA IMPROVEMENTS ACTS OF 1979
(S.1089 AND S.209)

December 5, 1979

Mr. Chairman and members of the Subcommittee, I am Charles A. Moran, senior vice president of Manufacturers Hanover Trust Company, and Chairman of the Employees Trusts Committee of the Trust Division of the American Bankers Association. I appear on behalf of the ABA, an association composed of over 90 percent of the nation's more than 14,000 full service banks. Approximately 4,000 of our members have fiduciary powers and most of these serve as trustees, investment managers, or in some other fiduciary capacity with respect to employee benefit plans. The American Bankers Association is committed to efforts to insure the strength, integrity, and further expansion of private plans covered by the Employee Retirement Income Security Act. On the whole ERISA has proven to be a workable and salutary law, but some of its provisions have placed conflicting, duplicative, and unnecessarily burdensome requirements on plans and those involved in providing services to plans. We are pleased that the Senate Finance Committee is holding these hearings on S.1089, "ERISA Simplification Act of 1979", and S.209, "ERISA Improvements Act of 1979", in order to explore what changes should be made in ERISA.

Our testimony today will cover a number of matters not directly involving the Internal Revenue Code. We believe, however, that all these matters are critical to sound changes in ERISA to promote the expansion of the pension system and improve its functioning.

of adequate consideration is the only real answer. If there is concern about difficulties which might be encountered in proving a transaction was not arm's length, it might be appropriate to shift the burden of proof to the fiduciary to show that a challenged transaction was arm's length.

In connection with our consideration of the prohibited transaction problem the Association is renewing its consideration of the establishment of a single independent agency whether it be an adminsitrative agency or commission. It is doubtful that such an agency would do much, if anything, to cure the problems we have experienced in the exemption application procedure. We are looking, however, at the impact such an agency might have on the overall administration of ERISA, particularly in promoting the interest of pension plans as well as protecting the interests of participants and beneficiaries. Congress indicated in its committee reports on ERISA its concern that ordinary commercial transactions not be unncessarily impeded. This has not been the record of ERISA administration to date.

Special Master Plans

S.209 offers a potential major step forward to provide pension plans for employees of small employers. The special master and prototype plan concept may allow a breakthrough in extending pension plan coverage if costs can be minimized under a responsible, effective regulatory scheme. We believe it particularly important to attract smaller financial institutions to sponsor such plans for the smaller businesses in their communities. Because of the size of the employers that will participate in the special master plans, it will be an economic necessity that the contributions of individual employers to their pension trusts be collectively invested.

This raises securities law problems. S.209, as introduced, would have gone a long way toward solving these problems by allowing banks to collectively invest assets of all employee benefit plan trusts without the added burden of SEC regulation.

As we read the bill a special master or prototype plan would have to meet the requirements of Section 401 of the Internal Revenue Code, the requirements of new Section 601 of ERISA and the other requirements of ERISA to qualify. All small employers regardless of business organization would be able to adopt the plan. Considering the past and current attitude of the Securities and Exchange Commission relative to Keoghs and IRAs it seems doubtful that the current Federal securities laws exemption for single or collective trusts for pension plan assets would be considered applicable.

Under current law the assets of corporate plans may be collectively invested regardless of the size of the company without registration under Section 3(a)(2) of the Securities Act of 1933. Congress has not, however, exempted Keogh plan collective trusts from registration under the 1933 Act. Nevertheless, banks with very few exceptions have not registered their collective trusts for Keoghs but have relied upon the intrastate exemption of Section 3(a)(11) of the 1933 Act. This has resulted in some strange consequences. In multistate communities such as Washington, D.C., New York and Chicago, Keogh plan trusts have to be tailored carefully so that the interest in the plan of any participant who resides out-of-state is not invested in a collective trust fund. The interest of such a person may be invested in an interest bearing deposit account. Because of the intrastate restriction, plans that are collectively invested must be policed continually to ascertain when any participant moves out of the state so the participant's interest can be withdrawn from the collective trust and reinvested in a deposit account. These nonproductive costs are borne by the plan and the bank trustee but the really unfortunate aspect is that the participant loses his ability to have his pension account invested in a diversified, professionally managed portfolio.

Many smaller banks have considered collectively investing their Keogh plan trusts and their corporate pension trusts in one fund because they do not hold sufficient assets to maintain two separate collective trusts. However, they have decided against such action because according to SEC registration would be required to do this unless all corporate plans including all their participants reside in one state. The reason for this result is that the intrastate exemption requires all securities in the issue to meet the intrastate requirement.

When Congress created individual retirement accounts, it attempted to remove impediments to the collective investment of such accounts with Keogh plan assets and other 401 pension plan assets. The SEC, however, has taken the position that interests in collective trusts for IRAs are not exempt from the 1933 and 1934 Securities Acts and the trusts themselves are not exempt from the Investment Company Act. The reason for this is that the exemption provisions of these securities laws are couched in terms of trusts qualified under Section 401 of the Internal Revenue Code and IRA trusts qualify under Section 408. There is nothing in the legislative history as to why Congress utilized an entirely new section in authorizing an entirely new type account. It is sheer speculation to argue, as some do, it was to avoid the exemptive provisions of the securities laws. Nevertheless, the SEC has not allowed banks to invest IRAs collectively without registration and compliance with the 1940 Investment Company Act. As a consequence, banks do not invest IRA accounts in securities except for large rollover accounts where they can be managed economically on an individual basis.

The same problem exists under the securities laws where a smaller bank wishes to invest collectively assets it holds as trustee for personal trusts and assets it holds as trustee for pension trusts because it does not hold sufficient assets to establish two separate collective trusts. Presumably, the intrastate exemption would be available under the 1933 Act if all the accounts met the residency requirement or, maybe, even the exemptions for common trust funds and corporate pension trusts might be available. But according to the SEC such a collective trust could not find an exemption from the Investment Company Act because the pension trust exemption and the common trust fund exemption are found in different subsections of the Act and there is no intrastate exemption which might cover all the individual trusts. The common trust fund exemption alone is not available because the SEC holds that the trustee of a pension trust is not a trustee.

If the special master and prototype plan proposal is enacted without action being taken to deal with the securities laws, it appears that the same situation will exist as with IRA accounts. No current exemption from the three Federal securities laws would be available but collective investment would be essential to sponsoring such a plan. S.209 as introduced would have cured the problem for the special master plan trusts and further would have cured many of the other problems we have discussed relative to other types of pension plans.

It is long past time to straighten out the hodge-podge quilt work found in the application of our securities laws to collective investment of trusts. The securities laws, as construed by the SEC, contain exemptions under which per-onal trusts, corporate pension trusts and Keogh pension trusts can be collectively invested so long as assets from the different types of trusts are not combined in one fund. Thus smaller banks may often find that they are precluded from using a collective trust fund not because of a lack of an exemption for each type of trust they would like to invest collectively but because they do not have sufficient assets to establish a separate collective fund for each type of trusts—personal, corporate pension and Keogh.

We have argued here in detail the current securities law problems of collective investment of employee retirement plans and the need for legislative change because if banks are going to be able to actively participate under the special master and prototype plan program a change in the application of the securities law is essential.

As mentioned before, S.209, as did its predecessor, originally contained language which would have cured the securities law problem for banks offering special master and prototype plans. As introduced the bill would have provided that interest in collective trust funds for employee benefit plans are not securities for purposes of the registration and reporting requirements of the 1933 Securities Act and the 1943 Exchange Act and that the collective funds themselves are not investment companies under the 1940 Investment Company Act. After having provided for the removal of this unnecessary duplicative regulatory burden S.209 unlike S.3017 went on to provide for additional duplicative regulations by the Department of Labor not only for collective trust for employee benefit plans but for all trusts for these plans. The bill mandated the Secretary of Labor to issue within 12 months regulations for single and collective retirement trusts governing disclosure of material information, advertising and any other matter found necessary by the Secretary to protect plan participants and beneficiaries.

The Senate and Labor Human Resources Committee apparently felt unable to remove one set of regulations without imposing an alternative set of regulations because in its markup session when it deleted the Labor Department new regulatory authority over pension trusts maintained by banks it also deleted the provisions which would have taken collective trusts for pensions out from under the registration and reporting provisions of the securities laws and the regulatory provisions of the Investment Company Act.

We urge the Finance Committee to consider carefully the need to restore the provision of S.209 which removes the duplicative regulatory burden of the securities laws on collective trusts maintained by banks. In maintaining these trusts banks carry the full obligations and duties of trustees subject to the fiduciary standards of ERISA and federal and state banking law and regulation. Full disclosure of these trusts is required on a continuing basis and their operation is subject to periodic examination by Federal and state bank examiners who, according to the Comptroller of the Currency's examination manual, have a duty to protect trust beneficiaries as well as bank depositors. Despite the lack of SEC registration and regulation we know of no pension plan participant or sponsor who has come forward to complain to Congress or the Labor Department of injury or harm due to the failure of a bank trustee to disclose information or a bank's advertisement of trust services.

The complete removal of bank collective trusts from the regulation and reporting requirement of the 1933 and 1934 securities laws and the 1940 Investment Company Act will in no way jeopardize the protection of plan participants and beneficiaries.

Finally, if maximum participation in the special master plan program is to be achieved among banks, they will need the ability to collectively invest in one fund all types of pension trusts, corporate, Keogh, IRA and special master plan, without the unneeded counterproductive burden of SEC registration. Thus, we urge the Committee to include in the exemption language not only employer and union sponsored IRAs but all IRAs.

Daniel Issue

In another, but related area of securities law application to pension plans, S.209 and the Senate Labor and Human Resources Committee took the same approach but rather than deleting the two provisions in markup the Committee kept both. S.209 provides that the interest of an employee benefit plan is not a security for the purposes of the antifraud provisions of the 1933 and 1934 Securities Acts and then the bill establishes its own new misrepresentation prohibition. We are troubled by the lack of certainty of this new standard. We are not before the Committee to defend misrepresentation, on the contrary we abhor the idea that any person in a position of responsibility might deliberatedly mislead an employee, participant, or beneficiary as to any right or interest he might have in a plan. We believe, however, that the existing provisions of ERISA currently prohibit bank fiduciaries from misrepresenting matters within their purview to employees, participants, and beneficiaries, plan sponsors, other fiduciaries, the plan administrators and the government. As we read this new section we must assume that the intention of S.209 is that persons other than fiduciaries would be subject to its requirement and possibly some new group not now protected by ERISA would come within the scope of its protections. Our concern goes to the lack of specificity in identifying those subject to the bar and those to be protected as well

EXHIBIT B

NEWARK STAR-LEDGER—June 20, 1978

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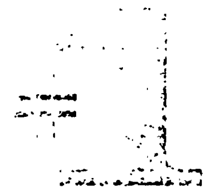

Bank Equity Fund Manager for the five years ended December 31, 1977 as measured by Frank Russell Co., Inc.; Computer Directions Advisors, Inc.; and Rogers, Casey, & Barksdale, Inc.

For Information Contact:
Gregory N. Schedler, Trust Officer,
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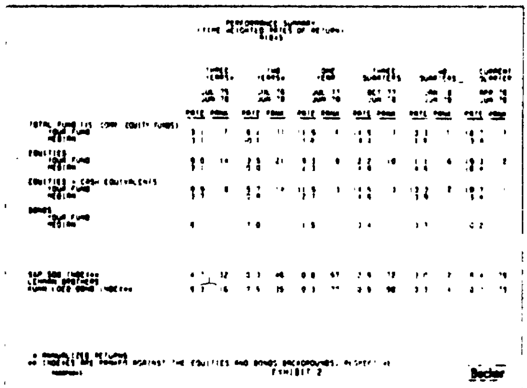

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PENSIONS & INVESTMENTS—May 21, 1979

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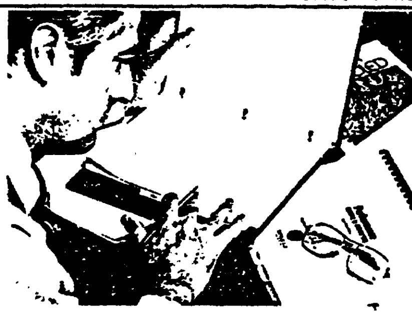

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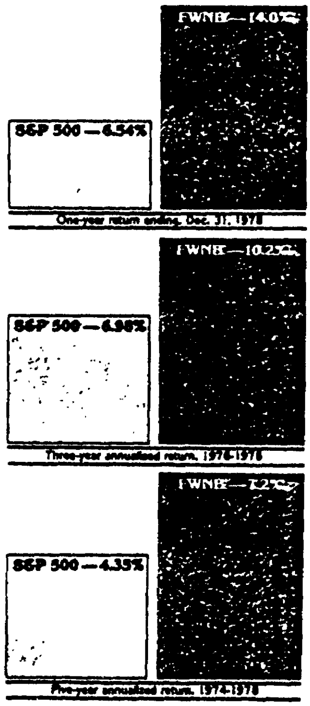

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Commingled Equity Funds

(Funds in top quartile over three or more time periods)

INSTITUTION	9 yrs	5 yrs	3 yrs	1 yr	1 Qtr
American Bank, Pa.	●	●	●	●	●
Bankers Life, Ia.	●	●	●	●	●
1st of Birm., Al.	●	●	●	●	●
FIRST PENNSYLVANIA	●	●	●	●	●
1st Variable, Ar.	●	●	●	●	●
Minnesota Mutual	●	●	●	●	●
Prov. Natl. Pa.	●	●	●	●	●
Fifth Third, Oh.	●	●	●	●	
Liberty Natl. Ok.	●	●	●	●	
Pacific Natl. Wa.	●	●	●	●	
1st City Dallas	●	●	●		●
1st Albuquerque	●	●	●		●
Cit. Chillicothe, Mo.		●	●	●	●
Citizens & So. Ga.	†	●	●	●	●
1st Natl. Exch. Va.		●	●	●	●
1st Kenosha, Wi.	†	●	●	●	●
1st Wis. Natl.	†	●	●	●	●
Guardian Ins. N.Y.	†	●	●	●	●
Hibernia Natl. La.	†	●	●	●	●
Mass Mutual		●	●	●	●
Natl. Westchester N.Y.		●	●	●	●
Phoenix Mu. Ct.		●	●	●	●
United Jersey N.J.	†	●	●	●	●
U.S. Natl. Or.	†	●	●	●	●
U.S. Natl. Galveston	†	●	●	●	●
Fort Worth Natl.	●	●		●	
Old Natl. Wa.	●	●			●
Chicago Title	†	●	●	●	
1st Trust Corp. Co.		●	●	●	
Marine Midland N.Y.		●	●	●	
Commonwealth Natl. Pa.	†	●	●		●
Oregon Bank	†	●	●		●
First in Dallas		●		●	●
Cont. Life, Ore.			●	●	●
Lincoln Union, Fl.	†		●	●	●

Commingled Fixed-Income Funds

(Funds in top quartile over three or more time periods)

INSTITUTION	9 yrs	5 yrs	3 yrs	1 yr	1 Qtr
Continental Illinois	●	●	●	●	
Equit. Trust, Md.	●	●	●	●	
FIRST PENNSYLVANIA	●	●	●	●	
1st Atlanta, Ga.	†	●	●	●	●
1st [illegible], Oh.	†	●	●	●	●
Hibernia Natl. La.	†	●	●	●	●
Lincoln Natl. In.	†	●	●	●	●
Liberty Natl. Ok.	●	●	●		
Morgan Guaranty, N.Y.	●	●	●		
Detroit Bank Trust	●	●		●	
1st of Minneapolis	●	●			●
Old Kent, Mi.	●	●			●
Bank of Oklahoma			●	●	●
Fourth Natl. Ok.			●	●	●
Mercantile of Dallas			●	●	●
Ohio Cit. Trust			●	●	●
Sec. Trust Rochester			●	●	●
Union Planters, Tn.			●	●	●
U.S. Trust, N.Y.		●		●	●

†Indicates fund was not in existence for entire nine-year period.

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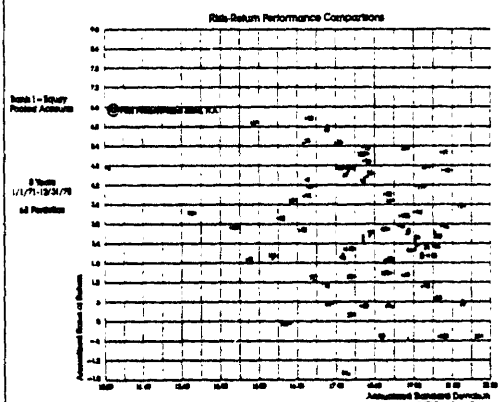

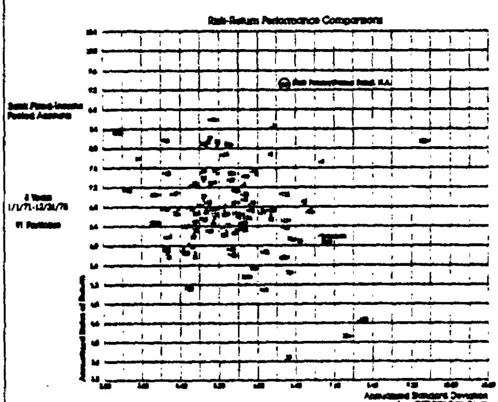

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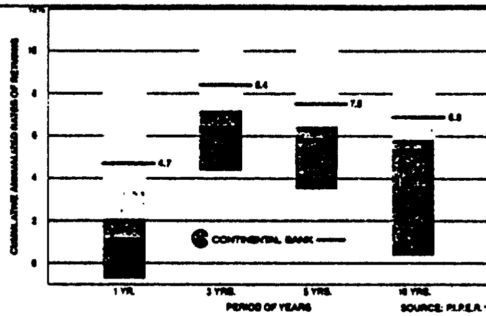
INSTITUTIONAL INVESTOR—April, 1979



If you're looking for top rated fixed-income management, come to a leader: Continental.

Continental Bank's fixed-income management continuously produces outstanding results. As the P.I.P.E.R. survey of 183 institutions shows: our Fixed-Income Fund is one of four to rank in the top quartile for all ten reporting periods.

Of course that's history, not a guarantee of future success. But past performance gives every indication that it's a history our fixed-income management team will repeat.

If that's the kind of performance you want, then let us create an actively managed portfolio for your employee retirement plan. Call Tony Wilson, Vice-President, at 312/828-7007. You'll find our past experience can help your tomorrows. We'll find a way.

*Pensions & Investments' Performance Evaluation Report, Pooled Fixed Income Funds of banks and insurance companies. Cumulative Periods Ending December 31, 1978.

CONTINENTAL BANK
TRUST AND INVESTMENT SERVICES

Continental Illinois National Bank and Trust Company of Chicago · 231 South LaSalle Street, Chicago, Illinois 60693

PENSIONS & INVESTMENTS—May 21, 1979

Our Fixed Income Fund has shown top quartile performance with lowest quartile risk. Has yours?

Compare your fixed income fund with ours. For the period ending December 31, 1978, as measured by Frank Russell Co., Inc., the performance of our fixed income fund for employee benefit accounts was in the top quartile for one, two, three, five and eight years. At the same time, our fund was in the lowest quartile of volatility for all these periods.

In fact, for the three-year period ending December 31, 1978, only five managers of the 111 bank-pooled fixed income funds measured by Russell delivered a higher return at a lower risk. Interestingly, the size of the funds handled by these managers only ranged from $8 to $25 million. Our fund is $111,000,000 and averaged an 8.3 percent annual return, while maintaining lowest quartile volatility.

If your fund's performance doesn't measure up to ours, shouldn't you turn to Detroit Bank & Trust as your next manager? We already have over a billion dollars of employee benefit assets under management.

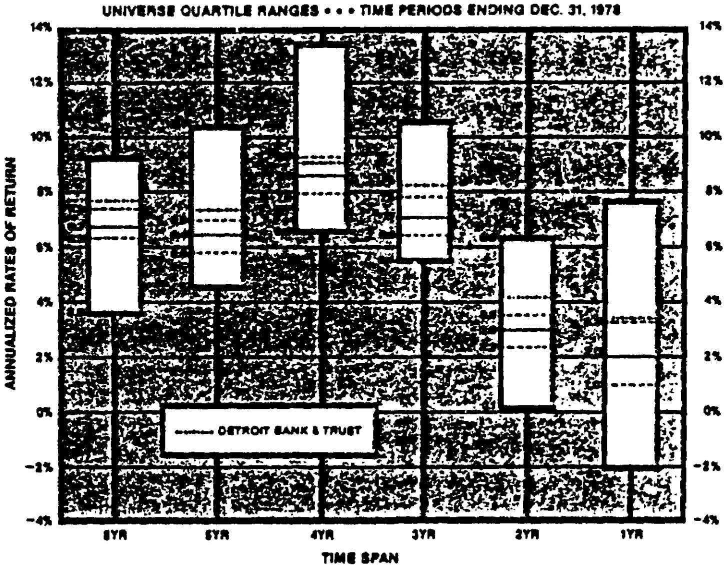
Call or write Terry Keating at (313) 222-3898, Detroit Bank & Trust, Box 59, Detroit, Michigan 48232.

DETROIT BANK & TRUST

you ought to know a DETROIT BANK-er better

BANK FIXED-INCOME POOLED ACCOUNTS

UNIVERSE QUARTILE RANGES • • • TIME PERIODS ENDING DEC. 31, 1978



130 years' experience, you can bank on it.

A bank at work:

producing positive investment results

The Philadelphia National Bank's commingled equity fund for employee benefit trusts has out-performed both the Dow-Jones Index and Standard & Poor's Index for the 5 years ended June 30, 1975, as follows:

	Total Rate of Return on a Cumulative Basis (income reinvested)	Compound average annual growth rate
PNB Philabank Stock Fund	**+98.1%**	**+14.7%**
Dow Jones Industrial Average	**+57.8%**	**+ 9.6%**
Standard & Poor's "500"	**+55.8%**	**+ 9.3%**

PNB offers a high level of experience and personalized service to meet the objectives of each fund. You'll find that PNB's investment management services are tailored to your needs and specific requirements. And we provide the specialized services of securities' and economic research, portfolio management and close personal account supervision. We are just the right size to do these things most efficiently and to make decisions with speed and flexibility.

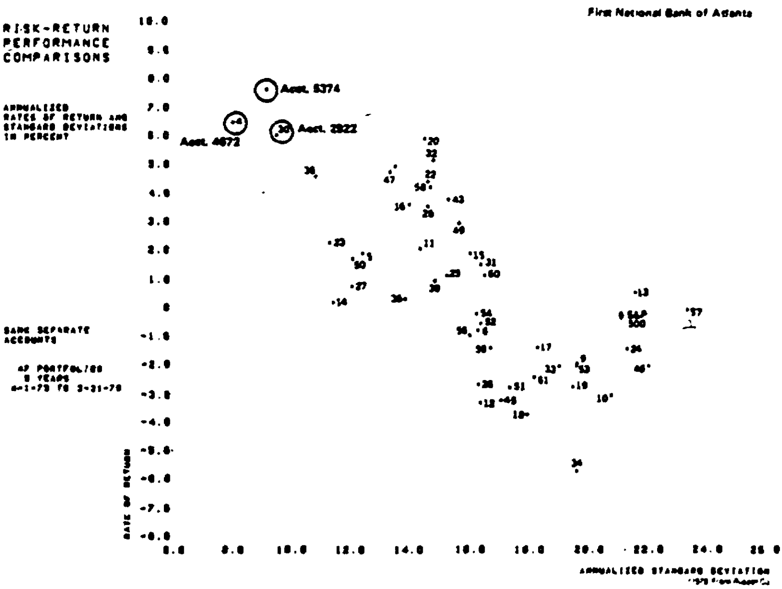
To learn how these results were achieved, call Harry A. Dorian at (215) 629-4031.

PNB Philadelphia National Bank

PHILADELPHIA NATIONAL BANK, PHILADELPHIA • PHILADELPHIA INTERNATIONAL BANK, NEW YORK
Offices: Philadelphia • New York • Bangkok • Caracas • London • Luxembourg • Nassau • Panama • São Paulo • Sydney
Associates: Dublin • Hamburg • London • Managua • Panama • Paris • Rio de Janeiro • Vienna

DECEMBER 1975

Our past is more than just performance. It's a philosophy.



For the past five years The First National Bank of Atlanta has consistently out-performed the other banks in the Frank Russell Survey. How so?

Well, the way we figure it, if we're going to optimize our clients' return, then we're going to have to conservatively manage the risks. Which is why we demand of ourselves a consistently conservative investment posture. And as you can see by the chart this policy has served our clients well over the past five years.

For more information on how we can help you in the future, there's no time like the present to contact Fred Betts 404/588-6817.

THE FIRST NATIONAL BANK OF ATLANTA

Trust & Investment Department, 2 Peachtree St., N.W. Atlanta, Georgia 30303

PENSIONS & INVESTMENTS—April 23, 1979

A lot of fund managers are happy to equal the S&P average. We start there.

Over the most recent 5-year period, Central National Bank achieved an average 6% return on its Commingled Equity Fund for Employee Benefit Plans. That's well above the S&P average for 500 stocks.

The same kind of above-average performance was recorded for the most recent 3-year and 4-year periods, too.

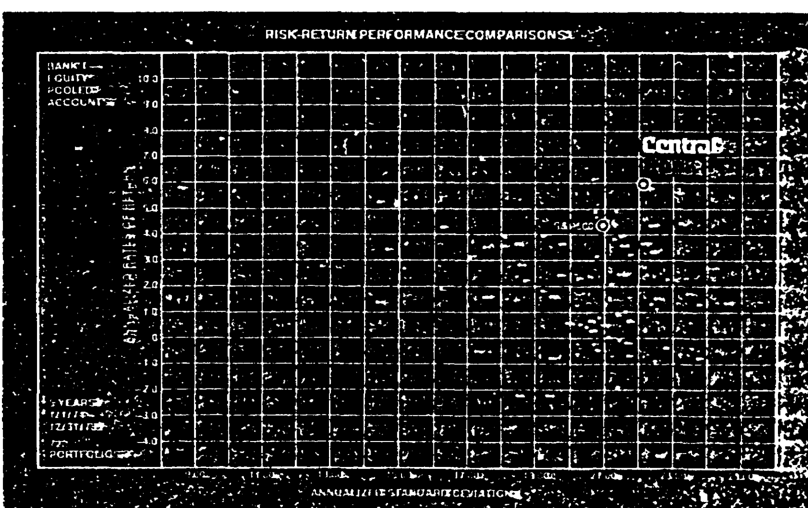
Ranked fifth out of 72 equity pooled bank portfolios by the Frank Russell Co. Inc., we're proud to have out-performed some of the best known names in the country. In fact, our record of performance clearly makes us a "little-known big name."

We employ multiple strategies. The unifying theme is a realistic appraisal of potential total return as related to risk, with an orientation toward quality growth companies.

You probably don't know us yet, but if you begin looking at who are the consistent performers, you'll want to talk to us.

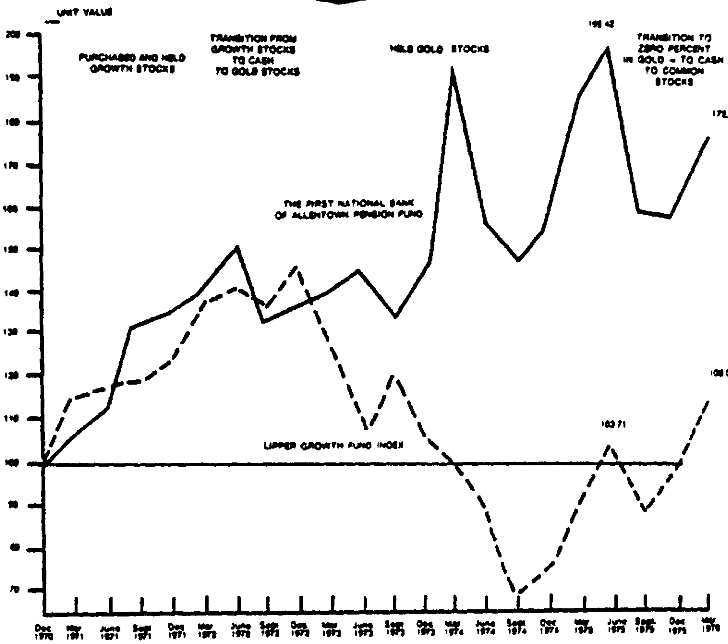
The person to start with is Chuck Meckes, Vice President, Trust Department. Call him at (216) 344-5023.

CentralBank
Central National Bank of Cleveland



PENSIONS & INVESTMENTS—May 10, 1976

Money management is where you find it, even in Allentown, Pennsylvania.



Wouldn't you agree?

For more information call Bill Snow
Investment Management Division
(215) 439-4360 or (215) 439-4209

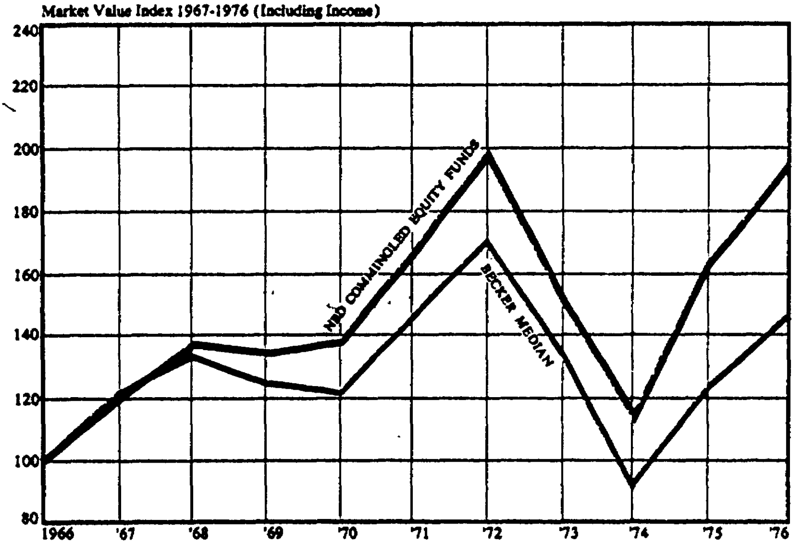
Lipper Growth Fund Index Adjusted December 1970 = 100
The use of the Lipper Index does not imply endorsement, approval or analysis by the Lipper organization.

1st NATIONAL BANK
ALLENTOWN, PA.

INSTITUTIONAL INVESTOR—November, 1977

Read between the lines.

Market Value Index 1967-1976 (Including Income)



OVER THE LAST DECADE, THE NATIONAL BANK OF DETROIT COMMINGLED EQUITY FUNDS HAVE OUTPERFORMED 97% OF THE BECKER UNIVERSE.

THIS RECORD IS A RESULT OF:

- Consistently superior performance from peak to peak, trough to trough, and over full market cycles.
- A uniquely disciplined approach to investment research and portfolio construction, utilizing modern asset valuation technology.

For some fascinating details on this process, and how it can benefit you, please contact RICHARD L. FOERSTERLING, Vice President, Trust Investment Department, National Bank of Detroit (313) 225-2820.

NBD Trust Division
National Bank
of Detroit

PENSIONS & INVESTMENTS—July 31, 1978

INSTITUTIONAL INVESTOR—November, 1978

To choose a money manager, first measure consistency.

No fund can afford extreme volatility in the performance of its money manager, nor run the risks that come with desperate efforts to foresee short-term swings in the market.

Consider a prudent alternative. Examine National Bank of Detroit's "equity percent" ranking in the Becker Securities, Inc. universe for periods ending 1972 through 1977.

NBD outperformed, on average, 86% of other money managers for the six latest ten-year periods, exceeding the Becker Median yearly by an average of 2.1 percentage points.

NBD outperformed, on average, 86% of other money managers for the six latest seven-year periods, exceeding the Becker Median by 2.5 percentage points.

NBD outperformed, on average, 80% of other money managers for the six latest four-year periods, exceeding the Becker Median by 2.3 percentage points.

Consistency of this caliber, under all market conditions, is the product of NBD's disciplined valuation system. This system reduces subjective bias and makes it possible to anticipate the value of securities without regard to type and to position your portfolio accordingly.

It will cost you nothing but a few minutes of your time to learn how these impressive results are achieved, and how we can put our capabilities to work for you. You begin with a telephone call to Richard Foersterling, Vice President at 313-225-2820.

Trust Division
National Bank
of Detroit

NEWARK STAR-LEDGER—April 24, 1979

Take a longer look at investment performance...

In evaluating bank-pooled investment funds, the only true measure is to examine performance over a 3 to 5 year period. No bank in New Jersey surpasses First Jersey in performance over the current full economic cycle.

Here are the facts from a recent long-term independent survey by Computer Directions Advisors.

NEW JERSEY BANKS EQUITY FUND PERFORMANCE 12/29/78	LATEST YEAR 12/77-12/78 RETURN	NAT. RANK	LATEST 3 YEARS 12/75-12/78 RETURN	NAT. RANK	LATEST 5 YEARS 12/73-12/78 RETURN	NAT. RANK
First Jersey National Bank	8.7	54	43.4	11	49.8	15
Fidelity Union Trust Company	9.1	46	N/A		N/A	
First National State Bank	8.1	64	31.9	33	18.0	92
Garden State National Bank	5.8	120	22.6	79	46.2	22
Midlantic National Bank	8.5	59	28.5	44	34.3	58
New Jersey National Bank #2	5.1	132	13.4	147	N/A	
Summit & Elizabeth Trust	8.1	66	.9	201	19.2	83
United Jersey Bank	7.3	[illegible]	33.8	26	38.1	29
No. of Funds Surveyed - National	215		206		188	
FJN's Percentile - National	25.1%		5.4%		8.0%	

NEW JERSEY BANKS FIXED INCOME PERFORMANCE 12/29/78	LATEST YEAR 12/77-12/78 RETURN	NAT. RANK	LATEST 3 YEARS 12/75-12/78 RETURN	NAT. RANK	LATEST 5 YEARS 12/73-12/78 RETURN	NAT. RANK
First Jersey National Bank	2.9	48	30.3	6	42.5	25
First National State Bank	(.4)	159	21.2	110	33.2	101
Garden State National Bank	2.5	62	28.7	12	40.2	33
Midlantic National Bank	1.8	92	28.1	17	38.7	68
New Jersey National Bank	1.7	59	25.3	38	N/A	
United Jersey Bank	.2	150	20.9	117	N/A	
No. of Funds Surveyed - National	162		153		140	
FJN's Percentile - National	28.8%		5.2%		17.9%	

And the First Jersey's commingled investment fund has grown equally dramatically in size — 140.8% in common stocks (to 10,101,560.86), and 130.4% in fixed income holdings (to 6,000,686.15) since the end of 1974.

John J. Squeracker
Sr. V.P. Investment Dept.

That is the kind of growth that can be achieved only by outstanding and consistent performance over the long haul. It's the kind of performance that puts the First Jersey National Bank in first place in New Jersey.

We invite you to participate in our success. A call to John J. Saueracker will introduce you to a concerned expert who will guide you to a plan that precisely fits your current needs and objectives for pension and profit-sharing fund investments. You can reach John at: (201) 547-7077.

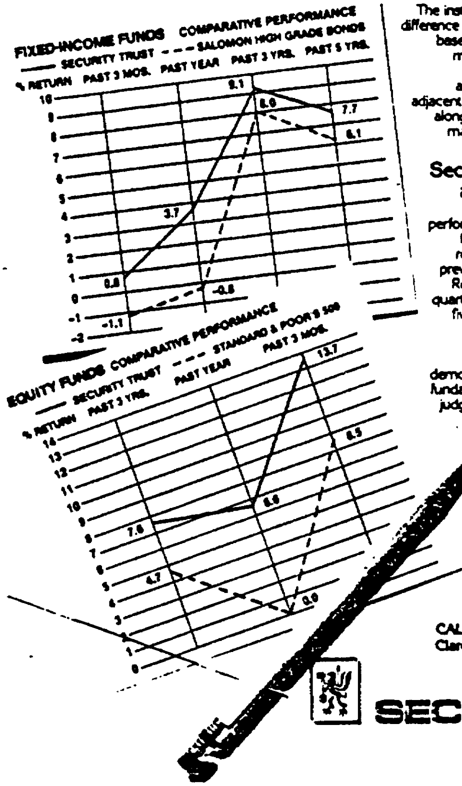
FIRST JERSEY
SINCE 1864 NATIONAL BANK
Banking on a first name basis.

Headquarters —
2 Montgomery Street, Jersey City, N.J. 07303
27 offices in Hudson, Bergen, Essex, Union, Monmouth and Ocean counties.
Member FDIC and FEDERAL RESERVE SYSTEM

PENSIONS & INVESTMENTS—November 6, 1978

CHART YOUR PENSION FUND'S PERFORMANCE RIGHT HERE.

YOU MAY BE SURPRISED BY WHAT YOU DISCOVER.



The instincts of professional money managers make the difference at Security Trust Company. Investment decisions based on a careful blending of intuitive judgment and modern investment theory are leading to favorable comparisons with random or computer-directed approaches to investment selection. If you use the adjacent graph to chart your pension fund's performance alongside ours, you'll see what we mean. Our money management philosophy is yielding exciting results.

Security Trust is a top quartile equity and fixed-income manager. A recent Pensions & Investments article comparing the performance of bank and insurance company pooled fixed-income and equity fund managers revealed remarkable results achieved by Security Trust. As previously reported in P&I's Performance Evaluation Report (P.I.P.E.R.), Security Trust ranked in the top quartile of the fixed-income fund survey in four of the five time periods* measured and in three of those periods for the equity fund survey.

Although not infallible, our money management philosophy has proven successful, as the charts demonstrate. Over the years, we have adhered to our fundamental principles, honing our skills, refining our judgments. As a result, Security Trust is today a top quartile equity and fixed-income fund manager.

*Ending June 30, 1978.

Our record could be your record. We believe that our management philosphy will continue to earn favorable results for our pension fund customers. If you're looking for a money manager with a uniquely successful approach to investment selection, then contact us for more details.

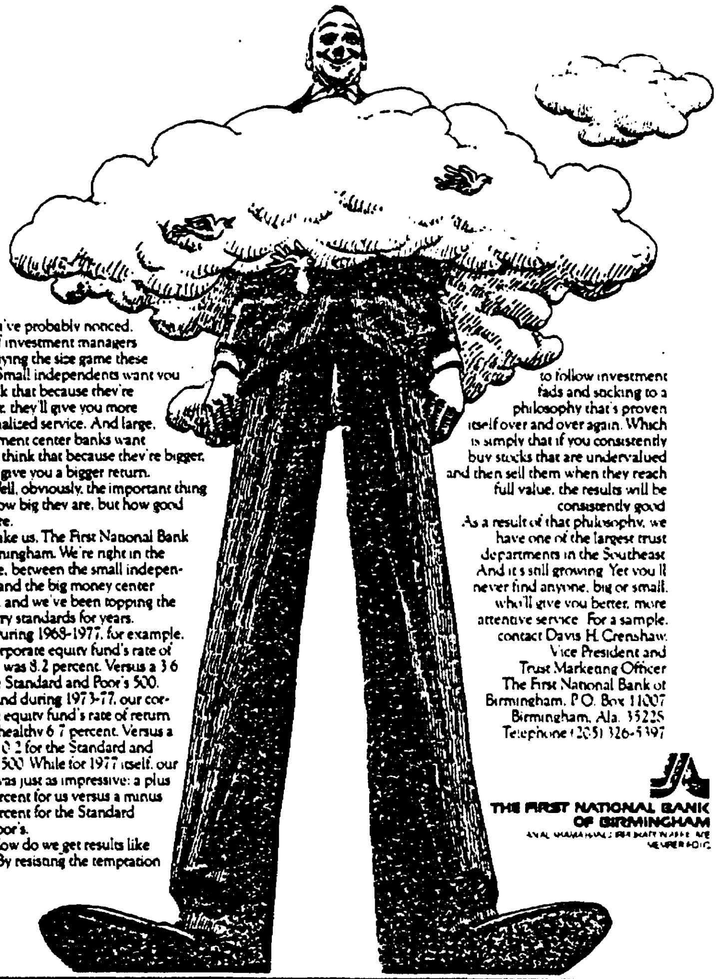
WRITE:
Security Trust Company, One East Avenue, Rochester, New York 14638

CALL:
Clarence Ellsworth, Vice President, (716) 262-4571

SECURITY TRUST
Nearest your needs
A Security New York Bank

INSTITUTIONAL INVESTOR—August, 1978

THE IMPORTANT THING ISN'T HOW BIG YOUR INVESTMENT MANAGER IS. IT'S HOW BIG YOUR RETURN IS.



As you've probably noticed, a lot of investment managers are playing the size game these days: Small independents want you to think that because they're smaller, they'll give you more personalized service. And large, investment center banks want you to think that because they're bigger, they'll give you a bigger return.

Well, obviously, the important thing isn't how big they are, but how good they are.

Take us. The First National Bank of Birmingham. We're right in the middle, between the small independents and the big money center banks, and we've been topping the industry standards for years.

During 1968-1977, for example, our corporate equity fund's rate of return was 8.2 percent. Versus a 3.6 for the Standard and Poor's 500.

And during 1973-77, our corporate equity fund's rate of return was a healthy 6.7 percent. Versus a minus 0.2 for the Standard and Poor's 500. While for 1977 itself, our edge was just as impressive: a plus 3.1 percent for us versus a minus 7.2 percent for the Standard and Poor's.

How do we get results like that? By resisting the temptation to follow investment fads and sticking to a philosophy that's proven itself over and over again. Which is simply that if you consistently buy stocks that are undervalued and then sell them when they reach full value, the results will be consistently good.

As a result of that philosophy, we have one of the largest trust departments in the Southeast. And it's still growing. Yet you'll never find anyone, big or small, who'll give you better, more attentive service. For a sample, contact Davis H. Crenshaw, Vice President and Trust Marketing Officer, The First National Bank of Birmingham, P.O. Box 11007, Birmingham, Ala. 35225. Telephone (205) 326-5397.

THE FIRST NATIONAL BANK OF BIRMINGHAM

34 AUGUST 1978

INSTITUTIONAL INVESTOR—November, 1977

Active investing in the fixed-income market makes sense and money.

Becker

FUNDS EVALUATION SERVICE

INTERIM REPORT

NATIONAL CITY BANK · CLEVELAND, OHIO
NATIONAL CITY BANK INVESTMENT FUND FOR RETIREMENT TRUST – FIXED INCOME

TIME-WEIGHTED RATES OF RETURN AND RANKINGS
PERIODS ENDED JUNE 30, 1977

YOUR FUND W1298

	12 MONTHS PERCENT		24 MONTHS PERCENT		36 MONTHS PERCENT	
	RATE	RANK	RATE	RANK	RATE	RANK
FIXED INCOME YOUR FUND	13.2	12	12.5	10	11.9	11
MEDIAN	10.4		9.8		9.7	

This rate of return was accomplished through efficient management of our $129 million Fixed Income Collective Fund for Retirement Trusts without impairing the quality of the portfolio. 98.45% of the market value is in Governments, Agencies and AAA Corporate Bonds. We feel this is the type of bond management you should be looking for. For further information or to arrange for a fact finding presentation, call (216) 861-4900 or write the Trust Group, New Business Division, National City Bank, 623 Euclid Avenue, Cleveland, Ohio 44114.

National City Bank
Cleveland · Ohio

It takes a broad range of investment skills to match retirement fund objectives today.

Here's how the people of First Chicago, with investment responsibility for $8.8 billion, can provide diversification that's beyond the realm of other major money managers.

Mention diversification to most money managers and they'll tell you about their stocks and bonds. Mention it to First Chicago and we'll tell you a lot more.

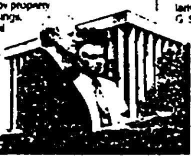
We believe that extraordinary times call for extraordinary measures. To cope with today's erratic market behavior, you need diversification that goes beyond conventional stocks and bonds, and beyond national boundaries. We've developed the skills to provide this full spectrum of diversification. And we have performance figures to prove its effectiveness. Here are a few examples.

Real estate to offset inflation.

A limited supply and increasing demand make choice income property an ideal investment for protecting assets from inflation. To provide easy access, First Chicago developed Real Estate Fund F, the oldest and by far the largest nationally diversified real estate fund, emphasizing outright ownership of properties, operated by any bank.

Properties are selected and managed by the Trust Department's own team of real estate specialists. As we invest only for funds we manage, we have no conflict as to allocation of choice properties. And investments are diversified both geographically and by property type: industrial buildings, office buildings, retail centers and garden apartments.

Fund F has provided an annualized return of 8.[illegible]% since its inception in 1973. And for the 12 months ending June 30 return was [illegible].



Assistant Vice President David L. Gremlee, C.P.M. (left), inspects corporate headquarters building owned and leased by First Chicago's Real Estate Fund F.

International securities to reduce volatility.

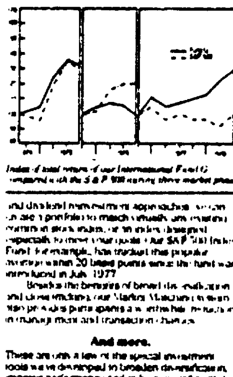
Since the securities markets of other countries tend to peak and valley at different times than our own, adding equities of overseas companies to your portfolio can reduce volatility. Yet this avenue of investment remains foreign to most major money managers.

Not to First Chicago.

We were among the first to recognize the advantages of international diversification. In early 1973, our Trust Department established a London base staffed with a seasoned investment team. Today that team has management responsibility for over $140 million in equity and debt investments.

Investments are diversified by country, type, industry and company. And our common stock emphasis is on well-managed, high quality corporations, especially those in sound, resource-rich, high-growth economies with solid currencies.

Recent equity performance has been particularly favorable, as reflected by International Fund G. Since Oct. '76, unit value has increased 31.[illegible]% while the S&P 500 was up only [illegible]%.



Index of total return of our International Fund G compared with the S&P 500 during three market phases

A market matching system that really matches.

Modern Portfolio Theory suggests, and we agree, that part of your employee benefit assets should be under passive index management. And First Chicago has developed a technology for it that's unique.

Using one of three asset comparison techniques, plus special trading strategies and dividend reinvestment approaches, we can [illegible] portfolio to match virtually any existing [illegible] index, or an index designed especially to meet your goals. Our S&P 500 Index Fund, for example, has tracked this popular [illegible] within 20 basis points since the fund was introduced in July 1977.

Besides the benefits of broad diversification and [illegible], our Market Matcher [illegible] [illegible] in [illegible] and transaction charges.

And more.

These are only a few of the special investment tools we've developed to broaden diversification, improve performance and reduce overall portfolio volatility. Each is available as a special service, or as part of our complete retirement fund management program. If limited diversification isn't doing the job for you, why not look into the full spectrum at First Chicago? Write or call John P. S[illegible], Trust Officer, Trust Department, The First National Bank of Chicago (312) 732-1152. Member FDIC.

The First National Bank of Chicago

Trust Department

BUSINESS WEEK—April 2, 1979

How international diversification improves return and reduces volatility for Morgan's investment clients

Member FDIC

Morgan officers at this international investment strategy meeting in London are (from left) Robert Rex and Nicholas Potter, New York; Karl Van Horn and Pierre Darteau, London; Hideo Ota, Tokyo; Carl Hathaway, New York; Walter Zimmer, London.

Alert pension fund sponsors, foundations, and other institutions are discovering the advantages of investment diversification by country. Through actively managed international portfolios they're getting improved return and lower volatility.

Many of them are clients of The Morgan Bank, which manages more than half a billion dollars in overseas equity and fixed-income securities for U.S. employee benefit plans. The chart at right shows the five-year performance of our commingled pension fund devoted to international equities.

At Morgan our investment approach traditionally has been international. Even when U.S. regulations made new overseas buying impractical, we kept up our research and our contacts. Today our international investment team includes professionals based in London, Paris, Geneva, and Tokyo.

Geographic diversification that's actively managed and based on careful research broadens the range of investment options. It can smooth the cyclical bumps that are likely to jar a one-economy portfolio. It can turn inflation differentials and currency fluctuations into opportunities rather than hazards.

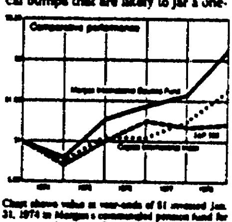


Chart shows value at year-ends of $1 invested Jan. 31, 1974 in Morgan's commingled pension fund for international equities, Standard & Poor's 500 Stock Index, and the Capital International Index for Europe, Australia, and the Far East. Reinvestment of income assumed.

But this kind of fund management takes special resources. Morgan's international investment managers draw on the knowledge of a multinational research team, the country-by-country analyses of the bank's international economists, and the currency judgments of its foreign exchange specialists in the world's money centers. Employing these strengths systematically, they build international portfolios that balance risk and return in accord with the client's specific objectives.

For more information on the advantages of international diversification, please write on your letterhead to Henry D. Cavanna, Vice President, Morgan Guaranty Trust Company, 9 West 57th Street, New York, N.Y. 10019.

The Morgan Bank

WALL STREET JOURNAL—June 29, 1978

Vice President Howard Hudson, right, head of Morgan's fixed-income group, exchanges market information and viewpoints with the group's specialists.

Why pension fund sponsors are choosing Morgan for fixed-income management

Increasingly, sponsors of employee benefit plans are choosing The Morgan Bank to manage their fixed-income investments. Here are some of the reasons why.

Morgan has a highly skilled group of investment managers working exclusively in the fixed-income field. This team of ten specialists has consistently achieved superior results, outperforming standard industry indexes. The chart compares their record over the past nine years with a leading index.

They are aggressive, active managers with well-defined goals – maximum return with minimum risk, consistency rather than volatility. Their strategy is to combine high credit quality, a carefully controlled maturity structure, and skillful timing.

Employee benefit plans with fixed-income assets managed by Morgan gain added flexibility and diversification through use of our eight commingled funds. Each concentrates on a specific segment of

the fixed-income markets, including leasebacks, corporate private placements, mortgages, money-market investments, as well as publicly traded bonds. The newest specializes in foreign bonds, using Morgan's far-reaching international research capabilities. In fact, we are the leader in investing abroad.

For more about how Morgan's management of fixed-income assets can be tailored to your needs, send for the new edition of our detailed booklet, "The Management of Fixed-Income Investments for Employee Benefit Funds." Write on your letterhead to Assistant Vice President John L. Griffith, Morgan Guaranty Trust Company, 9 West 57th Street, New York, N.Y. 10019.

The Morgan Bank

INSTITUTIONAL INVESTOR—August, 1978

EVEN IF YOUR PENSION FUND HAD A GOOD YEAR,

TELL IT TO THE MARINE

As good as our performance is, Marine Midland doesn't believe that performance is the only way to judge management. We believe there are other important issues to consider in addition.

That's why you should ask yourself these questions—even if your pension fund had a good year.

Does the performance run hot and cold as the market runs hot and cold?

Will the investment philosophy that worked in the past be flexible enough to work tomorrow?

Do you feel comfortable with the long-term goals set up for you?

Understanding this total picture is the way we approach pension funds. And it's paid off.

Marine Midland had the highest rate of return on a 5-year basis for collective equity funds among the largest 25 U.S. bank trust departments.[1]

We also ranked first in 1-year performance. And number seven in the 3-year category. (All periods ending 12/31/77.)[2]

In fact, Marine Midland is one of the few major investment managers whose collective equity fund has beaten the Standard & Poor's average over the last 5 years.

If you want the kind of performance that goes deeper than just a good rate of return, tell it to the Marine. Contact Judith M. Trepanowski. Marine Midland Bank, 250 Park Avenue, N.Y., N.Y. 10017, telephone (212) 949-6649.

[1] *Trust Assets of Insured Commercial Banks*, Joint Publication of Comptroller of the Currency, FDIC, and Federal Reserve Board, latest issue.

[2] Pensions and Investments Performance Evaluation Report (P.I.P.E.R.)—Comparative Data through 12/31/1977.

MARINE MIDLAND BANK

Buffalo, New York City, Beirut, Bogotá, Buenos Aires, Caracas, Frankfurt, Hong Kong, Jakarta, London, Madrid, Manila, Mexico City, Nassau, Panama, Paris, Rio de Janeiro, Rome, São Paulo, Seoul, Singapore, Sydney, Tehran, Tokyo, Toronto.

Your company's employee benefit plan can't profit from a bad fit.

Most money managers prefer that your company's pension or profit sharing plan be designed to fit one of their standardized investment programs.

At First of Tulsa, we don't think that's in your best interest. That's why we design our investment and administrative programs to fit your individual plan.

We're specialists in stocks, bonds, oil, real estate, and the complexities of ERISA. And regardless of the size of your trust, we analyze your particular requirements, then tailor an investment and administrative program to meet the performance goals of your plan.

This flexibility has enabled First of Tulsa's investment record to rank in the top 12% of those money managers surveyed nationwide by the Becker Securities Corporation.*

For more information about how our administrative and investment capabilities can help your company (and you), call collect for John Heard at (918) 586-5384. Or write First of Tulsa today.

*Pooled equity fund for employee benefit accounts, equities only, 1-1-70 thru 12-31-76

TRUST FIRST TULSA

Your First Resource

The First National Bank & Trust Company of Tulsa • Box One, Tulsa, Oklahoma 74193 • 918/586-5384

EXHIBIT C

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, D.C. 20510

April 2, 1979

The Honorable Harrison A. Williams, Jr.
Chairman
Committee on Labor and Human Resources
352 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Richard S. Schweicker
Room 253
Russell Senate Office Building
Washington, D.C. 20510

Dear Pete and Dick:

We are writing to express our concern about certain provisions of S. 209, the "ERISA Improvements Act of 1979" which, we understand, is scheduled to be marked up by the Committee on Labor and Human Resources on May 3, 1979.

For a number of reasons, including those summarized below, we request that Sections 153-154 of S. 209 be referred to the Committee on Banking, Housing and Urban Affairs after consideration of the entire bill by the Committees on Labor and Human Resources and Finance. We are mindful of your desire to present promptly to the Senate legislation to amend the simplify ERISA, and we have no desire to impede that effort. Therefore, we would be willing to agree that consideration and action on the relevant parts of the bill by the Banking Committee be accomplished expeditiously after referral.

Our conclusion that referral to the Banking Committee is essential is based on a number of considerations, including the following:

(1) The sections of S. 209 cited above would have the effect of amending in significant ways various provisions of the federal securities laws with respect to retirement plans. It is clear that amendments to the securities laws should, as

The Honorable -2- April 2, 1979
Harrison A. Williams, Jr.
The Honorable
Richard S. Schweicker

a general matter, be considered by the Banking Committee because of the expertise of the Committee developed over many years with respect to the securities laws and the recognition of the complexity of the issues often encountered in amending those laws.

(2) We note that these sections would affect, in a manner which is not entirely clear, the Glass-Steagall Act. As you know, the present statutory and regulatory scheme governing the relationships between financial institutions has been developed over many years. The limitations applicable to securities activities of commercial banks are particularly complex and interrelated, and the Subcommittee on Securities is engaged in an ongoing reexamination of the Glass-Steagall Act, including its application to retirement accounts managed by commercial banks. Under these circumstances, we would be very reluctant to see the Glass-Steagall Act amended in an indirect fashion without an opportunity for the Banking Committee to exercise its collective judgment on the issues raised.

(3) We are also concerned about provisions in S. 209 which would have the effect of shifting regulatory jurisdiction with respect to interests of retirement plans in collective investment media from the SEC to the Secretary of Labor. This approach would represent a fundamental departure from the present regulatory system developed over many years, and we know that members of the Banking Committee are very interested in examining that aspect of S. 209 in detail.

While the foregoing discussion merely summarizes some of the most persuasive factors leading us to request referral to this Committee of Sections 153-154 of S. 209, we believe that it amply demonstrates that referral to the Banking Committee is critical to complete consideration of the merits of the bill.

The Honorable
Harrison A. Williams, Jr.
The Honorable
Richard S. Schweicker

-3-

April 2, 1979

We would appreciate your response to our request as soon as possible.

Sincerely,

William Proxmire
Chairman

Jake Garn

WP,JG:jdj

APPENDIX B

Investment Company Institute
1775 K STREET N. W., WASHINGTON, D. C. 20006
(202) 293-7700

June 21, 1976

Morton Klevan, Esq.
Acting Counsel
Fiduciary Responsibility
Plan Benefit Security Division
U. S. Department of Labor
Washington, D. C. 20216

Re: Regulations to be Adopted Under Section 404(c) of ERISA

Dear Mr. Klevan:

Several months ago we discussed the regulations which are to be issued by the Department of Labor under Section 404(c) of the Employee Retirement Income Security Act of 1974, which deals with individual account plans. As I indicated, this matter is of major importance to the mutual fund industry.

We respectfully submit two copies of the enclosed memorandum which sets forth our specific suggestions concerning these regulations. We have based our suggestions in large part upon the actual experience of mutual fund organizations in offering a wide variety of investment vehicles and in serving as sponsors of master and prototype plans.

Set forth below is a brief summary of the conditions which we believe should be set forth in the regulations. We believe that the regulations should provide that a plan which meets these conditions will qualify under Section 404(c). However, we also believe that the regulations should make it clear that these conditions simply provide a "safe harbor", and that a plan which fails to meet one or more of the conditions will not therefore automatically fail to qualify under Section 404(c).

Our specific recommendations are divided into three general areas, and in summary are as follows:

1. <u>Broad Range of Investments</u> - The regulations should provide that in order to qualify under Section 404(c) a plan should:

   (a) offer at least one investment vehicle which stresses preservation of capital and current income;

   (b) offer at least one investment vehicle which seeks capital appreciation; and

   (c) permit participants and beneficiaries to allocate their individual accounts between these two vehicles.

2. <u>Individual Participant and Beneficiary Control</u> - The regulations should provide that a plan should:

   (a) permit individual participants and beneficiaries to determine where future contributions are to be invested;

   (b) permit individual participants and beneficiaries to shift investments from one vehicle to another;

   (c) permit participants and beneficiaries to allocate their investments among the various vehicles;

   (d) provide a procedure to deal with the situation where a participant or beneficiary fails to make an investment decision; and

   (e) provide a mechanism whereby participants and beneficiaries receive adequate information on which to base their investment decisions.

3. <u>The Employer</u> - The regulations should:

   (a) prohibit potential situations which might lead an employer to attempt to influence employee investment decisions; and

(b) permit the employer to service the plan in a strictly ministerial manner.

We would be pleased to furnish any additional material requested and to meet with you or your staff to discuss this most important matter.

Very truly yours,

Matthew P. Fink

Matthew P. Fink
Associate Counsel

MPF/am
Enclosures

cc: Messrs. Hass
Chadwick
Sacher

June 21, 1976

REGULATIONS TO BE ADOPTED
UNDER SECTION 404(c) OF ERISA

INTRODUCTION

This memorandum is submitted on behalf of the Investment Company Institute ("the Institute"), which is the national trade association of the American mutual fund industry. Our members include 383 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Our mutual fund members account for over 90% of industry assets and have approximately eight million shareholders, including tens of thousands of employee benefit plans.

The purpose of this memorandum is to offer our suggestions to the Department of Labor concerning regulations to be issued under Section 404(c) of the Employee Retirement Income Security Act of 1974 ("ERISA") dealing with individual account plans.

SECTION 404(c) of ERISA

Section 3(34) of ERISA defines the term "individual account plan" as:

> "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains, and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account."

Section 404(c) of ERISA provides:

"In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) -

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's, or beneficiary's exercise of control."

The Conference Report states:

"Certain individual account plans.--Under the substitute, a special rule is provided for individual account plans where the participant is permitted to and in fact does, exercise independent control over the assets in his individual account. In this case, the individual is not to be regarded as a fiduciary and other persons who are fiduciaries with respect to the plan are not to be liable for any loss that results from the exercise and control by the participant or beneficiary. Therefore, if the participant instructs the plan trustee to invest the full balance of his account in, e.g., a single stock, the trustee is not to be liable for any loss because of a failure to diversify or because the investment does not meet the prudent man standards. However, the investment must not contradict the terms of the plan, and if the plan on its face prohibits such investments, the trustee could not follow the instructions and avoid liability.

The conferees recognize that there may be difficulties in determining whether the participant in fact exercises independent control over his account. Consequently, whether participants and beneficiaries exercise independent control is to be determined pursuant to regulations prescribed by the Secretary of Labor. The conferees expect that the regulations

> will provide more stringent standards with respect to determining whether there is an independent exercise of control where the investments may inure to the direct or indirect benefit of the plan sponsor since, in this case participants might be subject to pressure with respect to investment decisions. (Because of the difficulty of ensuring that there is independence of choice in an employer established individual retirement account, it is expected that the regulations will generally provide that sufficient independent control will not exist with respect to the acquisition of employer securities by participants and beneficiaries under this type of plan.) In addition, the conferees expect that the regulations generally will require that for there to be independent control by participants, a broad range of investments must be available to the individual participants and beneficiaries."

Our specific suggestions concerning the regulations to be issued under Section 404(c) are set forth in detail at pages 16 through 25 below. We have based our recommendations in large part upon the actual experience of the mutual fund industry. Most major mutual fund complexes offer investors, including participants and beneficiaries of employee benefit plans, a wide range of investment vehicles designed to meet practically every investment objective. Further, for over a decade, mutual funds have sponsored master and prototype plans which specifically provide this broad investment flexibility to individual participants and beneficiaries on an efficient and economical basis. Therefore, before setting forth our detailed suggestions regarding the regulations, we believe that it would be helpful to discuss the mutual fund industry's actual experience with the "family of funds" concept and with the sponsorship of master and prototype plans.

GENERAL STRUCTURE OF MUTUAL FUND ORGANIZATIONS

A mutual fund organization generally involves three distinct functions. First, there is the mutual fund itself, usually in corporate form, which issues its shares to the public and uses the proceeds to acquire securities meeting the fund's investment objectives (i.e., growth, income, etc.). Second, there is an investment adviser, a separate entity, which not only provides investment advisory services to the mutual fund pursuant to a written contract with the fund, but which also performs many important administrative services for the fund and its shareholders. Third, there is usually a principal underwriter which, pursuant to a written contract, arranges for the distribution of the fund's shares to the public. Often the investment adviser and principal underwriter are the same entity or are under common control. The principal underwriters for most funds whose shares are sold with a sales charge arrange for public distribution through independent broker-dealers, but the shares of a few funds (including the largest) are sold by salesmen who work for the principal underwriter. Funds without a sales charge ("no-load" funds) deal directly with the public in the sale of their shares, although some no-load funds may technically sell their shares through principal underwriters.

Mutual fund organizations are the most strictly regulated business entities under the federal securities laws. Since most mutual funds continuously offer their shares, such shares must be continuously registered for sale with the Securities and Exchange Commission ("the SEC") under the Securities Act of 1933 and as to these funds there must always be a current prospectus. The mutual fund itself, unlike other corporations, must be registered with the SEC under the Investment Company Act of 1940. Investment advisers must register with the SEC under the Investment Advisers Act of 1940. Principal underwriters must register with the SEC as broker-dealers under the Securities Exchange Act of 1934.

The federal securities laws, and particularly the Investment Company Act, contain numerous provisions designed to prevent self-dealing, maintain the mutual fund's independence and prevent the payment of excessive fees and charges by the mutual fund and its shareholders, including employee benefit plans. These provisions are similar to many of the fiduciary provisions contained in ERISA and the Internal Revenue Code of 1954 ("the Code").

THE "FAMILY OF FUNDS" CONCEPT

When the first mutual funds were formed over fifty years ago, they were designed to offer investors of moderate means the opportunity to invest in portfolios consisting of a broad range of conservative equity securities.* Over the last four decades, the mutual fund industry has realized that different types of investors have different types of investment objectives. Therefore, most major mutual fund complexes have formed a wide variety of mutual funds with various types of investment portfolios. These mutual funds include: funds invested in conservative common stocks; funds invested in common stocks of new and developing companies; funds specializing in the securities of issuers engaged in certain industries or located in certain areas, including foreign issuers; income funds invested in high-grade corporate bonds or high-grade bonds and high-yielding equity securities; and balanced funds invested in a combination of bonds, common stocks and preferred stocks. Recently, a large number of mutual fund complexes have formed so-called money market funds which invest in short-term money market instruments such as treasury bills, certificates of deposit and commercial paper. This year witnessed the establishment of the

* The 1974 Annual Report of Massachusetts Investors Trust, founded in 1924, states:

> "The Trust's initial $50,000 capital stake was fully invested in a portfolio of 45 stocks, including 19 blue-chip industrials (among them 50 General Motors at 13 1/4), 14 quality railroad and equipment issues, 10 public utilities, and two insurance equities. In spite of the conservative nature of the list, the idea of being fully invested in common stocks was, of course, quite advanced in a period when the conventional wisdom in investing still focused mainly on fixed securities."

first mutual fund principally invested in tax-free municipal bonds. (The federal securities laws require a mutual fund to adopt a particular investment policy which can only be changed by shareholder action). In short, the "family of funds" concept has developed to the point where the mutual fund industry currently permits an investor to select the particular vehicle which meets his own investment objectives.

The mutual fund industry has gone to great lengths to inform investors of the wide choice of mutual funds available. (Attached hereto as Exhibits A and B are two "family of funds" advertisements which appeared in the "New York Times" of Sunday, May 2, 1976).

Most mutual fund complexes provide investors with the opportunity to shift investments from one fund in the complex to another at no charge or with only a nominal processing fee. The Investment Company Act of 1940 encourages this "exchange privilege" by providing that a mutual fund which is normally sold with a sales charge may eliminate this charge for an investor who purchases shares of the fund by redeeming shares of a "sister" fund. We have informally surveyed a number of major mutual fund complexes concerning the details of their exchange privileges. Most complexes permit an investor to exchange shares of one fund for shares of a "sister" fund if the investor has held the shares of the first fund for a very short period of time (e.g., 7, 15 or 30 days); some complexes do not impose any time limit. (One major complex restricts the use of the exchange privilege to twice a year). Most complexes do not impose any dollar minimum on an exchange; some require that the exchange involve at least $500. (Of course, an investor who wishes to exchange shares of one mutual fund for those of a "sister" mutual fund must meet the second fund's normal investment minimum). Most complexes charge a service fee of $5 for an exchange; some do not charge any fee.

Finally, it should be noted that many mutual fund complexes sponsor a variety of products in addition to mutual funds. These products include insurance and annuity policies, closed-end investment companies and face amount certificates.

MASTER AND PROTOTYPE PLANS

For many years, federal legislation and administrative procedures have recognized and encouraged the use of mutual fund shares as funding vehicles for employee benefit plans. The original Keogh legislation enacted in 1962 specifically provided that self-employed retirement plans could be funded with mutual fund shares. In 1963 the Internal Revenue Service issued regulations permitting mutual funds to sponsor master and prototype Keogh plans which could be pre-approved as to form by the Internal Revenue Service. Similar regulations concerning mutual fund sponsorship of master and prototype corporate retirement plans were issued in 1968 (Rev. Proc. 68-45). The Service has recently issued regulations permitting mutual funds to sponsor prototype plans for the new individual retirement accounts.

Master and prototype plans are designed to permit smaller employers and other persons (i.e., participants in individual retirement accounts) to establish employee benefit plans on a simplified and economical basis through the adoption of a standard model plan which has received Internal Revenue Service approval. If a system of master and prototype plans did not exist, each employer or other person would have to create his own plan and would have to obtain separate Internal Revenue Service approval of his particular plan.

Mutual fund organizations do not receive any compensation for serving as sponsors of master and prototype plans. (Instead, the mutual fund's investment adviser receives an investment advisory fee from the mutual fund, and, in the case of funds sold with a sales charge, the fund's principal underwriter and the retail broker-dealer receive commissions upon the sale of mutual fund shares). The trustee or custodian of the master or prototype plan generally receives an annual maintenance fee for each plan and participant account, and in some cases there is an additional fee for processing each contribution and distribution. These fees tend to be minimal administrative fees. For example, the April 1, 1976 prospectus of Dreyfus Fund Inc. s ·tes that the bank custodian of its Keogh plans and individual retirement accounts charges: "a one-time $5 acceptance fee per plan irrespective of the number of accounts thereunder; for each Keogh account, an annual fee of $5 for each employer's account and $3.50 for each other participant's account; and for each IRA, a $5 annual maintenance fee. Each time a premature distribution is made, $5 is charged on an IRA account and $2.50 on a Keogh account."

Master and prototype plans sponsored by mutual funds generally permit the investment of plan assets in any one of the various mutual funds or other products (e.g., insurance) offered by the complex. (In some cases the plans' sponsors have made arrangements with other financial organizations so that a plan may be funded with products which are not offered by the mutual fund complex. For example, some mutual fund master and prototype plans permit investment in savings accounts or insurance products not sponsored by the mutual fund complex). Generally, the master and prototype plans also permit the allocation of plan investments among a number of mutual funds, or between a mutual fund and another type of funding media, such as insurance. (This latter practice is commonly referred to as "split-funding").

The vast majority of mutual fund master and prototype Keogh and corporate plans are profit-sharing or defined contribution plans. Therefore individual shareholder accounts are available for each participant's and beneficiary's interest in the plan.

Many of these master and prototype plans permit each participant to make his own investment selection from among the range of mutual funds and other products offered under the plan. For example, the Lord, Abbett & Co. Keogh plan states:

> "All contributions hereunder by or on behalf of a Participant and earnings thereon shall be invested as specified by such Participant on the Application, or on the appropriate form (to be supplied by the Sponsor) if the person becomes a Participant after the Effective Date of the Plan ...."

Other master and prototype plans permit the employer to allow each participant to make his own investment decisions. For example, the declaration of trust for the Channing Prototype Keogh plan provides:

> "The Employer shall instruct the Trustee in writing as to the investment of the assets of the Trust Fund in one or more of the following media. In the sole discretion of the Employer, such Employer may allow each Participant in the Plan to designate in writing the manner in which the contributions made by such Participant or on such Participant's behalf are to be invested in such media. If the Employer allows Participants to so designate such manner of investment, such designations shall be transmitted by the Employer to the Trustee in writing."

Further, many of these plans permit each participant to spread his investments among several of the various products offered under the master or prototype plan. For example, The American Funds Keogh plan provides that:

> "Each participant, through his separate Participation account, shall be the beneficial owner of all investments so held in the Trust and in the Employer's discretion (exercised in a nondiscriminatory manner) shall have the right to select and direct, through the Employer, the specific investment(s) for his account in accordance with the terms of the Plan."*

The normal procedure is for the employer to have each participant select his own investments in writing and for the employer to transmit these designations in writing to the plan's trustee or custodian. Attached hereto as Exhibit C is the application form for the Scudder Keogh Plan which is completed by each adopting employer. Note that Item 2 provides for the employer to designate the particular investments to be made on behalf of each participant.

Participants are accorded the same exchange privilege as is accorded to other mutual fund investors - that is, a participant is free to exchange shares of one mutual fund for shares of another fund offered under the master or prototype plan, generally with no sales charge or with a nominal processing fee. Again, the procedure is for the participant to inform the employer of his change and for the employer to inform the plan's trustee or custodian.

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* Some master and prototype plans seek to limit administrative expenses by providing that a participant may only invest in more than one vehicle if his account exceeds a certain dollar amount (i.e., $3,000). In addition, many mutual funds require a minimum investment (i.e., $100) in order to establish a mutual fund account.

Master and prototype Keogh plans provide that each participant is to receive complete information regarding his investments. For example, the standard custodial agreement used in conjunction with Stein Roe & Farnham Funds' Keogh plan provides: "The Custodian shall deliver to each Participant all notices, prospectuses, financial statements, proxies, and proxy soliciting materials relating to the Investment Company Shares held hereunder. The Custodian or its nominee shall sign such proxies as record owner of such shares, but shall not otherwise vote any of the Investment Company Shares held hereunder except in accordance with the written instructions of the Participants." Therefore, each participant receives current information concerning his investments.*

SUGGESTIONS AS TO REGULATIONS

Section 404(c) of ERISA is based on Congress' recognition of the fact that participants and beneficiaries in an employee benefit plan may have very different investment objectives. For example,

* We note that Keogh plans and individual retirement accounts funded with mutual fund shares are not statutorily exempt from registration under the federal securities laws. However, the SEC staff has taken the position that such plans need not be registered as separate securities since they are funded with registered mutual fund shares provided participants receive the full rights accorded to mutual fund shareholders. However, corporate plans are statutorily exempt from registration. Therefore, the plan's trustee or custodian may be treated as the only mutual fund shareholder and only the trustee or custodian may receive proxy statements, prospectuses, etc. However, many mutual fund organizations, in accordance with the plan document or at the employer's request, do provide individual participants and beneficiaries with such materials.

an older employee who is near retirement age is likely to wish to have his account invested in a vehicle which stresses preservation of capital and the production of current income. Conversely, a younger employee may be likely to prefer an investment which offers the opportunity for long-term appreciation of capital. Other employees may prefer varying mixtures of the two. Section 404(c) represents a statutory effort to permit employees with varying investment objectives to select investments which are in keeping with their particular needs.

Section 404(c) also reflects Congress' recognition that many employers realize that they lack investment expertise and therefore do not want responsibility for investing employee benefit plan assets. Therefore, Section 404(c) provides that if each participant or beneficiary in a plan is given independent control over his account's investments, no fiduciary (i.e., the employer) should bear responsibility for his investment decisions. As the Conference Report states, the critical issue is "whether the participant in fact exercises independent control over his account." Section 404(c) and the Conference Report made it clear that the regulations to be promulgated by the Department of Labor are to be directed to this issue.

We have devoted a major portion of this memorandum to a description of the "family of funds" concept and to the existing system of master and prototype plans precisely because we believe that they offer a close approximation of Section 404(c) plans. Indeed, many mutual fund master and prototype plans may presently qualify under the section. Therefore, we have based our recommendations as to the regulations in large part on this pre-existing framework.

Our specific recommendations, which are set forth in detail below, are divided into three general areas:

1. A discussion of the essential condition, set forth in the Conference Report, that there be a "broad range of investments" available to the individual participants and beneficiaries.

2. A discussion of the specific details of individual participant and beneficiary control, including the ability of each participant and beneficiary to select his own initial investments; to change his investment decisions from time to time; and to devise the proper "mix" of investment media which meets his particular investment objectives.

3. A discussion of the role of the employer in carrying out the decisions of the individual participants and beneficiaries and in administering the plan in accordance with Section 404(c).

We suggest that the regulations make it clear that a plan which meets these conditions will qualify under Section 404(c). However, the regulations should also make it clear that these conditions simply provide a "safe harbor", and that a plan which fails to satisfy one or more of these conditions will not therefore automatically fail to qualify under Section 404(c).

Our specific comments in each of the three general areas are as follows:

1. "Broad Range of Investments"

The Conference Report explicitly recognizes that for there to be independent control, "a broad range of investments must be available to the individual participants and beneficiaries", and expresses the expectation that the regulations will deal with this "broad range" issue. We submit that the regulations in this area should be based on the essential philosophy underlying Section 404(c) -- the recognition that different participants and beneficiaries have different investment objectives. Some participants and beneficiaries will desire current income and preservation of capital; some will want the opportunity for capital appreciation; others will seek various combinations of the two. We believe therefore that the regulations in this area should set forth three basic conditions.*

First, the plan must offer at least one investment medium which stresses preservation of capital and current income. This could be satisfied, for example, through a mutual fund or bank pooled fund invested in high-grade corporate bonds; a savings account; a mutual fund invested in money market instruments; a fixed annuity contract; or life insurance. We do not believe that a guarantee of capital or income should be required: even under the most stringent pre-ERISA state prudent man test such a guarantee was never required.** What is required is a vehicle whose invest-

* Our analysis of the underlying rationale of Section 404(c) and our proposed conditions are supported by the analysis set forth in Note, "Fiduciary Standards and the Prudent Man Rule Under the Employment Retirement Income Security Act of 1974," 88 Harvard Law Review 960, 975 (1975):

> "ERISA does, however, provide a way of avoiding the difficulties caused by congressional failure to specify the level of risk appropriate for defined contribution plans. The Act permits a participant or beneficiary to control the assets attributable to his share of the fund if the plan so authorizes. In such a case, neither he nor any plan fiduciary will be liable for breach of fiduciary standards resulting from exercise of that control. Under such an administrative arrangement, the participants would bear responsibility for the amount of the benefits they ultimately receive by choosing the level of risk to be assumed and particular investments to be made." (footnotes omitted)

** See, 3 Scott, The Law of Trusts §227.3, at 1812 (1967): "It cannot be said that a trustee must always take the least risk possible"; and comment on clause (a) of §227 of Restatement (Second) of the Law of Trusts, at 531 (1959): "It is not ordinarily the duty of a trustee to invest only in the very safest and most conservative securities available."

ment objective is preservation of capital and the production of current income.

Second, the plan must offer at least one investment vehicle which seeks capital appreciation as a major objective. This could be satisfied, for example, through a bank pooled equity fund; a mutual fund invested in common stocks; a real estate fund; or a variable annuity contract.

Third, the plan must allow participants and beneficiaries to allocate their accounts between these two investment vehicles. Thus each participant and beneficiary will be able to devise the "mix" which meets his particular investment goals.

We do not believe that the "broad range" test requires that there must be a number of different vehicles offered on either the capital preservation side or on the capital appreciation side. (For example, we do not believe that the capital appreciation side must offer a real estate investment and a bank-sponsored equity fund and a mutual fund invested in common stocks). Since the underlying rationale of Section 404(c) relates to investment objectives, the regulations need only insure that the plan provide a range of investment objectives, not that it offer vehicles which invest in every conceivable sort of asset.

Further, we do not believe that in order to meet the "broad range" test, a plan must offer vehicles sponsored by different organizations (i.e., a vehicle sponsored by a mutual fund complex, a vehicle sponsored by a bank, and a vehicle sponsored by an insurance company); what is essential is that the vehicles which are offered provide a broad range of investment objectives.

Our view in this regard is reinforced by overwhelming practical considerations. As set forth above, master and prototype plans presently offer a system of individual account plans and individual employee investment selection on an extremely efficient and economical basis. The key to this system is the ability of a single financial organization (i.e., one mutual fund complex, bank or insurance company) to offer a variety of products and to economically service investors in such products. Administrative problems and costs to participants and beneficiaries would sky-rocket if the regulations required a plan to offer investments in products offered by a host of different financial organizations. (For example, the shareholder service agent for the various mutual funds in a single complex is already equipped to handle exchanges among the various funds on an efficient and economical basis. It obviously would be far more expensive and burdensome to establish and operate an exchange mechanism among unrelated products). In addition, if the regulations required that there be a number of financial organizations, master and prototype plans could not be used under Section 404(c) since by definition a master prototype plan is sponsored by a single financial organization.*

2. Individual Control

The regulations should require that each participant and beneficiary must be given the right to determine where future contributions on his behalf are to be invested. (In order to keep the employer's administrative costs and problems to a minimum the regulations should permit a plan to limit a participant's choice of future investments to periodic intervals -- e.g., quarterly or semi-annually).

Similarly, the regulations should require that a participant or beneficiary be permitted to shift his investments from one vehicle to another. (Again, the regulations should permit a limitation of this switching privilege to periodic intervals -- e.g., quarterly or semi-annually). The regulations should require that the employee be informed of any fees and charges in connection with a change of investment vehicles. As noted above, most mutual fund complexes permit an investor to exchange shares of one fund for those of a "sister" fund in the same complex with no charge or with

* The problem is analogous to that concerning the appointment of "investment managers". While a large plan may be able to select more than one "investment manager", a small plan cannot do so on an economic basis. See Franklin, "Feeling Comfortable With Advisers Should be a Major Objective in Selecting Managers", Pension & Investments, April 26, 1976 at p. 16.

only a nominal processing fee. (Of course, if an investor switches from a no-load fund to a load fund in the same complex, he will pay a sales charge. Similarly, an investor who switches from a low-load fund to a "sister" fund with a higher sales load will pay an additional sales charge). The regulations should permit the payment of such administrative fees and sales charges, as well as redemption fees, provided that such charges and fees are imposed on all shareholders of the mutual fund.

The regulations should also require that a participant or beneficiary be permitted to allocate his account among the various products offered by the plan. Thus part of an employee's account could be invested on the capital preservation side and part on the capital appreciation side. In addition, the regulations should permit an employee to select any sort of mix he desires. In order to reduce administrative costs, the regulations should permit a plan to limit this allocation feature to participant accounts which are in excess of some reasonable dollar amount. (For example, a plan might provide that a participant can only invest in more than one vehicle if his account exceeds $1,000). Further, many mutual funds (and other funding media) require that an investor cannot establish an account unless his investment meets a minimum dollar amount (e.g., $250.). Therefore, the regulations should provide that a participant or beneficiary can only invest in a vehicle if his investment meets the vehicle's normal investment minimum.

The regulations should also permit the participant or beneficiary to inform the employer of his investment decisions in writing and for the employer in turn to inform the plan's trustee or custodian in writing.

The regulations also must deal with the situation where the individual participant or beneficiary is given complete investment control over his account, but fails to make an investment decision. One solution might be to permit the employer to make the investment decision on the employee's behalf in this case. However, if the regulations adopt this approach, they should also make it clear that this will not cause the employer to be a "fiduciary" as to investment decisions. A better approach might be for the regulations to provide that the plan instruments themselves may specify the investments which are to be made in the event that the individual employee fails to make an investment decision. (For example, the plan instruments might provide that in such a case, the individual account is to be entirely invested in one or more specified vehicles on the capital preservation side). If this approach is adopted, the regulations should make it clear that this will not cause the sponsoring organization (e.g., the mutual fund complex) to be a fiduciary".*

Finally, and perhaps most importantly, in order to really exercise full investment control over his individual account, a participant or beneficiary must receive adequate information on which to base his investment decisions. The regulations should state that the plan must provide that when an individual first becomes a participant, he is to receive from the employer complete and up-to-date information concerning his various investment options. (In the case of a mutual fund, this requirement could be satisfied through the fund's current prospectus). At the same time, each participant should be told of his rights to change his options, to allocate and to switch from one vehicle to another. (Presumably this information could be set forth in a summary plan description). After a participant makes an investment decision, he should receive via his employer regular and current information as to his investment. Further, the participant should be permitted to request, through his employer, current information as to the other available vehicles.

* In this connection, we note that in April of 1975 we filed a class application with the Department of Labor and the Internal Revenue Service seeking an interpretation or exemption to the effect that a mutual fund sponsor of a master or prototype plan is not a "fiduciary", "party in interest" or "disqualified person" (File No. D-466). Our application was premised on the fact that investment decisions are made by the employer who has adopted the master or prototype plan or by the individual participants and beneficiaries. If the approach outlined above (whereby the plan itself specifies the investments which are to be made in the absence of a decision by the individual participant) the regulations obviously will have to grant relief beyond that requested in our class application of April 1975.

3. <u>The Employer</u>

The Conference Report expressly notes that a participant or beneficiary may lack independent control "where the investment may inure to the direct or indirect benefit of the plan sponsor since,.in this case participants might be subject to pressure with respect to investment decisions." We submit that the regulations should not only, as the Conference Report suggests, generally prohibit investment in employer securities, but should also prevent other potential situations which might lead an employer to attempt to influence employee investment decisions. (Many potential abuses in this area may already be barred by the provisions in ERISA and the Code dealing with prohibited transactions).

However, it is essential that the regulations permit the employer to service the individual account plan in a strictly ministerial manner. The regulations should permit individual participants and beneficiaries to relay their investment decisions to the plan's trustee or custodian through the employer. Similarly, the various funding media should be permitted to distribute information to the individual participants and beneficiaries through the employer. (The regulations should provide the employer with some reasonable period of time in which to inform the plan's trustee or custodian of the employees' investment decisions, and in which to distribute information from the various funding media to the employees). As set forth above, the widespread use of the master and prototype system is based on the efficiencies and economies of administration which they offer to employee benefit plans, their participants and beneficiaries. A major reason for this is the use of employers as administrative "middlemen" between the sponsoring organization and the participants and beneficiaries.

Finally we believe that the regulations should provide that if the conditions set forth above are met, the employer will not be liable for the investment decisions made by the individual participants and beneficiaries. Of course, the employer would be under a fiduciary duty in seeing to it that the plan qualifies under Section 404(c) and that the various vehicles are suitable for participants and beneficiaries with varying investment objectives, and in carrying out the investment instructions of the individual participants and beneficiaries.

In addition, we believe that sponsors of master and prototype plans should be permitted to request an opinion from the Department of Labor (similar to that issued by the Internal Revenue Service regarding Section 401 and 501 of the Code, as indicated by Exhibit D) regarding the acceptability of the form of plan as it pertains to Section 404(c) of ERISA.

CONCLUSION

We believe that Section 404(c) is one of the most important sections of ERISA. It is based on Congress' recognition that different participants and beneficiaries in an employee benefit plan often have different investment objectives, and that therefore many plans are designed so as to permit each participant and beneficiary to make his own investment decisions. Similarly, Section 404(c) recognizes that many employers do not want the responsibility for investing plan assets, and therefore it permits each participant and beneficiary to have investment control over his own account.

We have based our recommendations concerning the regulations to be issued under Section 404(c) on the actual experience of the mutual fund industry in offering a variety of investment products and in sponsoring master and prototype plans. We believe that this experience is extremely relevant to the regulations, and that indeed, many plans currently funded with mutual fund shares already qualify under Section 404(c). We have attempted to set forth the major provisions which we believe should be set forth in the regulations. We would be pleased to furnish any additional information requested and to meet with representatives of the Department of Labor to discuss this most important matter.

EXHIBIT A

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SCUDDER

EXHIBIT B

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EXHIBIT C

FUND APPLICATION FORM

THE ____________________ KEOGH PLAN
(Name of Employer)

FOR THE SELF-EMPLOYED

1. Employer Information — Check One: ☐ Sole Proprietor ☐ Partnership

Name ____________________

Nature of Business ____________________

Business Address ____________________

Federal Tax Employer's Identification Number ____________________
(This is not the social security number. If you do not have an employer identification number, it should be applied for on Form SS-4 which may be obtained from your local office of the Internal Revenue Service)

Plan Serial Number ____________________
(This is a three (3) digit serial number which is assigned by the employer to each plan that he has adopted. If this is the only plan adopted, the number would be 001.)

Normal Retirement Age ____________________

2. Participant Information (Employees and Owner-Employees)

Name	Check One: Owner	Check One: Employee	Date of Birth	Social Security Number	Investment Company	Contributions Employer	Contributions Employee	Total

3. Please include the $5.00 New Plan Fee with this application.

Total Investment: ______

Investment Companies may be abbreviated as follows:

Scudder Managed Reserves, Inc. as "Reserves," or "R"
Scudder, Stevens & Clark Balanced Fund, Inc. as "Balanced," or "B"
Scudder, Stevens & Clark Common Stock Fund, Inc. as "Common," or "C"
Scudder Special Fund, Inc. as "Special," or "S"

EXHIBIT D

Department of the Treasury

Internal Revenue Service
Washington, DC 20224

Date: APR 7 1972 | In reply refer to: T:MS:PT:1:2

Washington Mutual Investors Fund, Inc.
900 Southern Building
Washington, D.C. 20005

Gentlemen:

In Re: Self-Employed Individuals Retirement Plan
Plan Serial Number: 725031
Pension Plan: ☐
Profit-Sharing Plan: ☒

In our opinion the form of the above prototype plan and related trust/custodial account is acceptable under section 401 of the Internal Revenue Code for use by employers who adopt it for the benefit of their employees, including self-employed individuals.

Our opinion relates only to the acceptability of the form of plan and trust/custodial account. It does not constitute a ruling or determination of the qualification of any adopting employer's plan under section 401 of the Code, or of the exempt status of the related trust/custodial account under section 501(a). Moreover, this opinion has no application to other Federal or local statutes. For guidance in determining whether the plans of participating employers fall within general wage and salary standards, see the regulations issued by the Pay Board under authority of the Economic Stabilization Act of 1970, as amended.

A self-employed individual adopting this plan will be considered to have adopted a plan qualified under section 401 provided all its terms are followed, and provided the eligibility requirements and contribution or benefit provisions are not more favorable for owner-employees than for other employees, including all employees required to be covered under a plan for businesses controlled by such owner-employees.

Please notify us if you terminate the form of plan.

Sincerely yours,

J. G[illegible]

Chief, Pension Trust Branch

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Form M-5333 (Rev. 12-71)

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December 21, 1979

The Honorable Lloyd Bentsen
Chairman, Subcommittee on Private Pension
Plans and Employee Fringe Benefits
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Proposed Legislation to Amend ERISA

Dear Chairman Bentsen:

This statement is submitted on behalf of the Western Conference of Teamsters Pension Trust Fund ("WCT Plan") for inclusion in the record of Hearings of the Subcommittee held on December 4-5, 1979 relating to S.1089, S.209 and other proposed legislation to amend the Employee Retirement Income Security Act of 1974 ("ERISA") and certain provisions of the Internal Revenue Code affecting employee benefit plans. Our statement focuses on S.209, "The ERISA Improvements Act of 1979," the bill before the Subcommittee which includes many provisions affecting multiemployer plans such as the WCT Plan.

The WCT Plan is the largest multiemployer plan in the United States. The Plan currently receives contributions on behalf of approximately 670,000 employees working under Teamster collective bargaining agreements with nearly 15,500 employers in 13 western states. Over 100,000 persons are currently receiving benefits under the WCT Plan. As of September 30, 1979, the Plan's total assets exceeded $2.6 billion and all such assets are on deposit with The Prudential Insurance Company of America pursuant to a group annuity contract. The WCT Plan is administered by 28 trustees jointly representing management and labor pursuant to the Labor Management Relations Act, 1947.

The WCT Plan regards the ERISA Improvements Act of 1979 (S.209) as a positive and very important step toward the resolution of many of the problems which it and other plans have faced in their five years of experience with ERISA. As our statement indicates, there are a number of provisions of S.209 which we strongly support and which we believe should be enacted promptly to help relieve some of the costs and burdens which ERISA has imposed on multiemployer plans. At the same time, we believe there are a number of ways the bill could be improved further, and we will focus on these in our statement. Briefly summarized, our recommendations for improvements in the bill are as follows:

(1) ERISA should be amended to clearly establish that multiemployer plans may indemnify trustees and other fiduciaries against liability and expenses, including attorney's fees, where such fiduciaries are found to have acted in good faith (p. 4).

(2) The Internal Revenue Code should be amended to modify recently-issued IRS regulations which expose multiemployer plans to a risk of total disqualification on account of

the failure of only one employer to satisfy an applicable qualification requirement (p. 8).

(3) ERISA should be amended to relieve multiemployer plans of the obligation to give vesting credit for service outside collective bargaining units covered by the plan in those cases where an entire unit of employees joins or leaves the plan (p. 10).

(4) ERISA should be amended to clearly relieve multiemployer plans of the obligation to accrue benefits after a substantial period of time during which employers have been delinquent in making required contributions (p. 13).

(5) We support the enactment of the alternative document distribution method for multiemployer plans, but we urge the clarification or deletion of several aspects of that provision to ensure that the intended relief is actually provided (p. 15).

(6) We support enactment of the provisions of the bill relating to the enforcement of family support orders, but further modifications are needed to clearly relieve plans of substantially all of the costly and burdensome problems attendant to pension plan involvement in state family law proceedings (p. 16).

(7) We support the provisions of the bill which would promote the prompt payment of employer contributions to collectively bargained plans, but we believe these provisions should be expanded to expressly sanction the enforcement of reasonable plan provisions for the payment of liquidated damages (p. 19).

(8) We oppose the proposed anti-misrepresentation provision as an unnecessary, counterproductive and unwarranted encouragement to essentially vexatious litigation (p. 20).

(9) We oppose the proposed expansion of early survivor annuity protection as a costly and administratively burdensome requirement which should not be imposed on retirement plans (p. 23).

Before explaining our recommended improvements in further detail, we note for the record our strong support for several other provisions of the bill which are of particular interest to multiemployer plans. One of these provisions (sec. 142) would properly relax ERISA's restrictions on the return of contributions made by mistake or which plans are not allowed to retain under the Federal labor laws. This additional flexibility will provide relief for a very common problem of multiemployer plans and will eliminate the need for costly and unnecessary litigation. We also endorse the provisions of the bill which would clarify or modify the accrued benefit (sec. 124) and funding (sec. 131) rules for multiemployer plans. These provisions will resolve technical but very important problems for such plans.

PROVISIONS THAT SHOULD
BE ADDED TO S.209

1. ERISA Should Be Amended to Clearly Establish that Multiemployer Plans May Indemnify Plan Fiduciaries Against Liability and Attorney's Fees Where They Have Acted in Good Faith.

The cumulative impact of (1) ERISA's broad and complex statutory scheme involving the potential for an infinite variety of suits under the guise of an alleged breach of fiduciary responsibility, (2) its procedural and jurisdictional rules providing easy access to Federal courts, and (3) ERISA's prohibition of exculpatory clauses, has caused many plans to purchase liability insurance against potential liabilities and defense costs of plan fiduciaries.

Early in 1978, the WCT Plan encountered great difficulty in securing any fiduciary liability insurance for its 28 labor and management trustees. After several months of complex negotiations, the WCT Plan finally did obtain fiduciary insurance.

However, only one carrier was willing to insure it and the annual premium was nearly four times that charged in the three prior years. This serious problem occurred even though no suit alleging scandalous conduct, self-dealing, theft or other criminal behavior has ever been filed against the WCT Plan. Further, while most plans now have fiduciary insurance, there is no way of knowing whether adequate insurance will be obtainable in future years and, if so, at what cost.

We believe that the current practice of obtaining fiduciary insurance against defense costs is seriously inadequate (in terms of both its excessive cost and the absence of any reliability for multiemployer plan trustees), and that multiemployer plans would be better served if they could directly assume the cost of routine litigation against trustees. Accordingly, we urge that ERISA be amended to permit such plans to pay these costs subject generally to an independent judicial determination that the trustees have acted in good faith.

Before the enactment of ERISA, most multiemployer plans did not purchase liability insurance. Civil actions against such plans were customarily defended by attorneys retained by the trusts, and the law at the time did not preclude this practice. Since ERISA was enacted, as representatives of the Labor Department are aware, the common practice of multiemployer plans has been to purchase fiduciary liability insurance for the plan in connection with which individual trustees may purchase waiver of recourse coverage at a small charge. However, the proliferation of lawsuits, many of questionable merit, has caused the cost of insurance to skyrocket and made it difficult to secure appropriate coverage. Further, questions have been raised as to whether the fiduciary provisions of ERISA generally allow a multiemployer plan to follow the pre-ERISA practice of paying for the defense of actions brought against individual trustees.*/

Our concern is not with the defense of acts which are clearly culpable and should be expected to give rise to personal liability. The typical case does not involve allegations of such individual wrongdoing, but instead calls into question the collective judgment of boards of trustees on a wide range of issues involving plan design, administration and compliance with other Federal laws. The costs of defending only one major lawsuit of this type can involve tens or hundreds of thousands of dollars -- whether the claim is well-founded or

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*/ The Department of Labor has issued several advisory opinions indicating that plans may pay the defense costs of its investment managers in certain cases (subject to repayment if there is a finding of individual liability), and one court has recently agreed. Central States, Southeast and Southwest Areas Pension Fund v. American National Bank and Trust Co. of Chicago, No. 77C 4335 (N.D. Ill., Oct. 26, 1979). However, the Labor Department opinion letters are based on the particular facts and circumstances of individual cases and, thus, it is unclear whether they would be applicable to most multiemployer plans and their trustees in the wide variety of suits that may be filed. Further, while the cited court decision concludes that reimbursement of investment manager litigation costs does not violate the prohibited transaction and exculpation restrictions of ERISA, that decision does not address a number of other issues such as whether reimbursement would be permitted if the fiduciary were found liable, notwithstanding that such fiduciary was acting in good faith and in the best interests of the plan.

frivolous. For a plan of any significant size, many such suits will be pending at any point in time. Under these circumstances, the purchase of insurance, where available and even at great cost, is a practical necessity. Few people can be expected to assume or retain the responsibilities of a trustee of a large multiemployer plan knowing that their personal assets may be exhausted in the defense of a multitude of lawsuits. Without insurance or some other appropriate means of minimizing this risk, there is a serious and unacceptable danger that competent people simply will not be willing to serve. Thus, we believe it is imperative that the law be changed in such a way as to permit honest and sincere fiduciaries to perform their customary plan responsibilities without fear of personal liability for the costs of defending decisions which a court may or may not ultimately agree were the "right" ones.

In our view, the above objective would be realized by the inclusion in the bill of an amendment comparable to a provision (sec. 3508) included in the recently-introduced "Retirement Income Incentives and Administrative Simplification Act of 1979" (H.R. 6053), sponsored by Congressmen Erlenborn and Conable. We believe such a provision will properly minimize the dependency of plans on costly insurance, and will better enable plans to retain and attract competent trustees to serve them. At the same time, such proposal contains sufficient limitations to prevent plans from assuming any significant cost of individual wrongdoing. We strongly urge the inclusion in S.209 of a substantially identical provision.

2. The Tax Law Should Be Amended to Clearly Prevent Disqualification of an Entire Multiemployer Plan on Account of the Failure of One or More Employers To Satisfy an Applicable Requirement.

ERISA represented the first legislative recognition that special rules may be necessary in certain cases in order to sensibly apply the general tax qualification standards to collectively-bargained multiemployer plans which commonly cover employees of dozens, hundreds or (like the WCT Plan) many thousands of different employers. Such recognition was far from complete, however, and recently issued final regulations of the Internal Revenue Service vividly illustrate one area where adequate provision for the special nature of these plans was not made. The regulations to which we refer, issued under section 413 of the Code, raise the possibility that an entire multiemployer plan -- covering employees of thousands of different employers -- may suffer the devastating consequences of plan disqualification solely because of the failure (negligent or otherwise) of a single employer to satisfy an applicable requirement. Treas. Reg. § 1.413-1(a)(3). While we recognize that the risk that such results may occur is probably small, we respectfully submit that the magnitude of the potential harm to innocent parties is so great that the Subcommittee should act promptly to eliminate any possible risk that such results may occur by reason of this interpretation of ERISA.

Multiemployer plan administrators generally employ reasonable and diligent procedures to detect potential problems of compliance with tax and other laws and to ensure adherence to plan provisions. However, it should be apparent that, in the context of any plan of significant scope, problems affecting one or another employer may not be identified for some time. This is particularly true of factors relating to the qualification of the plan "in operation" such as the non-discrimination requirements of the tax law. Possible problems in this area could arise through inadvertence, changed circumstances or other events affecting a particular employer or local union whose employees participate in the plan. For example, a group of local union employees may have been covered for some time by the multiemployer plan (which also covers workers represented by the union) on a basis fully consistent with accepted non-discrimination criteria. Subsequently, however, gradual changes in the local union work force, and its resulting participation in the plan, may adversely affect satisfaction of such nondiscrimination criteria by the local union.

Under the cited IRS regulations, it is possible that the entire plan could be disqualified in the above example, notwithstanding that events affecting the local union's participation generally were beyond the control and knowledge of the plan administrator and the hundreds or thousands of innocent participating employers and their employees. Multiemployer plans cannot, at least not without incurring staggering costs, police all possible events that may affect a participating group, and it is unreasonable for the law in any way to allow the imposition of such unduly harsh consequences on innocent parties. In this regard, while we appreciate the Treasury Department's expectation that the "Service's administration of these provisions may shelter innocent and nonnegligent employers from some of the harsh results of disqualification"*/, we believe this is one area where absolute certainty is of critical importance. Such certainty can only be provided by legislation.

Accordingly, we urge the adoption of an amendment to section 413 of the Code which provides a clear statutory basis for generally preserving the qualification of a multiemployer plan where one or more employers is considered not to satisfy an applicable requirement. Such an amendment should furnish a mechanism for notice and opportunity to remedy any defect, and, alternatively, should provide for segregation of the participatio of the nonqualifying employer from the remainder of the plan.

3. Multiemployer Plans Should Not Be Required to Provide Vesting Credit for Service Outside Covered Collective Bargaining Units Where an Entire Unit of Employees Joins or Leaves the Plan.

Labor Department regulations (currently administered by the Internal Revenue Service) in numerous cases accord significance under ERISA to an employee's service with an employer during periods for which the employer has not made or no longer will make contributions to the multiemployer plan for that employee

*/ 44 Federal Register 65061, 65062 (Nov. 9, 1979).

pursuant to a collective bargaining agreement. 29 C.F.R. § 2530.210. The effect of these regulations is to require multiemployer plans to provide vesting credit to employees for service which falls outside the basic link of the employee to the plan -- the collective bargaining unit. We urge the Subcommittee to consider an amendment to ERISA that would allow a plan to exclude, for vesting purposes, service performed in a collective bargaining unit prior to or following the period during which such unit participated in the plan.

Since their inception, the basis of an individual's participation in a multiemployer plan has been his or her employment in a collective bargaining unit represented by the union and for which negotiated contributions are made to the plan. It is service in covered bargaining units, rather than status as an employee of a particular employer, which has made possible the significant degree of portability generally provided by multiemployer plans -- a feature unique before ERISA and, notwithstanding the minimum vesting standards, one which remains unique in the private pension system.

The Labor Department rules stretch the concept of the "employer" as applied to multiemployer plans to require service to be recognized in many situations which run counter to the collective bargaining process and the purpose of the plan itself. For example:

-- When one unit of employees has been affiliated with the plan for a substantial period (e.g., in Washington), a second unit (e.g., in Arizona) can vote to join the plan at a time when employees in that unit will be immediately vested in all benefits to be accrued. This may be the case where the unit repeatedly rejected plan participation in the past in favor of higher wages or other benefits.

-- Similarly, the second unit can, after a short period of contributory service under the plan, bargain out in favor of other benefits, or decertify the union as their representative, while continuing to receive credit toward vesting under the plan they left.

We would emphasize that administration of these rules, if possible at all, is extremely difficult because multiemployer plans are not equipped to keep track of service which is performed outside of a collective bargaining unit for which employer contributions are made to the plan. Moreover, compliance with other ERISA requirements, such as the reporting of accrued benefits of vested terminated participants, is complicated considerably by these rules because participants may become vested years after they left a bargaining unit covered by the plan.

In view of the significant opportunity which multiemployer plans have long provided for employees to accumulate vesting credit notwithstanding frequent job changes, we believe that, at least in the types of situations described above, a balancing of the interests of plans and their participants supports the adoption of a limitation on creditable vesting service to service performed in participating collective bargaining units.

4. Multiemployer Plans Should Not be Required to Provide Accrued Benefits After a Substantial Period During Which Employers Have been Delinquent in Making Required Contributions.

The benefits provided by multiemployer plans are financially supportable only if the employer contributions required by bargaining agreements negotiated with local unions are made. Consequently, most multiemployer plans provided prior to ERISA that credit would be given for service in covered bargaining units only to the extent that the employer made contributions for such credit.

The current position of the Labor Department at least is that multiemployer plans must provide for accrual of benefis for all "hours of service" (as defined by ERISA) performed by employees in covered units, whether or not their employer has made the required contributions for such hours pursuant to the bargaining agreement. This interpretation exposes plans to potentially substantial liabilities for benefits which they cannot realistically bear without the receipt of employer contributions needed to fund the benefits. Accordingly, we urge that ERISA be amended to provide that the period of service required to be recognized for purposes of the accrued benefit rules does not include any period of service which follows a substantial period (e.g., two months) during which the employer has not made the required contributions to the plan.

Delinquencies in employer contributions arise for many reasons including short-term cash flow problems, disputes over whether employer contributions are required under an agreement, and more serious potentially long-term financial troubles. The provision of S.209 (sec. 154(b)) which would make an employer's contractual obligation to contribute an ERISA obligation recognizes that the timely receipt of employer contributions is vital to the financial soundness of multiemployer plans. While this provision should help multiemployer plans collect employer contributions on a timely basis, it would not provide relief where the delinquency is prolonged and the employer ultimately goes bankrupt or goes out of business.

In cases of employer bankruptcy or insolvency, the plan may have incurred substantial unfunded liabilities over a period of one or more years for which minimal or no contributions will be received. We note in this regard that, under the recently revised Federal bankruptcy laws, pension and welfare benefit plan contributions are in the priority category below wages, and the maximum priority amount is determined by aggregating both wages and plan contributions. 11 U.S.C. § 507(a). As a result, the bankruptcy laws do not materially improve the status of plans in relation to other creditors. The potentially large unfunded liabilities that may be imposed on multiemployer plans by such delinquencies are borne in a very real sense by those employers who continue to contribute and their employees. We believe these considerations support a statutory limitation which clearly establishes that, when no contributions have been received for a significant period of time (such as two months), no further benefit accruals are required. We urge that such a limitation be included in the bill.

PROVISIONS OF S.209
WE STRONGLY SUPPORT

5. Alternative Document Distribution Method for Multiemployer Plans (Secs. 117 and 153(7)).

For several years, the WCT Plan has struggled with the requirement of present law that ERISA-required documents be distributed to participants by direct mail at their home addresses. As explained in detail in the WCT Plan's testimony before the Committee on Labor and Human Resources (and in the "Summary and Analysis of Consideration" of S.209 prepared by that Committee), the Plan's efforts to comply with this requirement with respect to its 600,000 participants have proven to be extremely costly and have produced discouraging results.

Section 117 of S.209 properly recognizes that it is unreasonable for the law to impose on multiemployer plans an obligation to communicate with their thousands or hundreds of thousands of mobile plan participants at their home addresses. Thus, this provision of the bill would allow a multiemployer plan to rely on contributing employers for assistance with respect to the distribution of ERISA-required documents to those participants they employ.

We strongly support the basic provisions of section 117 and we urge their prompt enactment. We believe, however, that a number of technical improvements should be made, particularly with respect to several of the procedural limitations therein.

For example, we believe the requirement that the administrator's determination to use the new alternative method "include the evidence and describe the methodology on which it is based" (proposed sec. 112(a)(2)) will merely invite vexatious attempts to "second guess" the decision of a plan that less costly and equally comprehensive distribution will result if such method (as opposed to the use of home address records) is used. As a result, plans may have to expend substantial sums for attorney's fees and staff time to establish that reliance on the alternative was proper. We believe these types of limitations are unnecessary because, as a practical matter, reliance on employers is not an "alternative" to present law for most multiemployer plans -- it is the only reasonable way that substantial compliance may be achieved.

Accordingly, we urge the Subcommittee to modify section 117 of S.209 along the lines of a comparable provision (sec. 3209) of the recently-introduced "Retirement Income Incentives and Administrative Simplification Act of 1979" (H.R. 6053). With such modifications, this provision of the bill will allow plans to realize the intended administrative cost savings and simplification benefits, and ERISA-required documents will reach the same or a greater number of plan participants as under present law.

6. Alimony and Support-Payments (Secs. 128, 155(3), 205(j))

The bill includes several provisions to clarify the relationship between the preemption and anti-assignment provisions of ERISA and the enforceability against plans of state law marital property rights to pension benefits and orders for unpaid alimony and family support obligations. These provisions properly recognize (1) the need to protect and enforce the legitimate rights of spouses and dependents of participants, and (2) the equally strong need to protect plans from undue administrative burdens and costs and to clarify their obligations under ERISA and the Code.

We strongly support the enactment of these provisions of S.209. However, we believe it is essential that these provisions be expanded to deal specifically with several additional problems arising from the substantial and ever-increasing involvement of employee benefit plans in state family law proceedings. Specifically, we urge the adoption of additional provisions to resolve the following serious problems:

(1) Family support, etc., orders may be entered and served on plans many years before the affected participant's benefits are scheduled to commence and are finally determined. As a result, when benefit payments are about to commence, it is likely that the terms of the original order will be inadequate to inform the plan of what it is required to do. Moreover, it may be difficult or impossible to locate the non-employee spouse. These problems should be resolved by provisions that discourage the entry of final orders until benefits are about to become payable, and provide a reasonable mechanism to inform plans of the whereabouts of non-employee spouses.

(2) Since family law orders may be entered years before benefits commence and, in fact, before a participant is even vested in any plan benefits, there is a serious risk under present law that plans will have to incur needless legal expenses. Specifically, where a plan is made a party to the state family law proceedings, it may be obligated to participate in such proceeding even though the subject ultimately becomes moot (because the participant dies or never vests), or the original order must be substantially revised at a later date to reflect changed circumstances, final benefit determinations, etc. We believe the law should clearly provide that plans are not obligated to participate in such proceedings until shortly before benefits are scheduled to commence.

(3) The current provisions of the bill may not substantially minimize the risk under present law that plans, their agents and insurers who provide plan benefits under nontransferable annuity contracts, may incur multiple liability for the same benefit payments. Clearly, it would be reasonable for ERISA to preclude multiple liability for good faith determinations to pay benefits to a participant (or to withhold benefits in anticipation of a spouse claim) either prior to service of an order, or pursuant to an order which may not clearly meet all of the specific requirements of the bill.

We would be pleased to work with the Subcommittee and its staff to develop reasonable solutions to these problems --

solutions which we believe are needed to protect plans against further substantial increases in the administrative and legal costs related to family law proceedings involving their participants.

7. Provisions to Promote the Prompt Collection of Employer Contributions (Secs. 153(4), 154(b)).

The provisions of the bill which would (1) make the contractual obligation of an employer to contribute to a collectively bargained plan an obligation enforceable under ERISA, and (2) ensure that plans will be paid reasonable attorney's fees and costs where they prevail in the action, will assist multiemployer plans in securing the timely payment of employer contributions. We strongly support these provisions, and we encourage the Subcommittee to expand them to declare reasonable plan provisions for the payment of liquidated damages by delinquent employers enforceable as a matter of Federal law.

Legislative recognition of liquidated damages provisions would benefit multiemployer plans in the following significant ways:

(1) Plans would be assured of recouping the full costs of delinquencies, including in-house administrative expenses, collection agent fees and lost investment earnings, incidental to late payment and collection.

(2) Plans will be relieved of the burden, commonly imposed by courts under present law, to prove the actual

amounts lost on account of the delinquency in order to establish that the plan's provisions for liquidated damages are reasonable, and therefore, should be enforced. Frequently, the cost of litigating this issue exceeds the recovery sought.

(3) Legal certainty with respect to the enforceability of liquidated damages provisions should provide a strong incentive to prompt payment by those employers who are inclined to delay payment while the funds are used as a short-term low or no cost loan for other purposes.

In our view, the effectiveness of the current provisions of the bill on this subject would be substantially increased by the addition of an amendment which declares reasonable plan provisions for liquidated damages, such as a provision for payment of an amount not in excess of 18 percent of the amount of the delinquent contributions, enforceable as a matter of Federal law. Such an amendment clearly would be consistent with the policy of the current provisions of the bill, and we urge the Subcommittee to adopt it.

PROVISIONS OF S.209 WE STRONGLY OPPOSE

8. Anti-misrepresentation Rule (Secs. 153(2), 154(b)).

S.209 includes a provision, enforceable in the Federal courts, that would render it unlawful for "any person" to make knowing mispresentations with respect to a plan, its financial condition or the status of a person under the plan. We strongly oppose the enactment of this provision and we urge the Subcommittee to delete it from the bill.

We do not quarrel with the underlying premise of proposed section 515 that the law should not allow persons to be deliberately mislead with respect to their plans (or any other important subject for that matter). However, the fact that one agrees with this premise should not lead to the conclusion that this type of provision is necessary and appropriate. For the reasons briefly summarized below, we believe the opposite conclusion must be reached.

(1) We seriously question whether the perceived abuses that this provision is intended to curtail, i.e., the making of knowing misrepresentations to employees concerning their plans, have been shown to be sufficiently widespread to warrant the enactment of such a troublesomely broad and vague provision as section 515. We are not aware that such a factual predicate has been developed; until it is, this provision can only be regarded as "legislative overkill."

(2) We believe that the broad fiduciary responsibility provisions of ERISA, in combination with generally available fraud remedies available against nonfiduciaries under state law, are adequate to provide appropriate relief in those situations where "fraud" -- in the commonly understood sense of the word -- has occurred. Even assuming that there may be isolated cases where these laws would not provide appropriate relief, it is submitted that the overwhelming costs and burdens that will be imposed on plans in the defense of the great

majority of ultimately baseless "anti-fraud" suits clearly outweighs any perceived marginal benefit from its enactment.

(3) We appreciate that portions of the explanation of this provision contained in the "Summary and Analysis" of the Senate Labor Committee are intended generally to allay the nearly unanimous public concern that section 515 will, by and large, merely provide a fertile ground for vexatious litigation. However, the fact that this explanation (pp. 41-42) needs to specify that certain general statements concerning a plan, made by persons who are not plan officials in several very common employment situations, are not to be considered "fraud" best illustrates the serious potential for abuse created by the proposal. Further, it is inevitable that suits against third parties, such as employers and local union officials, will involve the plan and its trustees notwithstanding their remote relationship to the statements complained of. As a result, this provision is likely to become a severe impediment to necessary efforts at cooperation between plans and the bargaining parties.

Finally, we note that it is important that the potential impact of section 515 not be considered in isolation. In the current environment of plans which have not yet fully overcome all of the costs and burdens of ERISA, and which have found themselves in court with increasing frequency since ERISA's enactment, there is reason to believe that the enactment of this proposed anti-fraud rule could seriously undermine the continued existence of many plans. We urge the Subcommittee to delete this provision of S.209.

9. Expanded Survivor Protection (Secs. 127, 205(i)).

Section 127 of S.209 proposes a number of changes to the joint and survivor annuity requirements of ERISA. The proposed change of particular concern to the WCT Plan relates to the requirement that a plan provide for the payment of a survivor annuity benefit on account of the death of any participant who has accumulated 10 years of vesting service, unless the participant specifically rejects the benefit. Under present law, plans are generally required to provide this benefit only with respect to vested participants who reach early retirement (usually age 55 but in any event not earlier than age 55) while still in employment covered by the plan. IRC § 401(a)(11)(C).

In our view, this proposed expansion of survivor annuity protection would impose unnecessary cost increases on retirement plans and would result in significantly increased administrative burdens and costs. We urge that this proposal be deleted from the bill for the following reasons.

(1) It should be noted at the outset that, while the bill would allow plans to "charge" participants for the expanded protection (if they do not elect out), as a practical matter, most multiemployer plans will have to absorb these additional

costs. This is because most multiemployer plans are simply not equipped to communicate to participants the information they need to decide whether or not the spouse protection should be accepted. (We note in this regard that the WCT Plan did make an effort to administer the current rules on an elective basis, but the Plan was recently amended to provide the early survivor annuity on a mandatory basis, without charge, after 1979.)

(2) While we have not actually calculated the additional cost to the WCT Plan of the expanded survivor protection proposed by the bill, the actuary for the WCT Plan expects that the additional cost would fall in the range of 2-3 percent of total current plan costs, or in excess of $5 million annually. Such an increase may not have a substantial adverse impact on the funding of the WCT Plan, but it could well be sufficient to adversely affect the funding balance of other multiemployer plans. Further, there is no doubt that any such increase will have to be taken into account in determining whether (or to what extent) retirement benefits provided by the WCT Plan may be increased and in determining the adequacy of current employer contribution rates to provide all Plan benefits. While we seriously question the advisability of any new legislation imposing increased costs on plans, we believe it is particularly important that <u>retirement</u> plan costs not be increased to provide what is in large part a benefit that will be supplemental to, or in lieu of, group life <u>insurance</u> benefits.

(3) The expanded survivor protection will impose an additional layer of administrative burdens on plans with attendant cost increases. For example, because the bill proposes that the survivor benefit not be payable to the spouse prior to a plan's early retirement age, plans would have to keep track of the whereabouts of spouses of vested participants who died as many as 25 years before the benefit is payable. Frankly, we suspect that such spouses may have entirely forgotten that they are even entitled to the benefit (which, of course, would be very small for a spouse of a participant who died at a relatively young age), but plans nevertheless will have an apparent obligation to find them. While we recognize it may be possible to develop solutions to this administrative problem and others (e.g., determining the entitlement of participants who attain 10 years of vesting service as a result of service outside the collective bargaining unit), we respectfully submit that the existence of such major problems raises serious questions as to the justification for requiring plans to provide the expanded survivor protection.

* * * * * * * * *

We appreciate the opportunity to present the views of the WCT Plan on the ERISA Improvements Act of 1979. If the Subcommittee or its staff would like any additional information, please contact either of the undersigned persons.

Very truly yours,

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January 10, 1980

Mr. Michael Stern
Staff Director
Finance Committee, Room 2227
Senate Office Building
Washington, D. C. 20510

Re: S. 209, The ERISA Improvements Act of 1979 - Sections 128, 155 - Preemption of State Domestic Relations Laws

Dear Mr. Stern:

This will supplement our letter to you of December 21, 1979, on the above subject.

We submit the following additional comments regarding the amendments of ERISA proposed by Sections 128 and 155 of the ERISA Improvements Act of 1979, S. 209:

1. In our earlier letter to you we cited In re Marriage of Lionberger (1979) 97 Cal.App.3d 56 as illustrative of the frustration of Congressional objectives which would result from the exception from preemption of State domestic relations judgments, decrees or orders proposed by Sections 128 and 155 of S. 209. There are other cases pending in the California courts which also illustrate this point, including the following:

(a) In In re Marriage of Preszler, El Dorado County Superior Court No. 32363, an order has been entered directing the Carpenters Pension Trust Fund for Northern California to withhold the sum of $150.00 from the monthly benefit of $235.13 being paid to a pensioner and to pay such sum to the pensioner's divorced spouse. The order specifies that $100 of this amount is for spousal support and the remaining $50 is to be applied against an arrearage of $1225.00 in payments ordered to be made by the pensioner in the marital dissolution proceedings, which amount includes $700 for attorneys fees.

Under California law a pension payable pursuant to a private retirement plan is exempt from execution, attachment or garnishment, even with regard to court-ordered child or spousal support payments (California Code of Civil Procedure, Section 690.18(c); Ogle v. Heim (1968) 69 Cal.2d 7; Miller v. Superior Court (1968) 69 Cal.2d 14). Thus, the order in Preszler not only requires a violation of Section 404(a)(1) of ERISA but also a violation of California law.

The pensioner, however, is not represented by counsel in the marital dissolution proceedings so that the burden of raising both objections rests upon the Fund in litigation which, if the experience in Campa, et al. is any precedent, may have to be carried to the United States Supreme Court.

(b) In In re Marriage of Evans, Sacramento County Superior Court No. 732405, a participant in the Carpenters Pension Plan elected the joint and survivor option which ERISA required the Plan to provide, thereby incurring a 21% reduction in his pension benefit -- from $650 to $513.50. His spouse knew of the exercise of this option and signed the option form. Thereafter, a judgment was entered in marital dissolution proceedings directing the Fund to pay one-half of the reduced pension to the spouse during the participant's lifetime, and an execution was levied upon the participant's remaining one-half for the recovery of an arrearage in support payments amounting to $1816.40. As in Preszler, the Fund must bear the brunt of defending against the judgment and the execution on the ground that they each violate Section 404(a)(1) of ERISA and against the execution on the ground that it violates California law.

(c) In In re Marriage of Reyes (1979) 97 Cal.App.3d 876, a participant's spouse sought an award of attorneys fees against the Carpenters Pension Fund because the Fund had appeared in marital dissolution proceedings to which it had been joined as a party and had presented defenses based on ERISA. The spouse's claim was founded on a California Civil Code Section and was denied by the trial court on the ground that the terms of the Section did not support the claim.

The California Court of Appeal overruled the Fund's ERISA defenses in an unpublished opinion and then affirmed the denial of attorneys fees in a published opinion,saying (97 Cal.App.3d at pps. 879-880):

> "No doubt the purpose of attorney's fees in marital dissolution actions is to enable a spouse to retain an attorney so that no unfair advantage will be gained by another party. Kopasz v. Kopasz (1949) 34 Cal.2d 423, 425; In re Marriage of Gonzales (1975) 51 Cal.App.3d 340.) Since the Legislature as of January 1, 1978, saw fit to make joinder of a pension plan as a party to marital litigation mandatory in order to have the court's judgment enforceable as against the pension plan (Civ. Code, § 4351) and because of the common financial disparity between such a plan and a marital litigant to employ and pay counsel, it would be a logical step for the Legislature to authorize fees and costs to be assessed

against such a party. However, the Legislature has not done so, and it is properly within its prerogative to make this type of policy decision." (emphasis added)

Thus, in the minds of the California courts, the California Legislature not only has the power to enact a procedure whereby an employee pension benefit plan covered by ERISA may be joined as a party to every marital dissolution proceeding involving a plan participant, but it also has the power to provide for an assessment of attorneys fees against the Fund in every such proceeding. Section 404(a)(1) of ERISA requires that a plan fiduciary discharge its duties with respect to the plan solely in the interest of the participants and beneficiaries of the plan and hence the fiduciary cannot sit idly by when the plan is joined as a party to a marital dissolution proceeding. If, as in the Preszler and Evans cases noted above, a judgment, decree or order entered or proposed to be entered, in the proceeding appears to be in violation of both ERISA and the State law, the fiduciary has no alternative under ERISA but to oppose entry of the judgment, decree or order, or to move to set it aside, if already entered. An order pursuant to a State domestic relations law assessing attorneys fees against the plan or the fiduciary for such action would not only frustrate the objectives of ERISA but would also be patently unfair.

2. Section 128 of S. 209 uses the term "individual" in referring to the person entitled to receive payments pursuant to a State domestic relations judgment, decree or order proposed to be excepted from the prohibition against assignment or alienation and from preemption. We assume from the context of Section 128 that one reason for using this term is to avoid making such person a "participant" or "beneficiary" as defined in Sections 3(7) and 3(8) of ERISA and thus entitled to rights under ERISA Sections 101, 102, 104(b) and (c) and 105 (requiring plan administrators to furnish, report or otherwise disclose specified information to participants and beneficiaries), Section 403(c)(1) (requiring that plan assets be held for the exclusive purposes of providing benefits to participants and their beneficiaries and defraying administrative expenses), Section 404(a)(1)(A) (requiring that plan fiduciaries discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying administrative expenses) and Section 502(a)(1)(B) (providing that a civil action may be brought by a participant or beneficiary to recover benefits due him under the plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan).

If this was a purpose for using the term "individual", we question whether Sections 128 and 155 will accomplish that purpose. Section 3(8) defines the term "beneficiary" as including a person designated by a participant who is or may be entitled to a benefit under ERISA. Section 128 includes within the exception a judgment, order or decree approving a property settlement agreement. It is a common practice under the California community property law for a participant in an employee pension benefit plan to agree that his spouse shall have an interest in his prospective pension in return for the spouse's agreement that he will receive an equivalent interest in other property, such as the family home or an equity therein, which can be more readily converted to cash. If Section 128 is enacted in its present form, the divorced spouse of a participant designated by the participant in a property settlement agreement to receive all or a portion of the benefits to which he would otherwise be entitled under the plan would be "a person designated by a participant who is or may be entitled to a benefit under ERISA."

Further, Sections 128 and 155 do not address the holding in Stone v. Stone (N.D. Cal. 1978) 450 F.Supp. 919, that State community property laws authorize "the transfer to the non-employee spouse of her spouse's federal cause of action under 502(a)(1)(B) [of ERISA] as well as the transfer of the rights to the benefits themselves" (450 F.Supp. 933, n. 17). This holding was followed by the California Court of Appeal in In re Marriage of Pilatti (1979) 96 Cal.App.3d 63, 67 ("Mrs. Pilatti... is not a creditor of her husband but a 'participant' in the pension by operation of law") and in In re Marriage of Lionberger (1979) 97 Cal.App.3d 56, 63 (holding that the non-employee spouse could sue in a State court under Section 502(a)(1)(B) as "a transferee of the participant's rights").

If the divorced spouse of a participant who has been designated in a State domestic relations judgment, decree or order as entitled to receive all or a part of the participant's benefit under a pension plan is a participant in the plan in her own right, the reporting and disclosure requirements of ERISA Sections 101, 102, 104(b) and (c) and 105 will be substantially and onerously expanded. Those requirements will then apply to such a spouse whether or not she is receiving benefits under the plan, and plan administrators will be faced with the necessity of keeping track of and otherwise dealing with persons whose only connection with the plan is that they once were married to participants. In addition, under the holding in Lionberger, every divorcing spouse who joined an employee pension benefit plan as a party to a marriage dissolution proceeding, or otherwise sued the plan in a State court for all or a portion of a participant's pension benefit, could claim an award of an attorney's fee pursuant to Section 502(g) of ERISA.

In view of the attitude expressed by the Court in In re Marriage of Reyes, quoted above, that there is a "common financial disparity between such a [pension] plan and a marital litigant to employ and pay counsel," the exposure of employee pension benefit plans to such awards would be substantial, particularly in California.

3. The litigation and the considerations summarized above illustrate that the result of the amendments to ERISA proposed by Sections 128 and 155 of S. 209 would be to give the divorced spouses of participants in employee pension benefit plans greater and more immediate rights than those given by ERISA to the surviving spouses of participants. In effect, Congress will turn over to the individual States the definition and enforcement of the rights of the divorcing and divorced spouses in plan benefits under the worst possible conditions from the standpoint of employee pension benefit plans, the participants and beneficiaries of such plans and the employers who contribute to and sustain the plans.

In a marital dissolution proceeding the principal if not the only concern of the Court is with the rights of the parties before it at the time, and where an interest under an employee pension benefit plan is involved, in the rights of the non-employee spouse with respect to the plan. The Court gives little if any attention to the interests of the employers who contribute to the plan, the employees covered by the plan other than the employee who is a party to the proceeding, the person or persons who may subsequently marry the party employee and the administrators of the plan.

The employers who contribute to an employee pension benefit plan are interested in reducing employee turnover and training costs and in maintaining a stable work force (Alabama Power Co. v. Davis (1977) 431 U.S. 581, 594, 97 S.Ct. 2002, 2009). Where, as under California law, the spouse of a plan participant acquires an enforceable property interest in the participant's prospective pension as soon as the participant earns a single pension credit (In re Marriage of Brown (1976) 15 Cal.3d 838, 842), an employee who has had his prospective pension benefits cut in half by a divorce decree during the early years of his employment is discouraged from continuing in that employment. By obtaining employment with another employer or in another industry he can start accruing benefits under another plan free of the decree and thus obtain greater assurance of an adequate pension when he reaches retirement age. If he is vindictive in nature, he may also be motivated by the opportunity to leave his divorced spouse with an empty bag.

Conversely, if the divorce occurs later in the employee's working career, the division in half of his prospective pension discourages the employee, even though his efficiency may be on the decline, from retiring and making way for younger workers (see Alabama Power Co. v. Davis, supra), to the detriment not only of the employer but also of the other employees participating in the plan. The Carpenters Pension Plan, and many other plans in the construction industry in California, provide for a service pension, which permits an employee to retire at any age with a full pension after a specified number of years of credit (30 years in the case of the Carpenters Plan; 25 years in the case of other plans). The purpose of this provision is to encourage long-time employees to retire and open job opportunities for younger workers -- a purpose which is defeated in the case of an employee who has had his pension benefit divided by a divorce decree.

When a divorced plan participant remarries, his new spouse acquires an enforceable property interest under California law in his prospective pension as soon as he earns a single pension credit after the remarriage, and this process can continue through successive divorces and remarriages until his retirement or death. Also under California law, the first years of service under a pension plan must be given the same weight in the division of pension rights between spouses as later years of service, even where the participant's earnings in the later years are significantly greater than his earnings during the first years (In re Marriage of Anderson (1976) 64 Cal.App.3d 36, 39; In re Marriage of Judd (1977) 68 Cal.App.3d 515, 523).

In the first years of the Carpenters Pension Plan employers were contributing 10 cents per hour of work by participants to support the Plan whereas they are now contributing $1.95 per hour for the same purpose. If employer contributions to the Plan are to be considered compensation for services rendered by the carpenter, it seems obvious that a spouse who was married to the carpenter while his work generated contributions at the rate of $1.95 per hour would be entitled to a greater proportionate share in the carpenter's pension than a prior spouse who was married to the carpenter when his work generated contributions at the rate of 10 cents per hour. If the second spouse's marriage to the carpenter is in turn dissolved, she may well obtain a judgment, decree or order which conflicts with the judgment, decree or order in favor of the first spouse. If the marriage is not dissolved and the second spouse becomes the surviving spouse and the beneficiary of a joint and survivor option, she will doubtless claim her survivor's benefit freed of any interest of the first spouse. In either event the proposal in Sections 128 and 155 of S.209 that the definition and enforcement of the rights of divorcing or divorced spouses in plan benefits be turned over to the individual States will lead to endless litigation and lifelong recrimination among the carpenter (so long as he survives) and his successive spouses.

Last to be considered, but of overriding importance from the standpoint of the purposes and objectives of ERISA, are the interests of the plan and the plan administrators. These interests were belittled by the Court in In re Marriage of Campa, 89 Cal.App.3d 113, with the remarks that "the Fund would ultimately have to mail two monthly checks instead of one in these cases and do the related record keeping," a task which is "hardly overwhelming" (p. 131), and that "in most of these [marital dissolution] proceedings there will be little, if any, need for the Fund to participate actively" (ibid).

As Preszler, Evans and Lionberger demonstrate, however, orders or proposed orders against employee pension benefit plans in marital dissolution proceedings can have a seriously adverse effect upon the interests of plan participants and their beneficiaries. It is difficult to see how plan fiduciaries, who are required by ERISA to discharge their duties with respect to the plans "solely in the interest of the participants and beneficiaries" (Section 404(a)(1)), can sit idly by when the orders not only violate ERISA but also are in contravention of State law. Once the orders have been entered and have become final, they may be enforced against the fiduciaries by contempt proceedings in the State courts, and plan fiduciaries are faced with the alternative of complying with the orders and risking personal liability under ERISA or refusing to comply with the orders and facing the inconvenience, embarassment and risk of fine or other penalty connected with contempt proceedings. The Boards of Trustees of the Funds we represent have already been threatened with contempt proceedings in several cases and instances of such threats will multiply as more and more orders are entered against the Funds in cases where pensions are in pay status.

The matter of defining and enforcing the rights of divorcing and divorced spouses in plan benefits presents major policy considerations, the resolution of which should not be left to State legislatures and to State domestic relations courts. The problems involved are not confined to California and the other community property states, but also extend to so-called "common-law" States, which increasingly are enacting marital property laws patterned after community property laws (Prager, Future Sharing Principles and the Future of Marital Property Law (1977) 25 U.C.L.A.L. Rev. 1,3). In view of the objective of ERISA to secure national uniformity in the regulation of employee benefit plans, Congress alone has the incentive and the ability to evaluate and adjust all of the conflicting interests involved, including the interests of the immediate parties to a marital dissolution proceeding and those of contributing employers, plan participants generally, subsequently acquired spouses of the participant party, the plans and the plan fiduciaries.

We respectfully submit that Congress should address the matter of benefits for divorcing or divorced spouses in the same way as it is addressing the matter of increased protection for surviving spouses; that is, by determining whether or not a divorcing or divorced non-employee spouse should have any interest in the pension benefit of the employee spouse, and if so, the nature and extent of such interest and the manner in which it is to be enforced. Only in this way can national uniformity be achieved, the endless litigation in which plans are presently embroiled be eliminated and plan fiduciaries be given the guidance and protection against liability which they need and deserve.

Yours very truly,

Thomas E. Stanton, Jr.

TES/d