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PENSION PLAN COMPLEXITY

HEARING

BEFORE THE

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

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

MARCH 23, 1990

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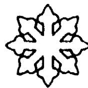

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PENSION PLAN COMPLEXITY

FRIDAY, MARCH 23, 1990

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

The hearing was convened, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Also present: Senator Heinz.

[The press release announcing the hearing follows:]

[Press Release No. H-14, Feb. 22, 1990]

FINANCE SUBCOMMITTEE TO HOLD HEARING ON PENSION PLAN COMPLEXITY, SIMPLIFICATION COULD ENCOURAGE MORE RETIREMENT COVERAGE, PRYOR SAYS

WASHINGTON, DC—Senator David Pryor (D., Arkansas), Chairman of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, announced Thursday that the Subcommittee will hold a hearing to review the Internal Revenue Code rules governing private pension plans and discuss options for simplification.

The hearing is scheduled for Friday, March 23, 1990 at 10 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"I am afraid that pension rules have become way too complex, and that is having a negative effect on retirement coverage. Many employers, especially small businesses, are scared away from starting pension plans because of the cost and complexity of administration," Pryor said.

"Even those employers who have retirement plans and have decided to stay in the game are finding they are spending more and more of their benefit money on administration, and less on increasing benefits. I look forward to having a frank discussion on how to simplify the pension rules to encourage coverage," Pryor said.

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

Senator PRYOR. Good morning, ladies and gentlemen.

The purpose of this morning's hearing is to take a look at the changes in ERISA over the past 15 years and to see what effect they have had on plan coverage.

When Congress enacted ERISA in 1974, many thought the act was sufficiently comprehensive and flexible that further changes would be relatively few and far between. But like many other good intentions, things have not quite worked out that way with ERISA: ERISA and the Internal Revenue Code have been amended an average of almost once a year since 1974.

Most of those changes that have been made in the law over the past 15 years are probably meritorious. They have attempted from

time to time to enhance benefit security, address possible discrimination in plans, and permit plans to adapt to the needs of a growing and economically diverse workforce.

But the time has come to take a look at what we have wrought. ERISA clearly has become a boon for lawyers and consultants, but I remain firm in my conviction that that was not the original intent of Congress.

The goal of ERISA, of course, is to provide income to our Nation's workers after retirement. And to achieve this goal, there must be security of assets and sufficient flexibility to allow employers and employees to establish pension plans that meet their needs.

I fear that maintaining a pension plan is no longer a routine, simple administrative matter performed at a reasonable cost, but rather has become a legalistic and very, very expensive endeavor.

I hope this morning that the witnesses will help this subcommittee address two major questions that we will pose:

First, is the complexity of ERISA discouraging the initiation and continuation of pension plans, particularly defined benefits plans?

And, two, how and in what areas would it be most fruitful to rationalize or simplify the law?

With the help of our witnesses this morning, we hope to find answers to these questions, answers that will help this subcommittee make an informed judgment. I am afraid that the complexity of ERISA has become so great that we risk stagnation or even decline in our private pension system at a time when we should be actively promoting it to support the Nation's growing retiree population.

The first witness that we will hear from this morning is probably perhaps the foremost authority in the House of Representatives and perhaps the Congress as a whole in the area of private pension plans and the complexity of these plans. He has truly delved into these complex subjects. We look forward today to hearing from Congressman Rod Chandler.

Congressman Chandler, we appreciate your attending today and thank you for the insight that I know you will give us.

STATEMENT OF HON. ROD CHANDLER, A U.S. REPRESENTATIVE FROM WASHINGTON

Congressman CHANDLER. Good morning, Mr.Chairman. And thank you for those very kind and generous remarks.

I frankly think sometimes things ought to be kept off the record, but now that you have said what you did, I perhaps will reconsider.

One of my friends in the front row asked me, what are you going to say? And I said, I am going to say this is a worthy cause, and Dave Pryor is a hell of a Senator. [Laughter.]

You could strike that if you want to.

Senator PRYOR. No. We will keep that on the record.

Congressman CHANDLER. All right. [Laughter.]

Mr. Chairman, and members of the subcommittee, I come from the State of Washington, and a few years ago we had a hanging in the rural part of our State. And this man sentenced to hang stood there on the scaffold, and the sheriff asked him if he had any last words, and he said, "well, yes, I do. I don't think this damned thing is safe." [Laughter.]

And I think you can imagine what it would be like to be running a small start-up business—I was in that position myself at one time—and thinking about setting up a pension system. When you consider the patch work of law and regulation, you would probably conclude that the damned thing just isn't safe or at least not workable.

Mr. Chairman, that is why I am so pleased to appear here today and to continue my work with you on a subject of great personal interest and of vital importance to millions of Americans, which is the simplification of the Nation's retirement system.

I have long been concerned that too many changes in pension law have been driven by revenue needs rather than by what constitutes sound retirement income policy.

The entire decade of the 1980's was replete with tax and budget bills that became vehicles for massive changes in pension law. The jargon of the benefits field is littered with the acronyms with which we are all too familiar: TEFRA, DEFRA, COBRA, OBRA and, of course, TRA and its offspring, TAMRA. And the process itself makes it virtually impossible to consider the pension provisions apart from the others when Congress legislates by megabill.

Now, we should take pride as a nation in the fact that tax incentives we have enacted enable employers to provide pension coverage to 45 million workers in this country. Employees and retirees are well served by the fact that employers make 87 percent of total pension contributions. The Treasury too benefits from this private system. Since benefits are financed privately, either with tax deferred or after-tax dollars, the burden on public programs is lessened. The question is hardly whether we can afford to support the private pension system, it is whether we can afford not to.

The Nation's pension system is not only important to ensure the retirement income security of America's elderly, but it is also vital to improving the Nation's savings rate. In 1986, pension funds accounted for 34.8 percent of the investment capital supplied by nonbank financial institutions.

Let there be no confusion on this point. The complexity of the pension system is not some esoteric issue. It is directly and significantly related to the issue of pension coverage. If Congress and the executive branch write laws and rules that sponsors of pension plans cannot understand or that cost them too much to implement, sponsors will terminate their plans. This is not a concern for the future. It is happening now.

Like so many of my colleagues, I support legislative efforts to allow individuals and families great opportunities to save for retirement, education, new home purchases, and a host of other good purposes. I hope the outcome of the current debate over expanded Individual Retirement Accounts and family savings accounts will be a responsible and attractive savings vehicle. But while Senate and House Republicans and Democrats are trying to outdo one another in crafting the best individual or family savings program, I hope that we will not overlook the proven value of the employer-sponsored retirement system.

Criticisms leveled against IRA's in the past is that they are attractive primarily to wealthy individuals who have money to save. Now, I disagree with that. But while reasonable people may differ

on the accuracy of that claim about IRA's, no one can argue that employer-sponsored savings plans, such as 401(k) plans with their typical employer matching contributions, are especially valuable to lower paid workers. These plans allow workers of moderate means to save for their retirement. But rather than encouraging employers to sponsor 401(k)s, we hamstring them with extraordinarily complex average deferral percentage tests—the ADP test—and it just doesn't make any sense if we are trying to encourage middle and lower income Americans to save.

Examples of this kind abound, and I know you have a long witness list today. Let me simply summarize, Mr. Chairman, by saying that I think that this is extremely important work, complimenting you on your efforts here, and also another organization, APPWP. As you know, they have issued an excellent report. This report called "Gridlock: Pension Law in Crisis and the Road to Simplification." The report is, I think, a major contribution.

If I could, I would like to quote one statement from it, which I think is the most compelling I have seen.

It says, "These intricate rules affect all employers, whether large or small, and all of the working people planning for retirement. The rules which have been altered by layer upon layer of legislative and regulatory change have become practically unworkable. Rather than promoting retirement security, they are becoming a barrier to it. Unless the rules are simplified, the Nation's growing older population will have inadequate resources to meet its retirement needs."

Mr. Chairman, I again commend you for your efforts. I thank you for this opportunity to walk across a beautiful campus this morning and to testify in behalf of legislation which I hope will solve this problem.

Senator PRYOR. Congressman, thank you. And once again, we thank you for your contribution.

Let me ask one or two questions. Like I said earlier, you are truly a real authority in this field. Why do you think that the Congress year after year is having to amend or change the pension rules? Why can't we enact something and just guarantee no changes for, say, 5 years?

Congressman CHANDLER. I think that there are two basic reasons. One of them reminds me of that old famous bank robber who was asked one time, why do you rob banks? And he said, because that's where the money is. And I think that is part of the problem here for the Congress with pension plans. There is a lot of money involved. And where that is the case, Congress is trying to capitalize on it for deficit reduction.

In addition to that, I think sometimes we see cases of abuse. And, unfortunately, that is a part of every society on the face of this globe. And we tend to overreact, Section 89, I think, is a prime example of that. And for the vast majority of employers and employees, you wrap them up in law which is practically unworkable, if not unworkable, while the others will probably continue to cheat anyway.

Those, I think, are the two major reasons. And I couldn't agree with you more that we need to enact this kind of legislation and leave it alone. If there's anything I hear from the employer com-

munity it is we need certainty. We need to know the law in effect is going to be there for a while so we can plan on it.

Senator PRYOR. You know, in Washington, we have a hard time knowing what the rules of the games are in this area. This is especially hard on smaller businesses, which often have no idea what the rules are or what they will be next month or next year. I think this constant changing of the law has certainly been a real detriment to the building of a healthier retirement system.

Congressman CHANDLER. Well, I do too, Senator. And I represent the Weyerhauser Co. On Section 89, for example they spent $2 million to demonstrate that they were in fact in compliance with that law. But contrast that with the business that my partner and I ran together in Seattle, WA. We didn't have $2 million to spend on anything. We did our books and our work on those kinds of things on Saturday afternoon or on Sunday when we didn't have to be meeting with clients and so forth. That kind of employer, if they have a plan, they throw up their hands and quit; or if they don't, they just say I just simply can't stand the thought of trying to involve myself in that complexity.

And cost is no small part of this too, because consultants don't come cheap. And even the consultants complain. We're the guys who have to deliver the bad news and we're tired of doing it.

Senator PRYOR. Speaking of people who really know this field, I know this is a sad day for you, in one respect, because your trusted aide, staff member, associate and colleague, Mr. Mac McKenney, is on his last day on the job. Now he is going into the private sector to try to interpret what we have done on the Hill. I would like to say, Congressman Chandler—and I see Mac here—he has been a very, very splendid resource for us on this committee in looking at these areas—so we share your loss in the departure of Mac McKenney, and we wish him well. And, Mac, I see you in the audience. We sincerely appreciate your contributions very much.

Congressman CHANDLER. Senator, that is very thoughtful.

Senator PRYOR. You have been very, very lucky to have a young man like this.

Congressman CHANDLER. And that is very thoughtful of you to make those comments. And I certainly agree. And I have got to tell you, we don't have a hole in our staff now. We have a crator. And if any of you up there are interested—[Laughter.]

Thank you, Senator,

Senator PRYOR. What about me?

Congressman CHANDLER. All right. [Laughter.]

Senator PRYOR. Thank you, Congressman Chandler, very much.

Congressman CHANDLER. Thank you, Mr. Chairman.

[The prepared statement of Congressman Chandler appears in the appendix.]

Senator PRYOR. We are going to call our first panel now. We have a very, very outstanding panel—Howard Golden, Elmer Van Egmond, Vance Anderson, and Paula Calimafde. Paula, I hope I pronounced that correctly. Did I?

Ms. CALIMAFDE. You sure did.

Senator PRYOR. Thank you.

Howard Golden is a partner with Kwasha Lipton, testifying on behalf of the association of Private Pension and Welfare Plans;

Elmer Van Egmond is chairman of the Arkansas State Legislative Committee of the American Association of Retired Persons. We welcome you, Elmer.

Vance Anderson is the assistant general counsel of the Allied Signal Corp., testifying on behalf of the ERISA Industry committee; and Paula Calimafde is the President of the Small Business Council of America.

We are going to ask each of our panelists this morning to limit their comments to 5 minutes. The entire body of their statement will be placed in the record. We look forward to the contributions that each of you can make to the committee. Howard, we will ask you to begin.

STATEMENT OF HOWARD J. GOLDEN, PARTNER, KWASHA LIPTON, TESTIFYING ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, FORT LEE, NJ

Mr. GOLDEN. Thank you very much, Mr. Chairman. As you stated, my name is Howard J. Golden. I am a partner in Kwasha Lipton, an employee benefits consulting firm, headquartered in Fort Lee, NJ. I am proud to serve also as chairman of the Retirement Savings Committee of the Association of Private Pension and Welfare Plans, the APPWP, which is the committee that, after a year and a half of deliberation, produced the report "Gridlock" which Representative Chandler was so kind to allude to.

We have sent a copy of this report, which is the basis for our thinking on this problem, to all members of the executive and legislative branches and respectfully request that it be part of the record today.

Senator PRYOR. Without objection.

[The report appears in the appendix.]

Mr. GOLDEN. Thank you.

The APPWP, of course, is a national trade association. Our members speak for employee benefit programs covering more than 100 million Americans on both the pension and welfare side. Of course, we are honored and express our appreciation to appear today, and also express our appreciation to the committee and the subcommittee for its interest in the simplification area, and particularly you, Mr. Chairman, for holding this hearing.

I would like to spend just a couple of minutes to summarize my written testimony and, of course, it is impossible to summarize 29 specific recommendations that appear in our report.

We have decided, after deliberation, to echo some of the comments already mentioned here that the pension system, while a great tribute to this country and to this body, is complex and is leading to employer discontent; termination of plans on both the defined benefit and defined contribution side; noncompliance, particularly with respect to small employers; and, most importantly, heavy administrative costs, paying to service providers such as outside counsel, consulting firms, and internal providers of services.

We think—and again, it has already been suggested—that the reasons for this are perhaps two- or three-fold in terms of the complexity. One is that there are taxation-driven interests, particularly with respect to the most recent legislation over the past 15 years,

as you suggested, Mr. Chairman. The other two are spelled out in the report to some extent. One we choose to call by the catchy phrase, "evil plan myopia." Perhaps this is too catchy a phrase, but it is one that simply means that a broad-based piece of legislation attacks the non-abusers as well as the abusers. And it may well be a feature of the legislation and a presumption behind it that everyone is abusing. As a result, complex material aimed at rare abusive situations becomes the law with which everyone has to comply.

The other point we attempt to express by a phrase is "computer omniscience." Much of the legislation, we believe, has the assumption behind it that it is easy to comply with some of the administrative matters occasioned by the legislation.

Now, although we have 29 recommendations, since we are happy to confine our remarks to 5 minutes, I would like to give you two or possibly three stories to reflect the tenor of our detailed recommendations. And, of course, we look forward, if asked, to working with the committee with respect to all of them.

One is something that seems as American as apple pie, and that is the determination of who is a highly compensated individual. I have become more of an expert in this than I care to be, but, technically, there are four separate ways of determining a highly compensated individual. Such an individual is one to whom the tests of nondiscrimination apply.

We have small clients throughout the industry that are unable to determine, based on the complexity of those tests, who such individuals are, and are throwing up their hands in despair, both in terms of the numbers of such individuals, and the years and compensation to be taken into account.

Another representative story—and again, this is based on a personal experience I had with a large company within the last 2 weeks—there is a 71-year-old secretary of an executive who is faced with the consequence of receiving a plan distribution under the rules that require that active employees receive distributions beginning at age 70½. Because the company maintains a number of plans, there are so many technical issues involved in terms of the nature of the taxation and the interrelation of the payments that she has suggested, Mr. Chairman, that it might well be better for her to retire than to invoke the ire of the IRS were there to be a mistake in the tax consequences occasioned by a bad choice.

And I see that the time has concluded. We are very much interested in these types of things, in the simplification of annual reporting and other documentation that I know is a big concern of the subcommittee, and in the elimination of multiple and redundant tests without attacking what we consider to be generally the valid policy behind it.

Thank you for the opportunity to speak, Mr. Chairman.

Senator PRYOR. Mr. Golden, thank you. I have a few questions. I think on those examples of individuals, real live stories, I hope that you will please feel free to put any further examples that you would like to share with us into the record. We look at those personal case histories and at the problems they present. They help us see what we should do to prevent some of the abuses and also some of the inconsistencies in the system. We thank you very much for your contribution.

Mr. GOLDEN. Thank you, Senator.

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

Senator PRYOR. Elmer, we welcome you to Washington and look forward to your statement this morning.

Dr. VAN EGMOND. Well, thank you.

Senator PRYOR. I hope you watched Arkansas defeat North Carolina last night. [Laughter.]

STATEMENT OF ELMER VAN EGMOND, PH.D., CHAIRMAN, ARKANSAS STATE LEGISLATIVE COMMITTEE, AMERICAN ASSOCIATION OF RETIRED PERSONS, LITTLE ROCK, AR, ACCOMPANIED BY DAVID CERTNER, LEGISLATIVE REPRESENTATIVE, AMERICAN ASSOCIATION OF RETIRED PERSONS, LITTLE ROCK, AR

Dr. VAN EGMOND. Thank you. My name is Dr. Elmer Van Egmond and I am chairman of the Arkansas State Legislative Committee of the American Association of Retired Persons. With me this morning is David Certner of the Federal affairs staff.

Senator PRYOR. David, we welcome you.

Dr. VAN EGMOND. I am pleased to represent AARP today on the important issue of pension simplification. First, I would like to thank the chairman, particularly for your lead sponsorship of the bill to restore age discrimination protection for older workers' benefits. And I have also personally attended your hearing in Arkansas on limiting increases in prescription drug costs and improving long-term care. We certainly laud you for those efforts.

The association commends this subcommittee for attempting to improve the pension system by simplifying the pension laws. Simplifying pensions with the largest single Federal tax subsidy and the largest pool of money in the world is truly a challenge. The association strongly believes that simplification efforts must achieve a three-way balance among plan sponsors, plan participants and pension and tax equity.

Simplification should further pension equity and ensure that plan participants, particularly lower paid employees, are not adversely affected.

In addition, simplification should ensure that tax subsidized benefits do not primarily benefit higher paid employees.

It has been said that nothing simple is fair and nothing fair is simple. And this is certainly true of pension law. For example, if simplicity were our only concern, we could merely allow one specific plan formula for all plans. Of course, this is not consistent with the flexibility which a plan sponsor desire nor with the needs of a diverse workforce. However, it is just this desire for flexibility which leads to lengthy pension rules.

To achieve simplification, the association believes that flexibility and not equity should give ground. The association suggests the following changes, which should simplify plan design and understanding, as well as meet pension equity goals.

First, eliminate pension integration. The practice of coordinating pension benefits with Social Security benefits permits unfair reductions in pensions. This complex and inequitable rule was partially rejected in tax reform. The new test, although an improvement, is still overly complex and still permits pension reductions for lower

paid employees. To simplify the pension system for employer and employee, and to improve pension fairness, pension integration should be eliminated entirely for all employees.

Second, modify the pension coverage rules. The coverage rules, also very detailed, were improved in tax reform, but the new tests also continue to permit plans to exclude a certain number of employees from coverage. The association, therefore, recommends modifying the coverage rules to simply require an employer to cover in any one facility 100 percent of the employee's earning under the Social Security wage base. This test is simpler in application and will increase pension coverage for those who may now be excluded.

This simplified rule was originally proposed by Senator Heinz in the 99th Congress.

The association believes that some aspects of pension law are more difficult to simplify because of equity considerations. One example is the top heavy rules which ensure that if a substantial portion of benefits go to higher paid employees—over 60 percent—then fairer benefits must be provided to lower paid employees. In particular, these important rules generally improve pension delivery in small plans by ensuring faster vesting and minimum benefits.

Instead of repealing or modifying rules that have been shown to provide important benefits, the association urges this committee to pursue alternatives, such as model plans. Small employers could then adopt these model plans which would ensure adequate benefits to lower paid employees without the necessary testing. This will achieve both simplicity and equity.

A second set of important rules are the so-called ADP test for 401(k) plans. These rules require that where significant 401(k) contributions are made by higher paid employees, lower paid employees receive comparable benefits. 401(k) plans have experienced tremendous growth in the past few years. These rules are essential to maintain equity and ensure that lower paid employees receive adequate benefits.

In conclusion, the association is prepared to work with this committee to pursue simplified alternative tests in this area as well as in other suggested aspects of pension law. However, any new test should continue to ensure that lower paid employees participate and receive their fair share of benefits.

Thank you.

Senator PRYOR. Dr. Van Egmond, thank you very, very much. We appreciate your coming today and thank you for your suggestions. I will have a couple of questions relative to your statement.

[The prepared statement of Dr. Van Egmond appears in the appendix.]

Senator PRYOR. Now, Mr. Vance Anderson, who is representing the ERISA Industry Committee, we appreciate you coming today, Mr. Anderson.

STATEMENT OF VANCE J. ANDERSON, ASSISTANT GENERAL COUNSEL, ALLIED SIGNAL, INC., TESTIFYING ON BEHALF OF THE ERISA INDUSTRY COMMITTEE, MORRISTOWN, NJ

Mr. ANDERSON. Thank you, Mr. Chairman. As you pointed out, I am here today on behalf of the ERISA Industry Committee, and my remarks and my comments will reflect the views of ERISA.

Over the past decade, Congress has seen fit to enact a virtual torrent of legislation affecting private-sector employee benefit plans. I must say that ERISA has found itself in the position to support the aims and objectives of much of that legislation, but we have also concluded after the fact that the result has been to generate hundreds of pages of technical, convoluted, difficult if not impossible to understand, statutory requirements in the Internal Revenue Code.

The result from our experience has been to cause dramatic increases in the cost of plan administration and compliance. We have created confusion among plan participants, and many, many plan sponsors feel extremely uncertain about their ability to comply with these new legal requirements.

As a result, the formation and continuation of benefit plans has been discouraged. We have produced, in the final analysis, a regulatory log jam at the Internal Revenue Service which has left many of us in the plan sponsor community virtually incapable of determining what course to follow if we want to comply with the statutory requirements.

We would agree with you, Mr. Chairman, that complexity in the Code, complexity in the regulatory scheme that governs benefit plans is a distressing problem. We would urge the committee, however, to be wary of simplistic solutions to the extent that they fail to enact reasonable practicable rules that people can live with.

Simplification for its own sake may not be the answer. Simplicity that can produce fairness and that can remove the instability and uncertainty that now exists in the system for both sponsors and participants is indeed a desirable goal.

Constant change is in itself an impediment to providing stability for participants and plan sponsors. The complexity that we have been dealing with results as much from the frequency of recent change over the last 10 years as it has been a result of the text of those changes.

Let me also point out, Mr. Chairman, that as much as we laud the goal of simplifying the statute, we nonetheless will continue to be concerned with the substance of those changes.

We believe that it is important to maintain reasonable integration rules that relate to private defined benefit plans and the degree to which those benefits may be integrated with Social Security benefits. We also believe it is important to retain the ability for private plans to receive after-tax contributions from its employees, as well as to provide that these plans may provide retiree medical benefit coverages.

Some individuals have proposed in the name of simplicity that some or all of these provisions be struck from the Code. We, of course, do not believe that that is the case.

Let me suggest to you that our own list of items that you might want to consider for simplification is co-extensive with the items that I suspect others may well choose to propose to you.

We think that, generally speaking, you should consider any area that can be identified for removing the constraints that presently are imposed on plan sponsors with respect to the benefit design issues generally. We would urge that you consider cost when you are looking at these proposals. We would certainly urge that the Congress consider more realistic—that is to say, longer effective dates—for any new proposals that are enacted. We would also urge that you seriously consider taking whatever hand you can take with the Internal Revenue Service to convince them to allow taxpayers to act on a reasonable, good faith interpretation basis of any new statutory requirements that you may wish to levy prior to the date that they are in a position to offer us final regulatory directions.

Finally, may I suggest to you that it would be our strong conviction that to the extent that Congress sees fit to delegate to the Internal Revenue Service legislative powers to regulate; that the Service should be following the Administrative Procedures Act, that is to say, provide notice of an opportunity for hearing before they promulgate regulations under those delegations.

Thank you, Mr. Chairman.

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

Senator PRYOR. Mr. Anderson, we will put the full text of your statement in the record. We appreciate you being here this morning, and thank you for your statement.

Paula, we look forward to hearing your statement. Thank you for being with us.

STATEMENT OF PAULA A. CALIMAFDE, PRESIDENT, SMALL BUSINESS COUNCIL OF AMERICA, WASHINGTON, DC

Ms. CALIMAFDE. It is a pleasure to be here today.

I am here on behalf of the Small Business Council of America, the Small Business Legislative Council, and the National Association of Women Business Owners, and as such represent the interests of literally millions of small businesses across the country.

We strongly support your effort to promote the voluntary private retirement system through simplification.

There is no question that the onslaught of legislation that has occurred over the last decade is having an adverse impact on the retirement plan system, and, unfortunately, the quest for short-term revenue is taking its toll on the system as is the piecemeal legislation.

Wilbur Mills, you may recall, said that "Tax legislation should only be passed every 15 years." This would give people enough time to learn what the law was, deal with the law, and you'd get certainty, you'd get compliance, you'd get clarity. I think Wilbur Mills was right, and I think we have got to go back, maybe not to a 15-year spread but even 3 or 4 years would feel mighty good at this point.

The situation is exacerbated by IRS. There is just no question that the regulations coming out from IRS are often untimely, often retroactive, and I hate to say it, but they are basically unintelligible. The system has now confounded the best and the brightest. And these are people who do nothing but pension law. They don't know what's going on. Anyone who is really honest will admit to that. I think it is even true at Treasury and at IRS; they don't know what's going on, and that's why something has got to be done to get the system back to where it was 10 years ago.

New plans are down 70 percent over the last 8 years. That's new plan startups. And plan terminations are up 100 percent over the last 9 years. This is based on IRS data. And this data may not even tell the whole story on plan terminations because you don't have to request letter rulings from IRS on a plan termination.

So those numbers prove what we are all saying, that the uncertainty in the system and the complex legislation which is adding increased costs, are taking their toll.

There is another side of the picture which is that benefits have been slashed in the system, and I cannot weigh which one is impacting it more at this time. But, clearly, you have a unique opportunity to get the system back on track in the simplification area without adversely impacting revenue to any great extent, and without adversely impacting the reforms underlying most of the legislation.

The system did work 10 years ago. Small business was adopting plans in record numbers. There was clarity. There wasn't these tremendous bills to the lawyers and other pension administrators. The system was really working and it was working in large part because the rules were clear.

In our paper I have set forth a number of specifics that would simplify the pension laws. Many of these suggestions have been derived from the excellent paper prepared by APPWP, "Pension Gridlock." Others are derived from an excellent paper by David Kautter for the American Bar Association and AICPA.

I think they are specific and they set out the changes. I just want to address a few, and I want to highlight some assumptions that seem to be sort of creeping around the edges in the small plan area. I want to challenge the tax writers here because there is an assumption that a small plan is some sort of an evil or a tax shelter for lawyers and doctors. And there doesn't seem to be any other small business out there but lawyers and doctors in the minds of the tax writers. Apparently because small business is not pyramidal—there's not a whole lot of staff employees for the top management—that somehow the plan isn't as good; that because it provides benefits for the key employees or the owners, as well as all the rank and file employees, it is still not as good as a large business plan. This evil reference is incorporated in the top heavy rules, where 60 percent of the benefits are going to the owners and key employees—well that is simply mathematics. Virtually all small businesses have top-heavy plans because of the way the test operates. And there is nothing evil in it. I would like to suggest to the committee that these plans in the small business area are providing a tremendous service as far as giving retirement security to

all rank and file and key employees, and in many cases are very generous plans.

How long small business will continue those plans, I don't know. The costs are escalating. Benefits are dropping. And as you may know, there is this audit program going on with IRS right now against small business defined benefit plans which was singled out in the President's budget to raise $660 million over 2 years. Well, I can tell you, if I was a small business owner I would not sponsor a defined benefit plan if I knew I was "buying an audit" because audits are expensive. A small business does not have the deep pocket necessary to litigate.

So, hopefully, your attempts to simplify will work, and, hopefully, IRS will stop this witch hunt as far as these audits, and I think then the system can start rolling again. Thank you.

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

Senator PRYOR. Thank you very much, Paula.

Speaking of simplicity—and all of you have mentioned that—I have received a letter today from the Pension Rights Center, with their suggestions, which I will include in the record.

[The letter appears in the appendix.]

Senator PRYOR. Also, I will include the contents of a brochure from the Pension Rights Center, entitled "The Pension Plan Almost Nobody Knows About."

[The brochure appears in the appendix.]

Senator PRYOR. Let me ask Mr. Golden this. In 1986, it seemed like we spent about 4,000 hours in this room on the tax reform bill. It was the first major tax bill I went through on this committee. Since that time, we have been waiting for the Treasury Department to give us rulings or regulations for most of the changes we made in the pension area.

Now, why does it take them so long? What is the holdup? How can we force them to do something? What should Congress do?

Mr. GOLDEN. Well, Mr. Chairman, I think that, first of all, it is appropriate to say that there are people in the Internal Revenue Service and Treasury Department who are trying hard to meet deadlines, and are aware of the detailed requirements that necessitate delay. On the other hand, our statement, in appendix B, shows a listing of regulations that were supposed to be out over 2 years ago and are not yet out. And our statement in appendix C, shows some of our interactions with the Secretary of the Treasury in terms of attempting to cause a diminution in employer anxiety about what these rules are going to say.

I think that it may well be the case that oversight by this committee could relate to the fashioning of regulations on a more timely basis and on a more equitable basis, and particularly with respect to the Tax Reform Act regulations, enable—either through legislation or through oversight—some kind of guarantee that, for years that have passed, the requirements of the Tax Reform Act will not be retroactive. Particular issues relate to plan years beginning in 1989, both in terms of complex aspects of the integration rules, and complex issues of the coverage rules where we don't have all the answers yet. It is not clear to us that the Treasury, although working in good faith, is going to give employers and em-

ployees some certainty that what they have done up to now is okay until the regulations come out.

Senator PRYOR. I don't think any of us in Congress realize how many individuals have to sign off on a regulation, how many desks that a regulation is ultimately going to have to cross, or how long it stays on each desk. Ultimately, I guess it goes to Dick Darman's desk at OMB.

One day I think it might be of interest to ask all of those in the IRS to come to the committee just to get an idea of how many people are involved in the issuing of a regulation.

And I imagine it would fill this room several times.

Any comments on that?

Mr. GOLDEN. I completely agree, Senator. And I also feel that, from my many years experience in the field—and there may be good policy reasons for this—but there is a duplication of effort in terms of both the IRS and the Treasury working on a particular regulation that has to go within both bodies for various types of internal review before it gets to the higher regions of the Treasury Department.

I want to emphasize that the IRS and Treasury have attempted to issue the regulations, but the task was well beyond their capacity and they have not performed sufficiently to enable employers plan participants, and beneficiaries to have clarity about the situation now.

Senator PRYOR. Paula, you mentioned pretty alarming facts about the number of pension plans that are terminating on how few new pension plans are being started. Is that because of the confusion or the fear of doing something wrong, or is it just pure disillusionment with the system?

Ms. CALIMAFDE. I think it is two different things. I think the first is the fear of not knowing what the laws are, coupled with the cost. Because as things get more complex, normal business owners cannot rely on themselves to do the work any more in the small business context. So they have got to go out to the specialists. And in many cases, the specialists are saying this is the best I can give you. This may not be the law either. And it is hampered by the way IRS is currently operating. For instance, IRS right now is apparently working on regulations on Section 401(a)(4) which is the underpinning of the whole retirement plan system. Congress has not asked them to work on those regulations. This is sort of a gratis act on their part. What is happening is that companies who sponsor these retirement plans are being told at major conferences by IRS spokesmen that there is going to be a major change in the law and it is going to be imminent. Well, we have heard this since last spring. And if you are running a retirement plan, and you know there is going to be some major change but you don't know what it is, then how do you operate your plan? This is the context in which companies are attempting to operate their retirement plans. Now, of course, I have to be honest with you, Senator. Benefits have also been cut back. So as costs go up and benefits go down, you know, there are a lot of companies saying we can do better by just skipping the whole retirement plan system here.

Senator PRYOR. All right.

How can we reduce paperwork for small businesses? How can we do this?

Ms. CALIMAFDE. Well, the steps outlined in the APPWP report and the steps that we have also outlined in our written testimony would go a long way. There is a lot of complexity that is really unnecessary because of the phobia of abuse, on the part of staff tax writers. For instance, this highly compensated employee definition, it is 94 lines to decide what a highly compensated employee is. Well, you and I would say a highly compensated employee is somebody who makes more than X dollars. And that's it. And it doesn't matter if they are an owner. And if they are making $30,000 and they are an owner, why should they be highly compensated?

So just by simplifying, getting to the meat of what was intended will go a long way in this area.

Senator PRYOR. Thank you.

Dr. Van Egmond referred to a recent General Accounting Office report which I am going to have printed in this record. I think it would be a real addition to the record. I would like to read just a couple of sentences from it and I would like all of you, if you would, to comment on it. And I quote: for a participant who would have lost vesting status had top heavy rules not been replaced by the Tax Reform Act rules, the effect on retirement income would likely be small and would occur only if she or he left the job before fully vesting. End of quote.

[The GAO report appears in the appendix.]

Senator PRYOR. Now, my question is: what does this mean in real dollars? What are we talking about here, if we could take some of those cases, for example, that Mr. Golden is going to share with us for the record? What does that mean in real dollars who has had 4 years of service, for example?

Mr. Certner, if you want to help and participate in this answer you are welcome.

Dr. VAN EGMOND. I think I would defer to Mr. Certner on that.

Mr. CERTNER. In many instances, we are talking about small additions to retirement income. But I think we have to remember who the people are that we are talking about. We are talking about the lower paid, shorter service employees. And these are the people who are least likely to earn a pension, the least likely to earn a sufficient pension. And we think that anything we can do to help bring these people who are on the bottom up—and these people generally tend to be some women minorities who are in and out of the work force—anything we can do to help them meet retirement income needs will be certainly a benefit. And we are talking about a $2 trillion pension system. And we think it is important that we help those people on the bottom have a chance to earn an adequate retirement income.

Senator PRYOR. Thank you.

Are there any other further comments on the GAO statement? Yes, Paula.

Ms. CALIMAFDE. Mr. Chairman, I would just say that in the top heavy rules, if you are technically expert in the area, they really only do two things at this time because of the reforms that have been put in the system over the years. In some cases, they give an employee a slightly higher defined benefit minimum accrual in a

defined benefit plan. But I am afraid that issue is more or less moot because there are really very few small business defined benefit plans left. And I think; after this next go around there will probably be none left.

The other thing that the top heavy rules do is that they provide for a 3-year cliff vesting instead of a 5-year cliff vesting.

Now, if that is what we are really concerned with in the top heavy rules, then it seems to me you can junk the top heavy rules and simply put in a provision that says if you have got a plan with fewer than 50 participants then the plan must have 3-year cliff vesting if it is going to have cliff vesting at all.

Technically, you have done it all at that point. And I think that that is the kind of simplification that again would go a long way in this whole area.

Senator PRYOR. Are there any further comments on that? Mr. Golden?

Mr. GOLDEN. Mr. Chairman, I want to associate my feeling with those just expressed. Our paper suggests, and I think many employees in our association both large and small feel, that the Tax Reform Act change to 5-year vesting, which is generally being used rather than the graduated vesting took care of most of the top heavy problems.

But even if it is a good thin to retain top heavy as a separate policy for small employers, we also suggest that certain aspects of the technical top-heavy rule can be modified to eliminate administrative complexities, such as eliminating a 5-year look-back rule in determining who the key employees are and so on. This is much beyond the need and also the abilities of the small employers to whom it is addressed.

And if I may, Senator, one very brief further comment. This whole GAO report raises the issue of the difference between simplification and policy. We have not attempted to usurp or even advise Congress' function with respect to policy.

There are good or bad reasons for integration, for example. I happen to think there are good ones, but there are arguments on both sides. What we are simply saying is whatever the policy is, it can be made more simple.

Senator PRYOR. Mr. Anderson in your statement you state you believe that repealing the integration rules would—and I quote—"impair the ability of employee benefit plans to operate effectively."

Why is this, Mr. Anderson?

Mr. ANDERSON. Mr. Chairman, let me qualify my remark if I was misunderstood.

I think that the charges, if we remain in a situation, where the Service is incapable or unable to come up with the regulations that we need to implement or to tell us what proper compliance is with the integration rules, then it would seem to me that the 1986 amendments to those rules should be repealed, and we should go back to the requirements that were in existence prior to 1986 with respect to permissible integration.

It strikes me that integrating the benefit structures between Social Security, or the Social Security benefit and the private benefit, allows participants and employers to come up with a salary re-

placement ratio which is rational and makes sense. Now, if Congress feels that it is appropriate to put some limitation on the percentage of the private plan benefit that can be offset or reduced because of the Social Security benefit, that makes good sense. But let me submit to you Mr. Chairman, that I think Congress tried to come up with that new rule almost 4 years ago, and whatever they did, either the Services doesn't understand it or we don't understand, or it just didn't get put down the right way. And it is a problem that ought to be remedied.

Senator PRYOR. You know, listening to this panel, I don't know why anyone today would try to establish a plan for their business, small or large. One thing that we did in the 1986 Tax Reform bill which I did not like was to make some requirements retroactive. I felt that was very bad policy. Mr. Anderson talks about some degree of retroactivity. He also mentions allowing some reasonable good faith interpretation of the statute by businesses until 6 months after the issuance of final regulations. Would this help to give some degree of assurance to employers who are looking at the possibility of setting up a plan?

Ms. CALIMAFDE. I think it would give a lot of assurance. It would also be helpful if IRS would stay within the guidelines that Congress has given it, because in a lot of cases they are just legislating. And the area is so technical that few people in Congress are aware of what is going on.

Senator PRYOR. I am very interested in your statement on the IRS legislating. If you, Paula, or if any other of our panelist this morning could cite some examples of this, I would appreciate it. I would like to ask the IRS to respond to this practice.

Ms. CALIMAFDE. I would be glad to.

Senator PRYOR. I am concerned that they are doing this. If you have any examples, I would appreciate your giving them to the committee.

Senator PRYOR. We are going to move on in just a moment. I want to ask one question on safe harbors. What about safe harbors for small plans as substitutes for the current top-heavy rules or other areas of particular concern, especially to smaller plans? Any further comment on this? Mr. Certner.

Mr. CERTNER. Senator, we would support changes like that in addition to some of the rules that already exist. And I think what we have said in our statement is instead of repealing rules that provide real benefits to some lower paid persons, what we should try to do for the small businessmen is to give them some simplified models or simplified plans that they can follow so that they can avoid the complexities.

Senator PRYOR. You are talking about a prototype plan?

Mr. CERTNER. Prototype plans, I think you had a booklet that you showed before that talked about simplified employee plans that can provide benefits without the complexities so we can ensure both equity and simplicity at the same time, and we would support pursuing those efforts.

Senator PRYOR. Thank you.

Ms. CALIMAFDE. Mr. Chairman, can I make a comment on that?

Senator PRYOR. Yes, Paula.

Ms. CALIMAFDE. Model plans are portrayed as a solution to the complexity problem, but in reality, the plan itself is very seldom the problem. It is the rules that underline the plan that are the problem. Someone can hand me a very simple plan, but if I still don't know how to get benefits out of that plan and I don't know how to get contributions into that plan, the fact that the plan itself is simple really makes no difference. The simplification efforts have to go far beyond simply a set of model plans. That won't do it, in my opinion.

Senator PRYOR. Thank you, Paula.

Are there further comments from this panel?

[No response.]

Senator PRYOR. We want to thank you on behalf of the committee for being here today and sharing your thoughts with us. And we will have your full statements, as I have stated, in the record. Also, we would appreciate the additional information we requested which will help us in our discussions. Thank you very, very much.

We are going to call our next panel, please.

This also is a distinguished group of Americans. Dallas Salisbury, the president of the Employee Benefit Research Institute. Mr. Salisbury is certainly no stranger to this committee, and we appreciate him as we appreciate all of you.

David Kautter, national director of Compensation and Benefits Tax Service, Ernst & Young, testifying on behalf of the American Institute of Certified Public Accountants; James Holden, Steptoe & Johnson, testifying on behalf of the American Bar Association; and Andrew Fair, Fair & Aufsesser, testifying on behalf of the American Society of Pension Actuaries.

We will ask Mr. Salisbury to go first. We would respectfully request your statements be limited to 5 minutes each. The full body of your written statements will be placed in the record.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Mr. SALISBURY. Senator, it is a pleasure to be here this morning. I would just summarize a couple of brief points.

First, I would underline that the biggest problem vis-a-vis the plan growth and decisions of employers to start plans with very frequent legislative and regulators change, very frequently comes down to the absence of individuals going out and asking employers to start new plans. If the people at companies are spending all their time trying to figure out how to comply, they are not out marketing. And much of the history of these plans, vis-a-vis small employers, has led small companies to set up a plan to begin with is somebody coming in and taking the time to explain to them why, how, the advantages, et cetera. If they never get a visitor, or if the only visitor the individual sees now is the accountant, and he says, "now, understand that there are several thousand pages of regulations that we will have to review before we take this step," it doesn't exactly encourage plan creation.

The legislation enacted clearly has increased benefit security, but it has moved us toward complexity and the loss of flexibility. And I would underline that on the last panel there was some discussion

of whether or not pension integration should be allowed. Setting aside the merits of the argument, the presence of integration allows companies the flexibility to make choices in plan design. Eliminating integration might well lead some companies that would otherwise have pension plans to say they are not going to have one at all. I would underline the difference between policy and the complexity issue. I think the witnesses were on both sides of that.

If we look at the system as well, it is interesting to note that while Congress is consistently looking at new legislation, and while the IRS is moving forward on proposals, the fundamental environment around pension plans and why people might or might not want them has changed fairly fundamentally.

For the small businessman some years back who was at a 70 percent marginal tax bracket, putting in a pension plan had significant tax advantage. At this point, with rates much, much, much lower, the economic value has significantly dissipated. And without wanting to argue with any of the prior witnesses, the fact is that with small businesses the tax angle is an exceptionally important one. Lower dollar limits have reinforced the effect of lower tax rates. First, I lower the tax rates, then I significantly lower what the individual can put aside. Then I lower the contribution capabilities with a 150 percent funding limitation. And as one of the last witnesses noted, then I go, as the IRS is now in the eyes of many, contrary to years of regulation, and saying retroactively to small businesses, you used the wrong interest rate assumption even though the regulations implied you were using the right one. And at that point, the small number of small businesses still having pension plans get to the point of putting up their hands and literally saying, why am I doing this anyway when there is no financial advantage for me? The businessman and the degree to which I can deliver benefits per dollar of administrative expense is constantly becoming a less favorable ratio.

And I underline that particular ratio. How much it cost me to have a plan, not contributions, but just purely what I pay, to actuaries, to lawyers, to investment people, to the accountants. The proposals the administration sent to the Hill this week which would increase the financial burden of the audits on individual plans will further aggravate that relationship such that the result on small business—now only 16 percent of workers in the very smallest businesses having pension coverage—we should expect that to dissipate. And, frankly, if policy stays the way it is we should presume that that is an objective of policy or at least a known result of policy.

I think the other point, vis-a-vis the last panel, that I would just underline is at times we seem to be losing sight totally as to why we have got any of this stuff in the law anyway. The last witness, one of them noted that if we did away with integration and required 100-percent coverage that the individual down there that is a sporadic worker, part-time worker, would be able to have pension coverage. I submit to you that it would be meaningless for that person to have pension coverage in the scheme of current law. We allow lump-sum distributions. We allow mandatory distributions for an amount of $3,500 or less, and the evidence of faster vesting,

3-year vesting, and top-heavy plans, low-income workers is that it does not produce pensions. It does not produce retirement income. It very effectively produces small severance payments for individuals. Is the objective severance payments? If so, we are moving well in that direction. But if the objective is supplementation of Social Security and retirement income, we are spiting ourselves at each turn. And if we look at what the administration is now talking about, setting aside its merits on a stand-alone basis of a family, savings account which would allow the ability without any or this hogwash, to be pejorative, to set money aside, and then if we look at proposals the administration says they are going to put forward on tax integration that would make dividend and interest payments non-taxable to any entity, let alone a pension plan, suddenly one of the final financial advantages for companies to have pension plans on top of contributions is eliminated while nothing will have been done to decrease the administrative cost of dealing with these.

So I just, in conclusion, note that I think it is time for a step back review of the way all of our tax policies interact in this area, and an understanding that changes that have nothing to do with pension programs are fundamentally affecting the equation of whether a business wants to have one. Thank you.

Senator PRYOR. Thank you, Dallas.

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

Senator PRYOR. David Kautter, we appreciate your being here this morning.

STATEMENT OF DAVID J. KAUTTER, NATIONAL DIRECTOR OF COMPENSATION AND BENEFITS TAX SERVICE, ERNST & YOUNG, TESTIFYING ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. KAUTTER. Thank you, Mr. Chairman, for the opportunity to testify on a subject of considerable importance to the American public and to our membership. I am David Kautter, chairman of the Employee Benefits Taxation Subcommittee of the American Institute of Certified Public Accountants.

Our testimony is from the perspective of CPA tax practitioners who constantly observe the conduct of taxpayers, both individuals and businesses.

The rules governing the taxation of private retirement plans have become increasingly intricate and complex over the past 15 years and we believe that they now rival any other area of the tax law in their complexity. In our opinion, his complexity is now at a point where it is adversely affecting both the private pension system itself and the administration of the tax system, and we believe this is an unhealthy state of affairs.

Specifically the current rules are having three adverse effects.

First, they are discouraging the establishment of new plans and encouraging the termination of existing plans. Employers without qualified plans, primarily small employers, are discouraged from establishing new plans because of the cost of establishing and maintaining arrangements which they cannot understand. Employers with existing qualified plans have grown weary of continuously

amending their plans with provisions that they cannot understand and which do not, to them, seem to enhance employees' retirement security.

We will, Senator, in response to your request to the first panel, submit some specific examples of terminations, which have occurred as a result of this complexity.

Senator PRYOR. The committee would appreciate those examples. Thank you.

Mr. KAUTTER. Second, the current rules are diverting more money toward plan administration and less toward actual benefits to plan participants than would a simpler system.

Third, the current rules are resulting in increased noncompliance, both intentional and unintentional. We believe this last trend is a particularly dangerous one since it not only means that our voluntary compliance system is diminished, but it means that taxpayers who attempt to comply with the law are at a competitive disadvantage with those who do not.

In the retirement plan area, as in other areas of tax policy, a balance must be struck between simplicity and equity. Equity usually comes in the form of nondiscrimination rules in the pension area. The size, shape, and scope of undue complexity are elusive and relative concepts, but it is clear that in reducing the complexity implicit in some of the current pension rules, some equity of current law will be lost. In simplifying other areas of the pension rules, however, equity will be enhanced. We believe the goal is to find the right balance between inhibiting as much discrimination as possible while utilizing rules that can be broadly understood and implemented, and which encourage employers to establish and maintain qualified pension plans. We also believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the tax policy objectives of current law.

We propose that as Congress looks at this area in the upcoming months it use the following test to guide it in determining which rules of existing law should be retained and which should be changed.

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

Although that test is easy to state, answering it in many cases will not be easy. In some cases, reduction of complexity will not involve a re-examination of the tax policy underlying the current rules. In others, tax policy re-examination will be required and may involve accepting, as a society, some incremental discrimination or enhanced equity beyond that which is currently provided. It may also involve accepting less flexibility on the part of taxpayers in the design and operation of tax-favored pension arrangements. These choices may not be easy for some to accept.

In applying our test, we would urge you to follow two general principles. First, completely eliminate rules which do not meet the test instead of trying to patch them up in ways that will only add more complexity. Second, use design based rules whenever possible in order to avoid detailed testing rules which add to uncertainty and plan administration costs.

As to specific proposals, my written testimony identifies 23 specific proposals which we believe would substantially simplify the

qualified retirement plan rules while retaining substantially all the underlying legislative policy behind current law.

Unless the complexity of the retirement rules is reduced, the trends of increasing plan termination and refusal to establish plans are likely to continue, increasing noncompliance, both intentional and unintentional, is likely to continue, and we will end up with a weakened private pension system. We would be glad, Senator, and enthusiastically look forward to working with you and your staff on specific proposals in this area. Thank you.

Senator PRYOR. Thank you, Mr. Kautter. We appreciate very much your statement and your suggestions, especially the 28 or 29 of them.

Mr. KAUTTER. Twenty-three.

Senator PRYOR. We will look at each and every one.

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

Senator PRYOR. Now, representing the American Bar Association, Mr. James Holden. We appreciate your being here, Mr. Holden, and look forward to your statement.

STATEMENT OF JAMES P. HOLDEN, ESQUIRE, STEPTOE & JOHNSON, TESTIFYING ON BEHALF OF THE AMERICAN BAR ASSOCIATION, ACCOMPANIED BY MARK DRAY, CHAIR OF THE EMPLOYEE BENEFITS COMMITTEE OF THE SECTION OF TAXATION, AND STUART LEWIS, CHAIR OF THE EMPLOYEE BENEFITS COMMITTEE OF THE SECTION OF TAXATION SUBCOMMITTEE ON PROPOSED PENSION LEGISLATION

Mr. HOLDEN. Thank you, Mr. Chairman. My name is James Holden. I am chair of the section of taxation of the American Bar Association and I am testifying today on behalf of the American Bar Association. I am accompanied by Mark Dray, who is chair of the Sections's Employee Benefits Committee.

Senator PRYOR. We welcome you, Mr. Dray.

Mr. HOLDEN. And by Stuart Lewis who is chair of our Subcommittee on New Pension Legislation.

Senator PRYOR. Mr. Lewis, thank you for coming.

Mr. HOLDEN. We are pleased to have this opportunity. The association is deeply committed to the principle of reducing the complexity of the Internal Revenue Code and there is no portion of the Code where that is more required than the employee benefit area.

The rules governing private pension plans have become far more complex than is necessary. The adverse effects include increased employer costs, reduced employee benefits, increased costs for the Government and noncompliance by both employees and employers.

We believe that there are several areas for immediate improvement and these involve statutory simplification, regulatory simplification and paperwork simplification. Under the heading of statutory simplification, we are concerned with the qualification rules, the taxation rules, and the funding rules.

With respect to the qualification rules we believe that the definitional terms, the discrimination tests, the contribution and benefit limitations, and the distribution requirements all create more complexity than is necessary to carry out their basic purpose.

I am happy to say that individual members of the tax section are now working with the staff of the Joint Committee on Taxation to develop simple alternatives to these complex requirements.

With respect to the taxation rules, complexity is particularly onerous because it falls directly on employees since they are the individuals who have to pay those taxes rather than the employer.

Our written statement identifies five areas that require congressional attention in this area. With respect to the funding rules, we believe that complexity seriously impedes the adequate and level funding of retirement plans.

Under the heading of regulatory simplification, we believe that encouragement from Congress will be very helpful. We applaud the current efforts by Commissioner Goldberg to achieve regulatory simplification. And we are also greatly heartened by the fact that Assistant Secretary Gideon has created the new position within the Treasury of Benefits Tax Counsel, and that that position will be filled by Thomas Terry who is a nationally recognized expert on the subject of employee benefit law.

Our written testimony, again, identifies four areas that we believe justify simplification in the regulatory area. Under the heading of paperwork simplification, we believe that the reporting and disclosure requirements as they currently exist are in great need of streamlining. Our written testimony, again, identifies specific contributions in this particular area.

Our recommendations are that Congress enact this simplifying legislation, and we applaud the chairman and this committee for its interest in that area. There are six principles that we would like to call to the committee's attention. First, we urge that the legislation avoid excessive concern over hypothetical and very limited abuses. Too often the legislative draftsmen seek perfection.

Second, simplification should be a priority goal and not merely a by-product of other legislative attention.

Third, we urge that the Congress minimize the short-term revenue considerations. We recognize the great concern about revenue neutrality in today's tax legislation. On the other hand, this particular system demands long-term rather than short-term thinking.

Fourth, we urge Congress to refrain from frequent modification of the law. We recognize that we are here urging changes and at the same time making that statement. On the other hand, after simplification has been achieved, a period of relative repose would be greatly welcomed.

Fifth, we urge the Congress take steps to encourage the regulatory agencies that administer the ERISA provisions to stress simplification.

And, finally we recommend that any changes in this area be made prospective only to avoid the reliance problems that other speakers have mentioned this morning.

In the face of all of this, the tax section looks forward to working with you and your staff. Our goals are to maintain the essential soundness of the existing system, to work to improve and simplify it, and to educate our members and the public that has to work with the system to operate within it.

And we thank you for your interest in this subject.

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

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

Senator PRYOR. And now from the American Society of Pension Actuaries, Mr. Andrew Fair. Mr. Fair, we appreciate you being here this morning.

STATEMENT OF ANDREW J. FAIR, ESQUIRE, TESTIFYING ON BEHALF OF THE AMERICAN SOCIETY OF PENSION ACTUARIES, WHITE PLAINS, NY

Mr. FAIR. Thank you, Mr. Chairman.

My name is Andrew Fair. I am an attorney and co-chairman of the Government Affairs Committee of the American Society of Pension Actuaries. ASPA is an organization whose 3,000 members are involved in the development and design of qualified retirement plans, primarily plans for small businesses, and, we estimate that our members service approximately 30 percent of the plans in this country. We thank you for the opportunity to present some of our suggestions to this committee as to how to better enable the pension law to operate to support the growth and maintenance of the system. And what I would like to do in the few minutes available to me is review some of the suggestions that we gave to this committee, and through this committee to the Congress, as to how these goals can be achieved. And these suggestions are both long-term suggestions in a couple of areas and some short-term goals as well.

On a long-term basis, one of our concerns have been and remains that pension legislation tends to be passed and developed in recent years as part of a body of other legislation, usually in the tax law, and it gets lost in the shuffle. It gets buried in all of the areas of consideration that are dealt with in the omnibus legislation in which it appears. And one of our recommendations is that pension legislation in the future—and that Congress specifically determine—that pension legislation in the future will be dealt with by itself; that legislation affecting the retirement income security of our Nation be dealt with separately from other areas of concern that Congress may have.

Senator PRYOR. In other words, not in a big tax bill.

Mr. FAIR. Not in a big tax bill. And also the legislation, as it develops, that the public be given the opportunity to speak on it, and to participate in hearings with reference to the specific areas that are proposed in the pension area, something that has been lacking in the last couple of years.

The other thing we feel very strongly is necessary is that Congress develop a national retirement income policy against which to measure legislation that is proposed. The legislation that is developed is generally scattered legislation, certainly in recent years, and doesn't relate to a coherent national policy, and as a result doesn't produce a consistent position with reference to where we are going with the retirement income security of our Nation. We at ASPA have already commenced a series of papers dealing with the national retirement income policy and submit it to this committee the first of a series of papers which we have developed.

Now, those are long-range goals, and those are things that we feel are an essential step that has to be taken in order to make on

a long-range basis our retirement income policy and our private pension system function.

On the short range, we have the complexity that we have today. We have the problem of the decline in new plan formation. Paula gave us some numbers based on an 8-year measure. We have figures showing that between 1986 and 1989 the new plan formation in this country declined by 63 percent, and the new defined benefit plans in this country declined by 80 percent. There are three times more defined benefit plans terminating in 1989 than we formed in 1989. And these are short-term concerns that we also feel we have to address. Those short-term concerns can only be addressed by doing away with some of the complexity that we are addressing, and modifying not just on a legislative basis but also on an administrative basis the manner in which the system now functions.

We have included in our written statement a series of proposals for change, modifications and repeal. These proposals are not too different from those contained in the APPWP report or in the other reports that members of these panels have prepared. However, one area that we also would address is that there has to be some recognition that the penalty structure that we are now dealing with is also operating as a significant chilling effect on the private pension system, on the new plan formation, and on the willingness of advisors to assist their clients in dealing with these plan problems.

In addition to legislative changes, however, we feel it is essential that there also be some changes involved in the manner in which the private pension system is administered. We have heard from other speakers on this panel about the Internal Revenue Service's delays, the policies that have been developed, and some of the steps that have been taken. There are two areas—actually one area—involving a change in the law. We would strongly recommend that Congress delay the implementation of a change in the law until after final regulations are issued to avoid the situation we are now in for more than 2 years, we are worried about these discrimination rules.

If I may have another minute, there are two points that I really would like to share with this committee.

Senator PRYOR. Surely.

Mr. FAIR. With reference to the administration of the private pension system, we have a law which is now in effect which applies a series of rules to these programs without the guidance from the Internal Revenue Service that is necessary to make these programs work. We have a position from the Internal Revenue Service which allows us, in effect, to pretend that these plans froze in 1988, and that since 1988 the plans basically have frozen their accruals under a model amendment program developed by the Internal Revenue Service because of the delays that have been resulting. Because the regulations just are not out, the guidance is not available.

As a result, we are not in a position to advise many of our clients what the benefits are for their employees, what the costs are for the benefits they will ultimately have to provide retroactively to 1989, and, therefore, we are dealing in a situation where we are totally lost in describing to people what it is they are doing or what their benefits are.

On top of that, we have an Internal Revenue Service policy apparently developed as part of a revenue estimate that, from what we can best tell, they are trying to support it this point, developing this small plan audit program which basically is going after 20,000 small plans in this country, challenging the methods used to develop contributions to these plans 2 years ago, using procedures which, in response to your invitation we will supply to you, using procedures which are not permitted under the law, and a policy approach that, in our opinion, is one that is, the best word we can describe it with, is reprehensible.

We are structured in a system where 20,000 employers in the small plan area have been told that they are going to have an audit of their plan. These audits are being conducted in a fashion where essentially the procedure that the Internal Revenue Service has set up vests in four individuals in the national office final authority to determine whether or not the program will be accepted or the deduction will be disallowed.

We are in a system where this whole program is creating a tremendous amount of additional costs, and has a significant chilling effect on individuals who might want to consider establishing or continuing to maintain one of these defined benefit programs.

And with that, I thank you for the time you have given me.

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

Senator PRIOR. Mr. Fair, I am fascinated by this issue of the IRS going after small businesses, and I am going to return to that in a moment. We are very fortunate to have Senator Heinz, of Pennsylvania, who I have worked with for many, many years, even when we were both young men in the House of Representatives. [Laughter.]

And here we are as old codgers and old nesters in the U.S. Senate.

Senator HEINZ. You are straining your credibility in saying that we were ever young men.

[Laughter.]

Senator PRYOR. Still together. But we are very proud that Senator Heinz is with us. John, you have been referred to favorably by at least one and perhaps two of our panelists this morning. And we look forward to any statement you have or any questions. And if you would take over for about 2 minutes, I will return.

Senator HEINZ. All right Mr. Chairman, thank you. Now, we can get some work done around here. [Laughter.]

Senator Pryor may pretend to be advanced in age but, as you can see, he is quite alert, particularly to any hostile takeover by Republicans.

I want to apologize not only to this panel but also to the previous panel of witnesses for not having been able to hear all the testimony, but this is one of those mornings when I have several hearings to attend.

I do share the general concern expressed today about the complexity of existing rules and the inability of the IRS to promulgate regulations quickly and fairly. I am also personally quite concerned about the failure of our public policymakers to develop a national retirement income policy.

Such a policy would include both equity and stability. Unfortunately, fairness and simplicity are natural enemies. Efforts to simplify the tax code may cause taxes to be assessed unfairly.

I do have one general question for the witnesses. Are the low pension participation and coverage rates by small businesses caused by legislation, the complexity of the tax code, or a function of changing labor market conditions? Let me start with Mr. Kautter.

Mr. KAUTTER. Well, Senator, I think it is at the moment largely a function of the legislation and the cost of maintaining plans. We have a number of clients of our firm who have terminated plans, small clients. We have got other clients who will not set them up because: (a) they cannot figure out what the cost of the plan will be; and (b) they cannot understand what the rules are or what they are expected to do for their employees. They have talked to other small business people and hear horror stories about what has happened to them and their plans.

There is a natural inclination to stay away from these plans.

Senator HEINZ. Is there one factor you can single out above the others?

Mr. KAUTTER. I think it is the complexity.

Senator HEINZ. And what is the best, or if you prefer, worst example of that complexity that you would care to mention?

Mr. KAUTTER. Well, I think the best example that you will see is a regulation that is going to come out in the next few months on discrimination in qualified plans under what is 401(a)(4). And that is really the heart of the issue. When you cannot answer that question simply, it becomes just a morass after that.

But I think, to finish my statement and move on to the other panelists, with small business people right now it is really the complexity, the cost and the uncertainty that comes along with that. They rely on their advisors to deal with the complexity, but when it gets too expensive—and even then we cannot tell them what the answers are for sure—they are discouraged and won't adopt a plan or will terminate the plan.

Senator HEINZ. It doesn't exactly make your job easy.

Mr. KAUTTER. It does not.

Senator HEINZ. They must say, I wonder if this fellow really knows his stuff. Right?

Mr. KAUTTER. That is true. And I think if you are honest with yourself as a practitioner, you don't take pride in saying you don't know the answers to these questions. When you run across a practitioner who says they do know all the answers, the don't have a whole lot of credibility with me, frankly.

Senator HEINZ. Yes. Beware of people in our line of work who tell you we have the answers, too.

Mr. Holden?

Mr. HOLDEN. Senator Heinz, as I explained to the chairman, Senator Pryor, a few moments ago, I delivered the testimony on behalf of the American Bar Association, but I am accompanied by two experts. I am simply a chair; they are experts. So with your permission and his, I am going to turn to Mark Dray and Stuart Lewis to handle questions for the association.

Senator HEINZ. All right. Thank you very much.

Senator PRYOR. Mr. Holden, that is the same role I occupy around here. [Laughter.]

I just chair this thing. I am the referee but the experts are behind us.

Mr. DRAY. I think I would pretty much echo David's comments. I think in the context of coverage issues where we see loss of coverage is in plan terminations and a failure for new plans to start up, I think both cost and complexities are major issues in this area and are what are leading to both of those events.

As an illustration, for the first time ever we now have a system where we have to pay to apply for a determination letter from the Internal Revenue Service.

The proposed fee for simply filing an application for a determination letter from the Service on an individually designed plan is proposed to move to $700. Again, that in itself is a deterrent for people wanting to be a part of the system.

Senator PRYOR. Excuse me. Would you say that again about $700?

Mr. DRAY. Under the system that we came to after the 1987 Act to help spread the cost of the work that the Internal Revenue Service does in giving an employer a determination letter that their plan meets the statutory requirements in form, not in operation, we now have a user fee, and that fee started out at $225 or so for an individually designed plan. The proposed increase—I am not sure when it is to take effect—would bring the fee to be $700 just to apply for a determination letter on an individually designed plan. These are the kinds of issues that do deter the consideration of a new plan or the continuation of an existing plan. At least that is a very simple threshold type of example of what we are dealing with here.

I would add to it——

Senator HEINZ. Mr. Dray, on that point, if they went to you or Mr. Kautter, how much would it cost to prepare such a plan.

Senator PRYOR. I wish I had the courage to ask that question. I wanted to ask that a while ago. And I am glad you are here. [Laughter.]

Mr. DRAY. I think you are talking about minimum fees for firms like ours of somewhere around $3,000 to $5,000 to set up a new qualified plan with summary plan descriptions and the like. And this is an individually designed plan. This wouldn't be a model plan or a shelf type plan. This would be an employer that wants something that may not be a shelf type product.

Senator PRYOR. But when you set up that plan then you say $3,000 tc $5,000. Then there is a continuing cost.

Mr. DRAY. Every time you change the law we have to go in and tinker with it. And we keep charging fees every time we make plan amendments.

I would add one kind of a footnote to it, that it is not only the lack of coverage, it is the type of coverage. What we have seen, because of the complexity in particular in the defined benefit plan area is really a termination of those kinds of plans in favor of defined contribution plans. And again, my reaction is that that is a very shortsighted kind of solution to a long-term problem.

We are fortunate in this country to have a private retirement system, unlike our health care system, that it is on a pretty sound funding basis, with assets that have been reserved to meet some very significant retirement income needs in the future. But we are clearly in the process, because of issues of cost and complexity, of undermining or perhaps even destroying that system.

Our firm, for example, is in the process of considering terminating a defined benefit plan that covers some 600 staff type people in our firm.

Senator HEINZ. Are there other comments on the panel? The chairman probably does not know that I had asked while he was out of the room.

Senator PRYOR. Yes. I heard you.

Senator HEINZ. Oh. I apologize. All right.

Mr. FAIR. I think I would add to the comments that were made by the other panelists. One other area that we are finding is of grave concern to people that are sponsoring these programs, and that is the penalty area. I mean, we have all heard the too little, too late, too much, too soon idea. No matter what you do, you are walking into a wall where there's a penalty in front of you.

We have a line we can't quite see that we have to walk, and if we slip off it, we owe somebody some money. And the penalties that have involved running from 10 percent for taking the money too soon, to 50 percent for not taking it soon enough, topped off with the costs involved of maintaining a plan make it very difficult to convince somebody that this is a good program to become involved in. And I have to come back again to the audit program which adds another element of uncertainty to the various elements of uncertainty that a plan sponsor faces, because IRS can walk in 3 years later and say this is what the rule used to be, and we are going to penalize you for not satisfying that rule.

All of this layering of penalty upon penalty for people who don't do the things that they can't quite understand in any event, coupled with the complexities and the inability to tell people what it is will really happen when they establish a plan, what benefits will really develop when they provide it, is affecting especially the small businesses because the small businesses cannot hack that kind of a risk.

We have a rule which is the subject of a lot of discussion under Section 401(a)(126) which sets up a structure for trying to describe how many people you have to include in a plan. We have regulations that are incomprehensible. In fact, they have been revised at least once. And we understand that when the 401(a)(4) regulations are issued they will be revised a little bit again.

These regulations were issued in February of 1989. They were issued in proposed form, but the IRS indicated that we can rely on them, meaning they are going to apply them as if they are final regulations, beginning in the plan years in 1989, meaning for many plans, January of 1989. If you fail that test, which you don't understand, your plan loses its qualification with the effect that certain employees—highly compensated employees who generally are the decisionmakers—have to pay income taxes immediately with whatever associated penalties are involved on the value of their benefit.

This kind of a structure, this kind of a penalty position in a program that is intended to support, or presumably to support the growth and maintenance of the private pension system, makes it impossible for advisors to advise their clients to go ahead, start a plan, go ahead, keep your plan. We just don't know what we are doing because we don't have the proper guidance and because of the complexity, and we run the risk for our clients, and in some cases, for ourselves, if we advise people in a certain way, and one of those myriad of penalties falls upon them.

Senator HEINZ. Thank you.

May I ask Mr. Salisbury?

Mr. SALISBURY. Senator, I would just add that I think we again are getting a little more realistic; have to note the fact that the decision as to whether or not a small business decides to have a plan or maintain a plan is principally financial. And on top of the things I mentioned earlier, I will just note, for small businesses today with the accommodation of recent increases in the minimum wage level—and they most predominantly have minimum wage employees—with the very significant increases in fica taxes, which have been the subject of debates in this committee of late, the cost of labor, per se, is going up significantly for small businesses that affects their decision as to whether or not they can financially afford to also have a pension plan.

A second factor is just what is happening in the system. The issue of a small business with relatively high turnover, compared to other businesses, of who is getting what. Whether they are producing retirement income or whether they are producing severance. And one of the reasons that many small businesses said in work that we did at the Institute in cooperation with the AARP found that small businesses weren't even attracted to the simplified employee pension that Senator Pryor has a booklet on, was this issue of severance versus retirement. The fact that because of the very fast vesting and other factors that they just aren't interested in giving people that are only with them for 2, 3, 4, or 5 years a severance payment out of a Simplified Employee Pension; that they would rather take those people that stay with them longer and pay them more compensation, or to give them a bonus, or to do it through some other means, which isn't an issue necessarily of complexity. It is far more just that simple issue of reward. So you have got two factors that go beyond I suggest the subject of the hearing in terms of complexity. It is the degree to which other actions taken by the Congress, whether they be fica taxes, minimum wages, anything that affects the cost of doing business and the cost of labor, ultimately has an impact on a decision particularly if a small business, as to whether or not to sponsor a plan.

Finally, I note that in the small business setting you have one other factor. From limited work we have done, it appears that until a company has between 250 and 300 employees, they do not have anyone on the staff who even claims to attempt to be a specialist in these programs. And up until that point, they are totally dependent on high hourly rate, outside technical expertise. And at the point that the senior people in that small business have to start worrying about and paying attention to these issues, frankly, they frequently say, look, that is not why I put this in. This is not the

way I want to spend my time. It is not worth my time for the enterprise if I have got all this stuff to worry about, and I can no longer rely on your advice, per the last example, if IRS comes back retroactively and says that the professional advice you are getting from your enrolled actuary was wrong, because they misinterpreted what we were going to say, but they didn't know we were going to say it. Then that executive says hey, I give up. I am paying this big hourly fee and I can't rely on it. Life is too short, I'll get rid of the plan. I'll pay myself more cash and I will save it in a post-tax reform environment quite favorably. Thank you very much.

So it all wraps up into economics and the various economic factors that go well beyond, if you will, pension law, per se.

Senator HEINZ. I might just follow that up with a question. If Senator Pryor and I were able to wave a magic wand of simplification and stability, is it your position, Mr. Salisbury, that even under those favorable circumstances small employers increase pension coverage because they must spend their money on too many other things?

Mr. SALISBURY. Well, if you look back, take 20 years, when I think everyone at this table would argue that the system was significantly simpler than it is today, that margin tax rates for businesses and individuals were far higher than they are today, the percentage of small businesses, and particularly the percentage of all employees of small businesses that were covered by pensions were larger than they are today, but they were not significant, meaning by itself.

Senator HEINZ. Is there anybody who disagrees with that conclusion?

[No response.]

Senator HEINZ. All right.

Mr. SALISBURY. I just want to add that I think what we are talking about to a very large degree at this point, if we look at the overall tax system and the overall economic system, is more an issue of how can we get people who already have plans to at least keep them. Than, frankly, in my view, we are looking at ways or ability at the moment to significantly increase through a voluntary action plan formation at the small employer level, I mean the very small employer level. We are talking 25, 35, 50. At the point you get to 250, 300 employees I think the dynamics of that change.

Senator HEINZ. Is there anybody who substantially disagrees with that conclusion?

Mr. LEWIS. The only thing I would like to add, Senator, is I think Mr. Salisbury would agree that the complexity is a piece of the cost factor that's involved here, and that there would be some incremental improvement. But, fundamentally, I think he is correct.

Senator HEINZ. All right. Thank you, gentlemen. And thank you, Mr. Chairman.

Senator PRYOR. Senator Heinz, I will tell you what we have done. We have created—the Congress and the IRS—we have created America's new growth industry. They are represented here in this room, those individuals who advise business how to stay out of jail if they establish any kind of a retirement plan. Truly, it is a new industry out here.

Now, what I would like to do—I would like to have a plan so simple and so fair and so stable, as Senator Heinz has stated, that all of you all would be out of work, and that we wouldn't need actuaries, and CPA's, and lawyers and consultants on almost a daily basis.

Now, having said that, I don't know where we go from here in the pension arena. I don't know that we even need any more hearings. But I would like to suggest that some day all of the witnesses who have appeared here—all of you and the panel before, Senator Heinz and myself and the other parties—that we ask officials from IRS to come up here and we close the doors and just see whether we can hammer out a plan. Maybe it would be a prototype plan. I don't know. Maybe that is too simple. Maybe it would be another avenue of approach. But I truly think that pension complexity has gotten to be totally absurd. Here we are at Congress trying to invigorate retirement systems and to protect benefits of employers and employees across the country. And here we have the IRS seemingly doing everything it can to chill anything that Congress attempts to do.

Let me ask this question. Does the IRS today have an advisory committee from business to meet with them from time to time before they implement any rules or regulations?

Mr. SALISBURY. Well, it's the next process, Senator, if I might. They have many advisory committees, as does the Department of Labor and other agencies. But under the terms of the advisory committee statutes passed by Congress and signed by the President, it is improper and technically illegal for those agencies and departments to submit any proposal to those groups until after it has been published in the Federal Register.

Senator PRYOR. It is too late then.

Mr. SALISBURY. So it basically ends up being the Catch 22, that they do not even have the legal ability to get the advice from the people that have been appointed to these groups before they take action. And I would add the statement which others in the panel might disagree with, that all too frequently by the time it is in the Federal Register so much is invested in it, and so much is tied to it, and it has taken so long for it to even get to that stage that the ability to then have meaningful change take place is very difficult unless they come and make your life and others very very difficult to the point that you make their lives difficult at the IRS, which is I would suggest not the ideal way for the system to work.

Senator PRYOR. I just finished reading a book by Mr. David Burnham, formerly of the New York Times, entitled, "A Law Unto Itself." It is a history of the IRS and it is very good. And a lot of the book talks about some of the class action decisions of the IRS in the past. I hope that we have curtailed that activity. But it appears to me, now, Mr. Fair, that the IRS is focussing on small business, and that this is almost a class action operation against small businesses with retirement plans. They are going to automatically audit them and raise revenue through penalties in the small business area. Is this a class action? Where did the IRS get this authority? Where did the IRS obtain this authority to single out small business firms?

Mr. FAIR. Actually ASPA has been asking them that for the last couple of months since the program was implemented, and at this point it is a little difficult for us to explain why or how they have the authority to run the program certainly in the way they are running it. In fact, we have had a difficult time at ASPA trying to determine, because our concern is, in part, for our membership. Our members are many of the people who have been designing and operating these programs that are now under challenge. And of course, their concern on their own basis is what happens if IRS is extremely successful in a program of this nature. And what we have been doing is trying to get background information from the Internal Revenue Service as to the program itself. And what we have ended up having to do was file one after another freedom of information request which, after a certain period of time, we may or may not get a response.

I believe this morning we went into court another time for information that has not been supplied to us upon our request. Twice before we have received information, and in one case we only got part of what was requested for reasons we still haven't quite gotten clear ourselves.

In order to understand the program we need to know how the program developed and what the genesis of the program is. And, frankly, it looks to us as ii this particular program was developed in part because somebody came up with a revenue estimate, and then had to make the program that was being conducted try to produce that revenue. It is like sending the traffic cops out in the morning with a certain number of tickets that must be delivered. IRS then sends out notice to the field basically directing the field personnel who are conducting the audits to conduct the audits without taking into account, as the law requires, the individual facts of the case, and then sets up a procedure a few months later, after we wrote to the Commissioner about the program, that says, if you think at the field level—and there are 20,000 audits in process at this point from what we understand—IRS sends a letter to the field agent, the fellow conducting the audit, and says, if you think you shouldn't disallow the deductions and raise these various problems, you must send that thought and the reasoning behind it back to the national office. And there are four individuals in the national office who are then supposed to pass upon it.

The cost to our clients of these audits, the cost to our members—ASPA's members, in this case the actuaries and advisors for these plans—of these audits is excessive. And the effect of the program itself, as I have indicated earlier is another element, and one that is extremely significant in adding a chilling effect to people who are considering maintaining or operating these programs.

Senator PRYOR. Let's take an audit like this. The IRS agent walks in. At that point where is the presumption of innocence and guilt? Where does that presumption really rest when that audit begins? Who has to come forward and prove his case?

Mr. FAIR. The taxpayer. The plan sponsor,

Senator PRYOR. The business.

Mr. FAIR. What happens is the internal Revenue Service comes in requesting information. Accumulating that information is in itself an expense. Much of that information they already have, al-

though that is in accessing it from the reports that were filed; tax return information, 5,500 filings. They come back and ask for it again from the plan sponsor. And this is information in a small business going back 3 years in most instances to a 1986 filing income or pension filing.

That information, plus certain information from the actuary, which in many instances was not prepared as part of the normal operation of the plan, has to be developed and submitted to the Internal Revenue Service agent. From there, depending on how the agent operates and how the audit process works—there was a computer program that was being used, which we understand has been discontinued—and basically the agent looks at this information, and then under instruction from the national office, appears to be suggesting that there just be a disallowance without going any further.

Senator PRYOR. Thank you.

Senator Heinz has to go. Let me ask Senator Heinz if he has further questions.

Senator HEINZ. No, I don't, Mr. Chairman, I think the panel has been extremely interesting.

Senator PRYOR. It has been a fascinating panel and it has been an interesting morning.

Senator HEINZ. Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Senator Heinz, for coming today.

I don't have many more questions. And perhaps I may ask your permission, if I think of further questions I would like to follow in writing with our panel.

I wonder if any of the panelists would like to make any comments before we close our hearing? Mr. Holden?

Mr. HOLDEN. Mr. Chairman, with your permission, I would like to comment on the question of the availability of advisory information to the Service before they act on some of these matters.

In the ordinary course of rulemaking, of course, a proposed rule is published in the Federal Register and comments obtained. However, in this era of a great backlog in the regulatory process, that has broken down. What we see today are either temporary regulations issued without advance hearings or, even more frequently, positions are adopted in notices and announcements that become binding immediately on the taxpayer. And these directives are not even signed by the Commissioner or the Assistant Secretary.

We have moved substantially away from the normal process of advisory guidance from the business community before the Service acts, and that has become I think a significant problem.

Mr. SALISBURY. Senator, if I could add to that.

Senator PRYOR. Yes.

Mr. SALISBURY. I think it goes even more dangerously beyond that, as there is a degree to which increasingly in this area we are also running into regulation by speech.

Senator PRYOR. Now, what do you mean there?

Mr. SALISBURY. That individuals from the Actuarial Division of the IRS go to meetings of the ABA tax section and other organizations and sort of mention things that, their positions or what they are doing or what will be happening or what tentatively, a conclusion is, and you get the Catch 22 that regrettably not everyone in

the world that deals with these issues can be at the ABA tax section meeting. And they may not, as a small business, choose to pay the several hundred dollars a year to subscribe to the Daily Tax Reporter, or now maybe $1,500 a year or whatever it happens to be.

And so you have change taking place in this area by the frustration and breakdown of the regulatory process, that there is literally no conceivable way that the small businessman in CENO is going to have any idea that something has happened that they should be aware of, let alone in many cases the small business person in Washington, DC.

Senator PRYOR. Are there other comments?

Mr. KAUTTER. Senator, let me just amplify. It is funny, looking at the people on this panel, most of us I think were in practice at the time when there was a fellow at the Service named Isidor Goodman, and his speeches were as good as the law. And we got away from that with ERISA. And it turns out that we are back to the same position now, 20 years later, where statements by IRS officials are more inciteful than either the law or the regulations themselves.

Senator PRYOR. Thank you.

When this transcript is completed, when our distinguished friend over here gets a copy of this in my hands——

Mr. SALISBURY. Will you give us protection

Senator PRYOR. Yes, I will. [Laughter.]

I am going to call Mr. Goldberg, and I am going to respectfully invite him to my office and I am going to hand it to him. And I am going to say, Mr. Goldberg, I know you are new on this job, but you need to read this transcript. I think it will be very, very educational for him. I am going to do that. And this hearing has been an education for me, and I know that this transcript and the proceedings of this session will be educational to this committee.

Once again, I may follow on with some written questions to the panel. I must say that I have got to go get on the plane. Tonight, in Bentonville, AR, up in the northwest corner of our State, is the annual bean supper, and I have got to go and attend that. I will tell them about our hearing this morning. [Laughter.]

Thank you very much

[Whereupon, at 11:33 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted

PREPARED STATEMENT OF VANCE J. ANDERSON

Mr. Chairman and members of the Committee, my name is Vance J. Anderson. I am Assistant General Counsel of Allied-Signal, Inc. I appear today on behalf of The ERISA Industry Committee, commonly known as ERIC. My remarks represent the views of The ERISA Industry Committee.

ERIC

ERIC is an association of more than 125 of the Nation's largest employers concerned with national retirement and welfare benefit issues. As the sponsors of pension, savings, health, life insurance and other welfare plans, covering some 25 million participants and beneficiaries, ERIC's members share with the Committee a deep interest in the success and expansion of the employee benefit plan system in the private sector.

Discussion

Over the past decade, the Congress has produced a torrent of legislation affecting private-sector employee benefit plans. The legislation has --

- generated hundreds of pages of technical and convoluted rules,
- increased the cost of plan administration, thereby reducing the funds available to provide benefits to employees,
- created confusion among plan participants,
- caused uncertainty on the part of plan sponsors regarding their compliance obligations,
- discouraged the formation and continuation of benefit plans,
- shifted incentives away from defined benefit plans and toward defined contribution plans, thereby weakening the financial condition of the Pension Benefit Guaranty Corporation, and
- produced a regulatory logjam at the Internal Revenue Service that has required many pension plans to stop accruing new benefits for many or all of their employees.

The backlog in regulations is substantial. Most of the new requirements imposed on pension plans by the Tax Reform Act of 1986 became effective in 1989. However, the Internal Revenue Service has not yet issued most of the regulations that are required to implement the new rules. None of the required regulations are in final form. Until the Internal Revenue Service issues a complete set of the final regulations governing qualified pension plans, many plan sponsors cannot reasonably be expected to amend their plans to comply with the Tax Reform Act.

The areas of particular concern to ERIC's members are the following:

- The Internal Revenue Service has failed even to propose nondiscrimination regulations for qualified plans under the Tax Reform Act.
- The IRS has failed to issue even proposed regulations under the separate line of business rules, which are an integral part of Tax Reform's new coverage requirements for qualified plans.
- The IRS has not been able to issue proposed regulations under the average benefit percentage test, which is also an integral part of the new coverage requirements.
- The proposed integration regulations for qualified plans are complex, rigid, and incomplete.
- The proposed regulations under the Code's new minimum participation standards are inordinately complex and completely inadministrable; even the Service now appears to concede that major surgery is required.
- The proposed regulations on leased employees are generally recognized to be unworkable; although the IRS issued the proposed regulations in 1987, it has failed to revise the proposed regulations.
- The IRS has completely disregarded the requirements of the Administrative Procedure Act when issuing legislative regulations.

<u>The IRS's principal response to the lack of guidance under the Tax Reform Act comes in the form of "transitional relief" that deprives employees of benefits</u>. The IRS has encouraged employers to adopt one or more of a series of IRS "model amendments" that freeze the accrual of pension benefits until the Service issues further guidance.

This is not an acceptable solution. It creates an enormous employee relations problem. When an employee with suspended benefits retires, he currently receives only a portion of his ultimate retirement benefit and typically does not know what his ultimate benefit will be. The thousands of employees each year who are affected do not readily accept being told that their benefits have been frozen, that their benefits are uncertain, or that their benefits depend on the content of future IRS regulations. More fundamentally, suspending the accrual of benefits prevents a plan from achieving its basic purpose: providing pension benefits to employees in accordance with the plan's benefit formula.

Indeed, "model amendments" are compelling evidence that the system has broken down.

Although complexity is a major source of the problem, we urge the Committee to be wary of simplistic solutions. Broad-based "simplification" that overhauls fundamental aspects of current law might well be a source of still more complexity. Additional complexity is the last thing that we need.

"Simplifying" basic features of current law would require plans to make substantial changes that will make their operation even more complicated and unstable than it already is. <u>Constant change is complex</u>. The complexity that concerns this Committee lies as much in the frequency of new rules imposed on benefit plans as it does in the composition of the rules themselves.

We would oppose any efforts to "simplify" the law by repealing the rules that allow plans to maintain integrated benefit structures, to receive after-tax contributions from employees, or to provide post-retirement medical benefits. We also would oppose efforts to repeal provisions that allow employees who receive lump-sum distributions to qualify for income averaging. These proposals have recently been presented to Congress on the basis of the argument that they would simplify current law. In our view, however, the proposals would further impair the ability of employee benefit plans to operate effectively.

At the same time, there are constructive steps that the Congress can and should take to alleviate the problems facing employee benefit plan sponsors and participants.

First, the Congress should identify discrete areas that can be simplified without creating more complications. For example, the leased employee provisions in Section 414(n) of the Code clearly require revision. Last year, the Senate passed a bill that would have successfully and simply addressed the problems created by Section 414(n) without defeating the statute's basic purpose. <u>See</u> S. 1750, § 6303(a) (1989). We would be pleased to work with the Committee to identify other discrete provisions that can be simplified without creating new complications.

In addition, the Congress should resist proposals to "improve" the law by imposing "theoretically correct," but highly impractical, restrictions on employee benefit plans. As Commissioner Goldberg testified before the House Ways and Means Committee on February 7th, although the quest for theoretical purity might be well intended, it is extremely destructive. We should seek what is fair and practical, not theoretical purity.

The Congress should reject proposals to "micro-regulate" employee benefit plans. The key is to be practical and "do it simple."

The Congress should carefully evaluate the costs, including the compliance costs, of imposing new requirements on employee benefit plans. For example, it is clear that when Congress originally enacted section 89 as part of the Tax Reform Act of 1986, the Congress did not give sufficient attention to the onerous recordkeeping and testing burdens that section 89 imposed on employers.

The Congress should avoid changing the rules governing benefit plans in the context of the budget reconciliation process. The experience of recent years graphically demonstrates that the budgetary process produces employee benefit rules that are complex, not fully thought through, and riddled with drafting errors. In addition, the revenue constraints imposed by the budgetary process encourage Congress to enact rules that are based on unrealistic expectations of how quickly the Internal Revenue Service and employers can implement the changes that the new rules require.

Entirely apart from budget reconciliation, the Congress should be more sensitive to the lead time that the Internal Revenue Service requires to issue regulations and to the lead time that employers need to digest the regulations and to make the required changes in their plans and in their administrative systems. If budgetary constraints or other considerations require the Congress to adopt an accelerated effective date, the Congress should insist that the Internal Revenue Service allow taxpayers to act on the basis of a reasonable good faith interpretation of the law until a reasonable period of time after the IRS issues final regulations.

Specifically, we think that the reasonable good faith standard should apply until the beginning of the first plan year that begins at least six months after the issuance of final regulations. In the case of a collectively bargained plan, the date should be extended until the beginning of the first plan year that begins at least six months after the expiration of the last to expire of the applicable collective bargaining agreements that are in effect when the final regulations are issued. (The traditional "25 percent" test should be used to identify collectively bargained plans for purposes of this rule. _See_ H.R. Rep. No. 807, 93d Cong., 2d Sess. 52 (1974); H.R. Rep. No. 1280, 93d Cong., 2d Sess. 267 (1974); Staff of Joint Comm. on Taxation, _General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982_, 97th Cong., 2d Sess. 290-91 (1982); 53 _Fed_. _Reg_. 29722 (Aug. 8, 1988).)

Until the Treasury issues a complete set of final regulations, many employers will not be able to adopt plan amendments on which plan participants and plan administrators can rely. Proposed regulations, which have not yet been revised to reflect public comment, do not represent an authoritative interpretation of the law and often do not provide a reliable basis for adopting plan amendments. For example, the proposed regulations on leased employees -- which are now generally acknowledged to be excessively broad -- fail to provide the guidance that employers need to comply with the Tax Reform Act's coverage and nondiscrimination requirements.

Until the Treasury issues a complete set of final regulations, an employer or plan administrator should be protected if he relies on a reasonable good faith interpretation of the statute. The legislative history of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") provides that until the regulations under section 89 are issued, a taxpayer may comply with the provisions of section 89 by following its own reasonable good faith interpretation of the statutory requirements. _See_ H.R. Rep. No. 1104, Vol. II, 100th Cong., 2d Sess. 30 (1988) ("Conf. Rep."); H.R. Rep. No. 795, 100th Cong., 2d Sess.

493 (1988) ("H. Rep."); S. Rep. No. 445, 100th Cong., 2d Sess. 487 (1988) ("S. Rep."). According to the committee reports for TAMRA, the interpretation must be based on the statute and legislative history and must represent "an objective determination of the likely position that would be taken by the IRS and the courts." H. Rep. at 493; S. Rep. at 487. The taxpayer, however, will not be considered to be acting in good faith if it consistently resolves unclear issues in its own favor. Conf. Rep. at 30; H. Rep. at 493.

Although the explanation of the "good faith compliance" standard in the legislative history of TAMRA refers specifically to section 89 (which has since been repealed), the House and Senate reports make clear that this standard is generally applicable to all statutes for which the Treasury has not issued rules on which the taxpayer may rely. The House and Senate reports state that "[i]f the Secretary does not issue the required rules by October 1, 1988, then until the issuance of such rules, taxpayers are expected to make reasonable interpretations of section 89 based on the statute and its legislative history, _as is the case with respect to any statute for which there is no guidance issued by the Secretary_." H. Rep. at 493; S. Rep. at 487 (emphasis supplied).

We are gratified that Assistant Treasury Secretary Gideon and IRS Commissioner Goldberg are committed to the issuance of more timely and less complicated regulations. We urge the Committee to do what it can to support and encourage their efforts.

Although many of the regulations that the IRS issues are interpretative, and therefore exempt from the Administrative Procedure Act, a significant number of the regulations in the employee benefits area are legislative, and therefore subject to the Act. Legislative regulations are those that are promulgated under a specific grant of authority to define a statutory term or to implement a statutory provision. For example, regulations under the following sections of the Internal Revenue Code clearly represent delegations of legislative authority that require the Service to comply with the Administrative Procedure Act:

- _Section 401(a)(26)(I)_, which authorizes the Service to issue regulations providing that a separate benefit structure shall be treated as a separate plan for purposes of applying the Tax Reform Act's new participation requirements;

- _Section 414(o)_, which authorizes the Service to issue regulations to prevent the avoidance of certain employee benefit requirements through the use of separate organizations, employee leasing, or other arrangements; and

- _Section 415(b)(5)(D)_, which authorizes the Service to issue regulations providing that the reduction in the Section 415 dollar limit on benefits for employees with less than ten years of plan participation shall apply to each change in a plan's benefit structure.

This is an illustrative list; it is not exhaustive.

Compliance with the Administrative Procedure Act will assure that employers, employees, and other interested parties have an opportunity to comment on the IRS's proposed regulations and that they are given a reasonable time to prepare for the effective date of the final regulations. We regret to say that, to date, the Service appears to have ignored the requirements of the Administrative Procedure Act. This Committee can make a real contribution by insisting that the IRS comply with the Act.

Finally, we are concerned about so-called ERISA enforcement proposals that would subject employee benefit plans to still greater burdens. If the IRS or the Department of Labor requires additional resources or personnel to discharge its enforcement responsibilities, we would support the necessary appropriations. However, this Committee and the Congress should resist any effort to impose unnecessary and superfluous private litigation, auditing, recordkeeping, and testing requirements on employee benefit plans.

Like Section 89, such requirements will only place more costs and more burdens on plan sponsors, further impairing their ability to provide benefits to employees and their beneficiaries. Moreover, encouraging litigation is a costly, inefficient, and haphazard way of assuring that plans are properly administered and that employees receive the benefits to which they are entitled. If, in addition, participants are given standing to sue to enforce the provisions of the Internal Revenue Code, as was proposed last year by the House Labor Committee, it would establish a dangerous precedent that could cause the IRS ultimately to lose control over the administration of the tax laws.

An employer has only limited resources for employee benefits. To the extent that those resources are spent to conduct compliance audits and to defend lawsuits, less is available to provide the benefits that the employer and its employees desire.

ERISA already gives employees the right to bring suit to recover their benefits, to correct a breach of fiduciary responsibility, and to recover attorney's fees and other costs of the suit. The Committee should oppose any efforts to enact superfulous remedies that increase the cost of providing benefits and discourage additional coverage.

Thank you very much. I will be happy to respond to any questions that the Chairman or other members of the Committee might have. ■

PREPARED STATEMENT OF PAULA A. CALIMAFDE

Mr. Chairman and Members of the Committee, I am Paula Calimafde, President of the Small Business Council of America, Inc. (SBCA). I am pleased to appear today on behalf of the SBCA, the Small Business legislative Council and the National Association of Women Business Owners. As representatives of millions of small businesses, we strongly support the effort to promote the voluntary retirement system by simplification.

I can also speak on behalf of the Small Business Delegates to the 1986 White House Conference on Small Business at which I served as the commissioner of the Payroll Cost Section. This section covered employee benefits and the private retirement system. The 1,813 delegates to the White House Conference on Small Business from across the country formulated, for the President and the Congress, 60 detailed policy recommendations. The 20th recommendation reads as follows: To promote the retirement security of our nation's employees, Congress must support and promote the continued viability of the private retirement system in the small business community. In support of this goal, there must be a five-year moratorium on further changes in our private retirement plan laws except for the following changes which we recommend: (a) promote-parity between large and small plans and between private and public sector plans; simplify filing requirements and paperwork; (c) increase contribution benefit limits, including 401(k) plans and IRAS, to be at least as great as the pre-1986 tax reform act limits . . . .

NEEDLESS COMPLEXITY IN THE PRIVATE RETIREMENT SYSTEM AND ITS NEGATIVE IMPACT ON PENSION COVERAGE

The voluntary private retirement system is being slowly destroyed by a relentless layering of complex tax laws. Over the last decade, Congress has amended and revised the tax laws governing retirement plans at an alarming rate. In the quest to find short term revenue to offset the budget deficit, the long term impact of a bill on the retirement system is not given enough consideration. This piecemeal legislation is taking its toll on the retirement system in America.

In the last seven years alone, the following major laws have impacted significantly on retirement plans: The Tax Equity and Fiscal Responsibility Act of 1982; The Deficit Reduction Act of 1984; The Retirement Equity Act of 1984; The Tax Reform of 1986; The Omnibus Budget Reconciliation Act of 1986; The Omnibus Budget Reconciliation Act of 1987; The Technical and Miscellaneous Revenue Act of 1988, and The Revenue Reconciliation Act of 1989. This is simply too many changes for any system to assimilate properly. One of the outstanding practitioners in the country recently wrote to Mr. Gideon at the Department of the Treasury, "You may recall that Wilbur Mills insisted that there be 15 years between major tax laws. We had the 1939 Code, the 1954 Code, and what we thought (erroneously by today's standards) was a major tax bill in 1969. Such a time frame allows the taxpayers, their advisors, and those of you in tax administration to become comfortable with the system. It is constant change which is the problem." This same practitioner has determined that there have been over 8,280 changes to the Internal Revenue Code sections since 1981!

The frequency and complexity of these changes in the retirement plan area is greatly exacerbated by IRS regulations which are often untimely, retroactively effective, and difficult to comprehend. In some cases, the change is so incomprehensible that IRS basically suspends operation of the law until it can figure out what to do with the change. This is what it has done in determining the rules for integrating plan contributions with Social Security. This suspension of benefits has assisted IRS and companies sponsoring retirement plans, but it sure makes for bad plan law. For over a year, IRS spokespersons have said new regulations on Code section 401(a)(4) will be issued "imminently." These regulations were not mandated by any Congressional change to that Code Section, but rather have been devised by IRS as part of an overall plan to revamp the rules of comparability. IRS says that these new regulations will dramatically change the way plans are designed, written and operated *not* because of any change in the law by Congress but because of IRS fiat. At this writing, these regulations are still expected to be issued "imminently." In this same time frame, Rumania has ousted its leaders, Nicaragua has ousted the Sandinistas, the Soviet Union has become capitalistic, but the IRS cannot release the 401(a)(4) regulations. Companies, however, are attempting to make major decisions based on the law as it stands today, knowing there may be substantial changes coming, and having no way of ascertaining the possible impact of those changes. Meanwhile, there are many other areas where regulatory guidance is essential but not forthcoming. Apparently, the IRS would rather restructure the entire retire-

ment plan system through changes to the 401(a)(4) regulations even though Congress has not changed the law in this area or asked IRS to rewrite the regulations.

Today the laws governing the retirement plan system even confound the "best and the brightest." By this, I mean the elite of the pension world—the practitioners who work exclusively in this area as well as the people at IRS and Treasury working at the very highest levels. Few if any, of these practitioners, can honestly say that they completely understand the law in its present state or that the plans they represent are operating in compliance with the law at this time. This is the result of overly complex, piecemeal legislation where one small change in a Code section impacts other Code sections—even though the impact may not be discovered until months after the legislation has been passed.

CURRENT STATE OF AFFAIRS: INCOMPREHENSIBLE LAWS AND REGULATIONS, ESCALATING TERMINATIONS OF EXISTING PLANS AND DRAMATIC SLOWDOWN OF NEW PLAN ESTABLISHMENTS

Statistics are now available which show that retirement plan terminations are increasing rapidly while new plan adoptions are slowing down dramatically. Data derived from Internal Revenue Service determination letter requests Indicates that the establishment of new retirement plans has declined by at least 70% in the last 8 years. The decline for new defined benefit plans is even more precipitous—a drop greater than 80%. Conversely, termination of plans has increased markedly more than 100% in the last 9 years. This is the result of additional costs and complexity injected into the private retirement system over the last decade and the reduction of benefits to retirees. It is not clear how much the system has been harmed by the cutback in benefits as compared to the Increased costs of complexity. It is clear, however, that the needless complexity is a real threat to the continued health of our private retirement system and that the Congress, under the leadership of this Committee, can simplify the system without adversely impacting revenue or the underlying policy of the changes.

Small business represents the most vital sector of our Nation's economy the new ideas, the new jobs, the entrepreneurs willing to take risks—are found in this sector. Small business employs approximately 60% of all employees. If the small business sector has to offer comparable benefits to retain employees, staff as well as key employees, then it cannot be whipsawed by costs which are far higher proportionately than those assumed by larger businesses. It has been shown that the costs of maintaining a retirement plan for a small business on a participant to participant basis is as high as 10 to 1 (Mitchell & Andrews, 1981). Nonetheless, stable and/or profitable small businesses will voluntarily sponsor a retirement plan when benefits are meaningful in order to provide retirement security for its key as well as staff employees to attract and retain a good labor force.

A current trend facing employers is the aging of the population. The percentage of the population 65 years and over has grown from 10% in 1970 to 12% in 1985 and is projected to go to 13% by the year 2000. In 1970, approximately 20 million Americans were age 65 or older; by the year 2000, that number Is projected to be approximately 85 million. Further, several economists predict that employers will be facing a labor shortage as we approach the year 2000. An estimated 75% of the work force for the year 2000 Is already in the labor force today. Small businesses employ approximately 60% of all employees.

If the retirement security of our Nation's employees employed by the small business sector—including the retirement security of key employees and entrepreneurs who are driving this sector—is important, then Congress should take immediate steps to resuscitate the system. Retirement benefits in the small business context are provided primarily by the retirement plan; this is not true for key employees in a large company. In the large company context, other vehicles provide most of the retirement savings for top management. If Congress wants to ensure the competitiveness of the small business sector in the Nation and the world, then Congress must place retirement benefits within the reach of small business by making the provision of benefits affordable.

IF THE VOLUNTARY RETIREMENT SYSTEM ISN'T WORKING, SHOULDN'T IT JUST BE THROWN OUT AND A NEW SYSTEM PUT IN ITS PLACE?

Ten years ago, when the voluntary retirement system was stable and the rules were clear, the system was flourishing. Costs to administrators and pension specialists were reasonable and companies were able to take actions knowing what the results would be. The system was working extremely well. Instead of throwing out the baby with the bath water, Congress, under the leadership of this Committee, has a

real opportunity to return the system to its prior simplicity, reliability and clarity while retaining the reforms that have been injected into the system during the last several years. The second step in restoring the system to its prior viability would be to restore retirement benefits to the levels that existed prior to the onslaught of legislation.

SIMPLIFY THE SYSTEM

The following proposals are respectfully offered, for changes to the present law which could simplify the administration, and thus, the costs of maintaining retirement plans. These changes would be a necessary first step to revitalizing the system.

- Repeal or modify Code Section 401(a)(26). The reach of the proposed regulations is to broad that almost all plans, except the most elemental, will be subjected to this code section. These proposed regulations are the antithesis of simplification and can be expected to waste taxpayer and IRS dollars.
- Simplify the definition of Highly Compensated Employee. The definition of highly compensated employee which applies a number of highly complex rules to four basic definitions should be streamlined to a single rule that says that any employee who earns over 875,000 (indexed) is a highly compensated employee.
- Modify the full funding limitation. Code Section 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current termination liability. This is misleading because termination liability is often less that the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. In effect, current law inappropriately mortgages benefit promises by prohibiting the level funding that is the reasonable way for plans to fulfill benefit obligations and, instead, requires plans to be funded with payments which escalate in later years. Instead, the full funding limitation should be based on ongoing (projected) liabilities, and not on termination liability.
- Eliminate the Top-Heavy Rules under Code Section 416. Because of many of the changes enacted under the 1986 Tax Reform Act, including the new coverage and participation rules, new vesting standards, strengthened integration requirements, and new limits under Sections 401(a)(17), 402 and 415, the top-heavy rules are unnecessary and redundant. They should now be repealed. The slightly higher defined benefit minimum accrual which resulted from the top-heavy rules is no longer an issue since small business is terminating defined benefit plans due to the combination of increased costs and reduced benefits. Some people argue that if the top-heavy rules are repealed, small business employees, in particular women employees, would be hurt by the three-year cliff vesting provisions changing to a five-year cliff vesting. A simple solution to this problem would be to require small business employers (for example, with less than 50 employees) who elect cliff vesting to vest employees after three years of service. Although this is patently unfair, the top-heavy rules themselves are patently unfair in operation.
- Make uniform the definition of compensation under the Code. Code Sections 414(s), 414(q), 415, and 401(a)(17) all provide different definitions of compensation which are relevant for different purposes under the pension laws. Having to comply with so many different definitions is confusing and invites error.
- Simplify the rules on affiliated service groups and leased employees under Code Section 414. Inexact language in the statute and overboard regulations issued in proposed form have combined to creates artificial affiliations which do nothing to promote the integrity of the retirement plan system. Solution: have Congress give greater direction to the IRS on the types of abuses to be covered.
- Simplify the minimum distribution rules under 401(a)(9). Solution: return to a rule similar to the one in effect prior to the 1986 Act: requiring that distributions begin by the April 1 of the year following the later of (i) the year in which the employee attains age 71 or (ii) the year in which the employee retires; and by simplifying the calculation of the minimum distribution (e.g., by requiring that the full amount be distributed in 25 years, which is the expected return multiple for an ordinary joint and last survivor annuity for a 71 and 61 year-old individual).
- Eliminate the excise tax on excess distributions. The rationale for maintaining such taxes, the prohibition against excessive accumulations, is outweighed by the complexity of the provisions. This provision was initially intended to take the place of the complex 415(e) calculations. However, since 415(e) was not repealed, the excise tax is unnecessary. Alternative: repeal the 415(e) fraction.
- Repeal the new 401(l) rules on permitted disparity. These rules are incomprehensible to many practitioners. Solution: Outright repeal of the new rules and a return to the former rules with a minimum benefit or contribution requirement to ensure inclusion of all eligible employees would go far towards simplifying this area.

• Repeal new Code Section 401(m) and the multiple use limitation. Subjecting matching contributions to the 401(a)(4) rules and defining voluntary after-tax contributions as annual additions for purposes of the 415 limits provides sufficient restrictions on the use of such contributions.

• Eliminate Code Section 414(o). This section provides a broad grant of regulatory authority to the IRS to deal with business arrangements which would allow circumvention of the qualified plan requirements. We believe that this section should be eliminated because it has made it virtually impossible for a sole proprietor and other small businesses to determine eligibility for plan contributions when it is involved in any way with another entity.

• Simplify coverage under Code Section 410(b) by eliminating the second part of the average benefit test. Solution: return to the "old" fair cross-section test as the alternative test for determining adequate coverage under a qualified plans.

• Simplify distribution of qualified preretirement survivor annuity. Solution: Notices of such survivor annuities should only be required upon commencement of employment and when requested thereafter.

• Eliminate the average deferral percentage test under Code Section 401(k). This test was initially adopted prior to the $7,000 limit on elective deferrals. The ADP test was found to be unnecessary for the Federal Employees Thrift 401(k) Plan because the $7,000 limit on elective deferrals adequately limited participation by highly compensated employees. The same reasoning should be applied to eliminate the ADP test for 401(k) altogether.

• Eliminate the tax on nondeductible contributions. This tax combined with the quarterly contribution rule of Code Section 412 places many employers in an unfair position. Either or both of these rules should be repealed.

• Simplify basis recovery rules under Code Section 72. Solution: repeal the rule requiring pro-rata recovery of basis and return to the ruler permitting basis recovery in three years. Any potential benefit of pro-rata recovery is outweighed by the administrative costs of compliance.

• Simplify the distribution rules of Code Section 402. Solution: Code Section 402 should be restructured in a more comprehensible form and unnecessary distinctions between the treatment of types of distributions should be eliminated. A participant should be able to roll any amount over into an IRA from any type distribution (other than from required minimum distributions). The current restrictions on partial rollovers not only add complexity but also limit portability.

Finally, Congress must halt the overt discrimination audits which is occurring in IRS small business defined benefit plan audits. The President in his proposed budget has directed IRS to collect 660 million in 2 years from small business defined benefit plans. Next year, we'll be told they want 1 billion dollars from any small business plan! This is, plain and simple, reprehensible. To go after a class of taxpayers because it is known they do not have the deep pocket necessary to litigate against the IRS cannot be tolerated. This program is unseemly—secret memos requiring agents guidelines for small business, key officials at IRS and Treasury publicly stating they know nothing of the program and forcing the public to get the memos and other data through Freedom of Information. It will not be enough to simplify the system if companies know that by sponsoring a retirement plan, they are basically "buying" an audit. Audits are expensive. Congress must direct the White House and the IRS that overt discrimination against any sector of our economy cannot be tolerated and to call off this unseemly witch hunt immediately.

Attachments.

DALE BUMPERS ARKANSAS, CHAIRMAN
SAM NUNN GEORGIA
MAX BAUCUS MONTANA
CARL LEVIN MICHIGAN
ALAN J DIXON ILLINOIS
DAVID L BOREN OKLAHOMA
TOM HARKIN IOWA
JOHN F KERRY MASSACHUSETTS
BARBARA A MIKULSKI MARYLAND
JOSEPH I LIEBERMAN CONNECTICUT
RUDY BOSCHWITZ MINNESOTA
ROBERT W KASTEN JR WISCONSIN
LARRY PRESSLER SOUTH DAKOTA
MALCOLM WALLOP WYOMING
CHRISTOPHER S BOND MISSOURI
CHARLES E GRASSLEY IOWA
TRENT LOTT MISSISSIPPI
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United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510-6350

December 12, 1989

Paula Calimafde, President
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Bethesda, MD 20814

Dear Paula:

Recent news reports have documented the decline in the number of pension plans administered by small businesses for their employees. The Social Security Administration estimates that the number of full-time workers with employer-financed pension plans fell to 46 percent last year, from 50 percent in 1979. Further, only 29 percent of the workers in companies employing between 25 and 49 workers have such plans.

As the ranking Republican on the Senate Committee on Small Business, I have for some time been concerned that Congress is slowly but surely regulating the retirement planning industry out of business. Although the latest figures seem to support this view, my colleagues here in Congress take a different view and seem to think the number of people covered by retirement plans is not declining.

I am writing to ask your assistance in answering this question. I am gravely concerned with the proclivity of members of Congress to further micro-manage these plans. In order for me to effectively respond to advocates of further regulation, I need solid data. My intention is to review this at a hearing in the Small Business Committee in the Spring. In addition, I will be looking for ideas to reinvigorate the retirement planning industry, especially in the context of small businesses. Any suggestions you wish to make in that regard will be most helpful.

If you have any questions, please contact Peter Coyle of my staff at 202-224-5175. I appreciate your assistance.

Sincerely,

Rudy Boschwitz
Ranking Member

cc: Sam Gilbert

ROBERT WILLIS ASSOCIATES
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April 18, 1990

ROBERT T WILLIS, JR., CPA
(404) 396-7160

Rudy Boschwitz
United States Senator
Committee on Small Business
Washington, DC 20510-6350

RE: SMALL PENSION PLANS BEING REGULATED OUT OF EXISTENCE

Dear Senator Boschwitz:

The purpose of this letter is to comment on your letter to Paula Calimafde, President of the Small Business Council of America, dated December 12, 1989 (copy of your letter attached). I am also sending a copy of this letter to Laura Wilcox, Hearing Administrator for the Senate Finance Committee concerning this subject, and to Senator Sam Nunn.

Many large pension benefits consulting firms have undoubtedly provided their comments. This letter will succinctly put the matter into simple dollars and cents perspective. My firm has been involved exclusively with small pension plans. Over the last ten years, we have handled most every aspect of pension plan implementation and administration: plan design, document amendments for law changes, annual administration, participant recordkeeping, and investment of plan assets. Our typical client has less than 50 employees, does not have a personnel or benefits department, and does not have in-house legal counsel.

The following cost analysis should clearly explain why many small businesses are terminating their pension plans and why an increasing number of small businesses are deciding not to incur the prohibitive cost of implementing plans. <u>The result is less retirement security for the rank and file employee and therefore greater dependence on the social security system and government financing thereof</u>.

Description of Services Required	Frequency Of Services	Estimated Fee
1. Explanation of plan design alternatives to client	One time cost	$ 500
2. Adoption of prototype plan and submission to IRS for approval	One time cost	750
3. Explaining plan amendments to client and change in administrative procedures	Every two or three years when Congress changes the law	500
*4. Annual administration including IRS 5500 and participant reporting	Annual amount	700
*5. Participant termination procedures and forms	Whenever a participant quits, is fired or dies	100
*6. Independent investment management to avoid ERISA trustee liability	Annual fee at 1% of trust value	1,000
*7. CPA audit	Annual amount	700
8. Proxy voting	New DOL requirement	?

Plus proposed legislation that would add to these fees.

9. Visclosky bill	Annual legal fees to deal with joint trustee issues	250

* Sum of these amounts approximates annual administrative costs. Note, the CPA audit requirement currently is not required for plans with less than 100 participants. However, the DOL is now strongly lobbying for that 100 participant exemption to be removed thereby requiring all plans to have an annual audit.

Sum of *s $2,500

The typical owner of a small business cannot justify the above costs and administrative burdens because of the following cost-benefit analysis:

Item	Amount
Amount of plan contribution for 15 employees, including owners, at 10% of employees' compensation	$ -30,000
Amount of contribution allocated to owners	10,000
Amount of contribution allocated to non-owners and viewed by owners as an expense	-20,000
Tax savings on $30,000 contribution deduction	10,000
After tax cost of providing pension to non-owners	-10,000
Annual administrative fee cost (see *s p.2)	-2,500
Net cost to owner to maintain a pension plan	$ -12,500
	versus
Economic benefit to owner	$ 10,000
LOSS	$ -2,500

The above cost-benefit analysis ignores the initial implementation cost of a plan and the enormous amount of time an owner has to spend with advisors regarding ongoing administrative issues. The owner has no economic incentive or reason to establish a plan because of the excessive annual costs and the lack of tax or economic benefits for himself.

The foregoing analysis should clearly illustrate why more and more small business owners are concluding it simply is not worth it to implement a plan, or to keep the plan they currently have.

Respectfully,

ROBERT WILLIS ASSOCIATES, P.C.

Robert T. Willis, Jr., CPA

RTWJR/ab

cc: Laura Wilcox
Senator Sam Nunn

PREPARED STATEMENT OF HON. ROD CHANDLER

Mr. Chairman and members of the subcommittee, I am pleased to appear here today on a topic of great personal interest to me, and of vital importance to millions of Americans—the simplification of the nation's retirement system.

I am a former state legislator, and now a Member of congress who served first on the Education and Labor Committee and serves now on the Ways and Means Committee. During my career, I have tried to promote policies that would protect the benefits of the current private retirement system and foster the growth of that system. Frankly, from my review of the recent litany of Congressional tinkering in the pension area and from speaking to my constituents who are struggling to comply with what Congress, the Treasury Department, the Internal Revenue Service, the Labor Department and the Pension Benefit Guaranty Corporation require, I am sometimes surprised that we still have a private, voluntary pension system. And if the current trend continues, the system may not survive.

I have long been concerned that too many changes in pension law have been driven by revenue needs, rather than by what constitutes sound retirement income policy. I said at the time that I thought it was a mistake to include such far-reaching pension changes in the 1986 Tax Reform Act. There was neither the time nor—to some extent—the inclination during that process to carefully evaluate how these changes would effect the ability of employers to continue to provide retirement plans to their employees.

And, of course, TRA was only one example. The entire decade of the 1980's was replete with tax and budget bills that became vehicles for massive changes in pension law. The jargon of the benefits field is littered with acronyms: TEFRA, DEFRA, COBRA, OBRA and, of course, the TRA, and its offspring, TAMRA. Of course, the process itself makes it virtually impossible to consider the pension provisions apart from the others when congress legislates by megabill.

We should take pride in the fact that tax incentives we have enacted enable employers to provide pension coverage to 45 million workers in this country. Employees and retirees are well served by the fact that employers make 87 percent of total pension contributions. The Treasury, too, benefits from this private system. Since benefits are financed privately—either with tax deferred or after-tax dollars—the burden on public programs is lessened. The question is hardly whether we can afford to support the private pension system, it is whether we can afford not to support it.

The nation's pension system is not only important to ensure the retirement income security of America's elderly, but it is also vital to improving the nation's savings rate. In 1986, pension funds accounted for 34.8 of the investment capital supplied by non-bank financial institutions, up from 27.6 in 1970. Equity holdings as a share of pension portfolios quadrupled from about 7 to 35 from 1950 to 1987. This money provides the equity capital necessary to fuel America's growth. That means we should encourage employers to sponsor retirement plans and we should make it possible for individual participants in these plans to contribute savings.

Let there be no confusion on this point: the complexity of the pension system is not some esoteric issue. It is directly and significantly related to the issue of pension coverage. If Congress and the Executive branch write laws and rules that sponsors of pension plans cannot understand—or that cost them too much to implement—the time will come when they will drop their plans. Certainly, new and small companies are not going to set up retirement plans in this environment—and that's where the new jobs are.

Like so many of my colleagues, I support legislative efforts to allow individuals and families greater opportunities to save for retirement, education, new home purchases and a host of other good purposes. I hope the outcome of the current debate over expanded Individual Retirement Accounts and Family Savings Accounts will be a responsible and attractive savings vehicle. But while Senate and House and Republicans and Democrats are trying to outdo one another in crafting the best individual or family savings program, I hope that we will not overlook the proven value of the employer-sponsored retirement system.

A criticism leveled against IRAs in the past (and one to which I take exception) is that they are attractive primarily to wealthy individuals who have money to save. Certainly that was the theory behind the limitations on IRAs in the 1986 Tax Reform Act. But while reasonable people may differ on the accuracy of that claim about IRAs, no one can argue that employer-sponsored savings plans—such as 401(k) plans with their typical employer matching contributions—are especially valuable to lower paid workers. These plans allow workers of moderate means to save for their retirement.

Considering this reality, it troubles me that 401(k) plans which we should be encouraging—are hamstrung by extraordinarily complex average deferral percentage (ADP) tests. Before 1986 when highly-paid individuals could put up to $30,000 into 401(k) plans, there was a justification for strict nondiscrimination rules. But when we drastically lowered the limits to $7,000 (indexed) in 1986 we should have eliminated the ADP tests. Instead we made them harder. The irony, of course, is that the very highly compensated executive can still put aside $7,000 into the 401(k) plan because he or she is limited by the dollar limitation. But the middle income earner who falls just inside the so-called "highly compensated" group is drastically limited in the amount he or she can save—while co-workers earning just a shade less can save higher amounts. This is complex, inequitable and just plain silly if we are trying to encourage middle and lower income Americans to save.

I am, of course, pleased that Chairman Rostenkowski has announced that simplification of the Internal Revenue Code is a priority for him and for the Committee. I intend to work with the chairman and my House colleagues to make sure that a large component of any internal Revenue Code "simplification" bill includes much-needed simplification in the pension area.

Mr. Chairman and members of the subcommittee, like you, I have received a copy of an excellent report prepared by the Association of Private Pension and Welfare Plans (APPWP) entitled "Gridlock: Pension Law in Crisis and the Road to Simplification." I have reviewed the report and believe that it contains many practical, equitable and doable recommendations. I understand that other respected organizations also are preparing reports urging the adoption of these and other simplification measures that will help the pension system prosper.

I note that APPWP and some of these other groups are appearing here today to describe their recommendations. I commend you for bringing before your subcommittee these experts who will help us determine which areas of pension law are most "in crisis" and how we can start down that "road to simplification."

Mr. Chairman, I commend you for initiating this important effort in the Senate. I will be working with my colleagues in the House to do the same. Together, on a bipartisan basis, we can achieve something positive for the pension system. It is essential that we do so if we are to provide the financial security to which older Americans are entitled.

Thank you.

PREPARED STATEMENT OF ANDREW J. FAIR

REASON FOR CONCERN

The American Society of Pension Actuaries (ASPA) is an organization whose 3,000 members are primarily involved in the design and administration of qualified pension plans, primarily plans maintained by small businesses. ASPA estimates that its members provide services to about 30 percent of the qualified pension plans in the country.

Statistics developed from Internal Revenue Service records indicate a disturbing trend: From 1986 to 1989, new pension plan formation has declined by about 63 percent; defined benefit plan formation has declined by about 80 percent. For 1989, there were about three times as many terminations of defined benefit plans as there were startups. In addition, the level of confusion on the part of plan sponsors, plan participants, and their advisors, and the uncertainty which prevails throughout the private pension system, leaves those still maintaining qualified plans without confidence in the system upon which they depend.

NEED FOR SIMPLIFICATION

The private pension system in the United States is in disarray because the legislation governing the system has become too complex and overbroad for even those administering the system to understand. This is clearly indicated by the inability of the Internal Revenue Service to issue regulations within the time mandated by Congress and by the need for the Internal Revenue Service to withdraw and/or modify regulations once they are written. The problem is compounded by the unwillingness of the agencies administering the law to recognize that the confusion and uncertainty make it difficult, if not impossible, to operate a plan in total compliance with the law. The problem is further compounded by the perception on the part of those within the Internal Revenue Service that the primary functions of the IRS in its administration of the private pension system are revenue generation and the prevention of any possible abuse (without consideration of the likelihood of such abuse occurring).

The only way the problem can be resolved is through a two-part simplification process. The first part is legislative, and is addressed in the immediately following material. The second part is administrative, and is addressed toward the end of this series of proposals.

Legislative Changes

A workable private pension system must be governed by a consistent set of rules, developed in an understandable fashion and interpreted intelligently. The starting point for such rules is a national retirement income policy, against which proposed legislation is tested. Such a policy does not now exist.

ASPA has been in the forefront in the development of a national retirement income policy and has already released the first in a series of papers addressing the need and a suggested approach. Copies of this paper have been provided to the Subcommittee.

We urge the Subcommittee to consider the paper, and the policy outlined, in its determination as to the long-term retirement income security of our populace. However, we recognize that the development of a national retirement income policy is a long and difficult process; in the meantime, the private pension system must obtain some relief from the onerous rules under which it now attempts to operate. Without such relief, the system will not survive.

Provisions Which Should be Repealed

With reference to specific legislative provisions, we recommend the repeal of the following rules:

1. **Top-heavy rules under section 416 of the Internal Revenue Code.**

These rules have outlived their usefulness given the vesting changes and compensation limitations applied to all plans under the Tax Reform Act of 1986. There is no difference in the

compensation limits applicable to top-heavy and non-top-heavy plans. There is limited difference between the vesting schedules applicable to each type of plan. The minimum accrual and contribution requirements are almost irrelevant as a result of the permitted disparity requirements of section 401(l). Yet the law still requires annual testing to determine whether or not a plan is top-heavy. The cost and complexity are not worth any benefit derived from these provisions.

2. **The minimum participation requirements of section 401(a)(26) of the Code.**

These rules, which require that a minimum of 50 employees or 40 percent of the employees participate in the same plan, were intended to address a particular concern relating to the comparability of benefits provided under separate plans maintained by the same employer. The proposed regulations issued by the IRS in February 1989 (and which we understand are to be substantially modified whenever proposed regulations are issued with reference to section 401(a)(4), which prohibits discrimination in favor of high compensated employees) are so broad in their application, and have been interpreted in so complex a fashion, that no one appears to really understand the rules. The repeal of section 401(a)(26) will go a long way toward reducing the confusion now confronting the private pension system.

The coverage requirements of section 410, in conjunction with modifications to the comparability formula developed by the Internal Revenue Service in Revenue Ruling 81-202, will more than protect against the perceived abuse against which section 401(a)(26) is directed.

3. **The family attribution rules under section 414(q) and 401(a)(17).**

These rules limit the compensation considered for benefit purposes for all family members of certain highly compensated employees to $200,000, indexed for inflation. The law discriminates against spouses and children, who are effectively prevented from receiving pension benefits on their earnings simply because they are married to or the offspring of a highly compensated employee. The law presumes that there is something reprehensible about a business which employs family members of highly compensated employees, apparently because somebody assumed the compensation would, of necessity, be excessive. IRS already has in its arsenal a procedure to prevent the abuse against which the family attribution rules are directed through its ability to disallow deductions for unreasonable compensation and benefits related to such compensation.

4. **Rules which distinguish plans for self-employed individuals from those for corporate employees.**

Special aggregation and deduction rules, and a myriad of other provisions, continue to be different between plans for self-employed individuals and those benefitting common law employees. These distinctions serve no useful purpose.

5. **Permitted disparity under section 401(l).**

Like the provisions of section 401(a)(26), the permitted disparity rules as interpreted by the Internal Revenue Service are incomprehensible. The IRS has announced it will be "simplifying" some of the rules contained in proposed regulations issued in November 1989 when it finally produces regulations under section 401(a)(4), but it seems virtually impossible to apply that section in a manner which makes sense. Repeal of permitted disparity should be replaced by rules similar to those in effect prior to 1989, with minimum benefit or contribution requirements to avoid the exclusion of otherwise eligible employees.

6. **Virtually all of the draconian penalties established by the Tax Reform Act of 1986.**

The penalties and excise taxes imposed on plan sponsors, advisors, and participants have had a serious chilling impact on those affected. In some instances, affected individuals are unable to determine the proper application of a rule which, if they fail to apply same, results in a penalty. This is especially true in the funding of defined benefit plans, where lack of regulations leaves employers uncertain of required contributions and subject to penalties for over-contributions and under-contributions, and to attack by the IRS if assumptions used to develop costs do not accord with IRS determinations.

Provisions Which Should be Modified

1. **The combined plan limits set forth in section 415(e).**

These limitations require complicated calculations to test benefit limits when more than one plan is maintained by the same employer. In some cases, annual testing is required, and records of benefits, contributions, and compensation must be retained for the entire period of an employee's employment. If the combined limits are retained, the formula for measuring the limit should be simplified by using projected rather than accrued benefits and contributions.

2. **The definition of highly compensated employee under section 414(q).**

The definition of highly compensated employee is much too complicated to be accurately applied, especially in larger plans. There is no reason a simple compensation measure (for example, $75,000 indexed for inflation) can not be used in place of the alternate tests now imposed. This would eliminate the need for plan administrators and employers to maintain detailed data with reference to employees without affecting the ability to test discrimination concerns.

3. **Modify the full funding limitation.**

The computation of the full funding limitation now required under section 412(c)(7) involves actuarial calculations using methods and assumptions not otherwise necessary. In effect, a second actuarial valuation is required for all defined benefit plans, purely to verify the full funding limitation. The cost of such calculations, and the inability in many instances to adequately fund benefits, jeopardizes the retirement income security of plan participants and the long-term viability of the defined benefit plan. The full funding limitation should be returned to its pre-OBRA 1987 position.

4. **Require the use of projected benefit calculations in measuring discrimination under section 401(a)(4).**

Since the introduction of discrimination rules under section 401(a)(4), the Internal Revenue Service has measured discrimination by comparing projected benefits available to employees under defined contribution and defined benefit plans. During the last two years, the IRS has threatened to change its approach to such testing, and to measure benefits accrued each year by highly and non-highly compensated employees. That process would virtually eliminate the defined benefit plan, since the accrual for older employees, by definition, must exceed the accrual for younger employees in defined benefit plans in almost all cases. Section 401(a)(4) should be clarified to indicate that the measure of discrimination is the projected benefit provided employees under a plan, not the benefit accrued in the year tested.

5. **Simplify the affiliated service group rules and the leased employee provisions under section 414.**

The affiliated service and leased employee rules under section 414 have proven a fertile ground for confusion, in part because of the imprecise language of the statute and in part because of the overbroad definitions contained in IRS proposed regulations. Those regulations, proposed some years ago and neither finalized or withdrawn, were an abuse of the discretion vested by Congress in the IRS under section 414. The IRS now states that the proposed regulations were a trial balloon, not intended to be applied, yet those regulations caused a major problem for certain professional organizations in 1989 because the IRS would not respond to their concern as to the IRS interpretation.

The discretion vested in the Internal Revenue Service to draft regulations to prevent avoidance of the statute should be rescinded, and specific rules should be set forth in the law to address whatever concerns remain with reference to the use of separate entities to avoid discrimination requirements.

Administrative Changes

The manner in which a law is interpreted and administered is as important as the content of the law, and in recent years the interpretation and administration of the pension laws, primarily by the Internal Revenue Service, has compounded the confusion and complexity now destroying the

private pension system. In many instances, the Internal Revenue Service has not only contributed to the problems of the private pension system, but has actually caused them.

Consider the following examples:

1. **Regulation delays.**

Despite a Congressional mandate to issue final regulations with reference to certain pension provisions of the Tax Reform Act by February 1988, the IRS not only failed to provide such guidance in the time provided, but in certain areas has yet to provide needed information to the industry. The private pension system is now operating under a law which has not yet been fully explained, with promises from the IRS that the explanations already provided are being rethought. Many plans are already well into their second year under a law which is not yet understood, and many plan participants remain unsure as to their benefits.

The regulation delays are in part the result of the complex nature of the law, but are, in our opinion, more the result of the refusal of those writing the regulations to deal with the issues in a responsible manner. The attempt to prevent any possible perceived abuse, whether or not there is evidence that such abuses exist, has led to a virtual paralysis in the regulatory process. When regulations are finally issued, they are so complicated and confusing that they are literally meaningless. The 401(a)(26) regulations, the 401(1) regulations, and it would appear, the as yet unissued 401(a)(4) regulations, are all examples of the problem created by the overprotective approach to the regulation process.

2. **The nondeduction penalty.**

The Tax Reform Act of 1986 imposes a penalty on employers who contribute amounts to plans which are not deductible. The legislation was passed in 1986 and first applied to contributions made in 1987. There was a great deal of confusion after the 1986 law was passed as to the amounts which could be deducted for contributions to qualified plans, and that confusion was compounded by the changes in funding limits imposed by the 1987 Omnibus Budget Reconciliation Act. That confusion was further compounded by quarterly contribution requirements which were added at the same time.

The Internal Revenue Service was aware that many employers were confused and contributions were made in 1987, 1988, and 1989 which could not be deducted in the year made. These contributions were made in good faith, and, in fact, in the legislation Congress permitted a withdrawal within a certain period of time to avoid the application of the otherwise applicable penalty. However, almost as soon as the problem developed, the Internal Revenue Service began advising employers that a withdrawal of a nondeductible amount could disqualify the plan. Efforts to encourage the Internal Revenue Service to develop a procedure to deal with such withdrawals, although commenced immediately after the law was passed, did not bear fruit until mid-1989 with the issuance of a Revenue Procedure. The procedure established required an employer to spend almost $1,000 in actuarial and user fees to obtain a ruling from the Internal Revenue Service that a contribution was not deductible. That procedure was issued more than two years after the IRS became aware of the problem, and at a time and in a manner which made it unavailable to employers who made nondeductible contributions in 1987 or 1988 if they filed their tax returns on time.

Now, the Internal Revenue Service has announced that it is reconsidering the procedure because it has not worked, and it has indicated it may adopt a method recommended by ASPA more than a year ago involving actuarial certifications. The extraordinary delay, the development of a procedure which was structured to discourage its use, and the belated recognition of the problem it created is a classic example of the problems created by the IRS for the private pension system.

3. **Improper procedures.**

In the last few years, the Internal Revenue Service has followed procedures which we consider improper in its administration of the pension law. We have already discussed the proposed regulations under section 414 relating to affiliated service groups and leased employees and the difficulties presented to certain employers by those regulations. In fact, those regulations apparently were proposed, even though the IRS had no intention of finalizing the rules in that fashion, purely in the form of a trial balloon. Those regulations defined management services so broadly that

virtually all service providers fell under the definition, and they extended the concept of leased employee to include many professionals who are clearly independent contractors.

In 1989, the IRS issued a notice establishing an effective date for new limitations on benefits provided under a defined benefit plan, even though the law and prior pronouncements by the IRS required that the limitations would not be effective until regulations were issued. No reason was given for the violation of law here involved.

In 1987, Congress imposed a new series of rules for the determination of the full funding limitation under defined benefit plans. Congress directed the IRS to issue regulations with reference to the rules by August 1988 and to provide Congress by that date with the results of a study as to the effect of the limitation. IRS neither issued the regulations (they remain unissued at this writing) nor conducted the study.

Many actuaries expressed concern that the limitation would adversely affect the security of benefits provided under defined benefit plans. ASPA formed a task force specifically to provide information and recommendations with reference to the regulations to IRS representatives. Our task force proposed a method of determining liabilities which we felt would go a long way toward protecting benefits for participants in defined benefit plans. Representatives of the IRS repeatedly stated over a two-year period that the rules, when finally published, would not permit the approach suggested by ASPA.

Then, in 1990, IRS issued Notice 90-11, which did incorporate the ASPA suggestion, but for reasons not explained permitted its use only for 1988 and 1989 plan years. Again, the guidance was not issued in the form of regulations, as mandated by Congress, but in the form of a notice. Again, the guidance was issued well after the date Congress set. And the guidance, issued almost one and one-half years after it was supposed to be issued, permits the calculation of liabilities in a way the IRS insisted would not be available. This, of course, requires the recalculation of funding liabilities for years already completed, at additional expense to the plan sponsor, if the additional protection accorded by the notice is to be used.

There are many other examples of interpretations given by the Internal Revenue Service in a manner most devastating to the private pension system. The regulations which have been issued under section 401(k) have been modified and may soon be modified again because of too harsh initial interpretations of the rules. The regulations issued under section 401(a)(26) and 401(1) have been modified and will soon be modified again. Regulations issued in proposed form are applied as if they were final and, in what ASPA considers one of the most egregious abuses of power by an administrative agency, the IRS has launched an abusive attack against the small plan segment of the private pension system.

4. **The small plan audit program.**

In 1989, the Internal Revenue Service launched a purely revenue driven campaign to disallow deductions taken for contributions to small defined benefit pension plans in 1986 and 1987. The IRS first estimated the revenue which would be obtained through the program, and then apparently designed the program to assure the generation of the projected revenues. The program requires the agent conducting an audit of a small defined benefit plan to deny the small plan sponsor the opportunity to demonstrate compliance with the requirements of the law, forcing the plan sponsor to expensive appellate procedures and possible litigation.

The law provides that contributions to a defined benefit plan must be determined based on actuarial assumptions which are reasonable based on facts and circumstances. The IRS, ignoring the statutory provision, has directed its field personnel to disallow deductions if certain predetermined assumptions were not used. Through ASPA's efforts, certain information with reference to the campaign was made public, and the IRS modified its audit position slightly. However, the effect of the modification is primarily cosmetic, and still precludes an agent auditing a small plan from exercising his or her own judgment.

The audit program is, in ASPA's opinion, a reprehensible exercise of power by the IRS. The program targets only one segment of the private pension system, the small plan. The program targets that segment because it is least able to defend itself, both because of the costs of such defense and the time involved. The development of an audit program purely as a revenue generating measure, the determination to ignore the law in the audit process to generate the

anticipated revenue, and the failure to adequately modify the instructions to the field auditors even after the program was revealed, provide significant evidence of the need for oversight with reference to IRS administration of the pension law.

5. **Model amendments and compliance.**

Because the IRS did not provide the needed guidance to permit employers to comply with the changes made by the Tax Reform Act of 1986 in time, the IRS published model-amendments and permitted plan sponsors to freeze benefit accruals until the guidance was provided. The first notice was published in December 1988, less than a month before the new law became effective, and required employers to operate plans as if they were in compliance even though plan language did not conform. Apparently, at the time the notice was issued, the IRS expected to provide guidance some time in 1989 because the original amendments expired at the end of the 1989 plan year.

Because guidance was not forthcoming, in November 1989, IRS issued a second notice extending until the end of the 1991 plan year the date by which plan documents must be brought into compliance with the 1986 law changes and imposing a series of conditions on employers electing to continue the freeze on accruals. Those conditions include, in some instances, an inability to deduct contributions which must be made to satisfy funding rules, with the resulting penalty for making nondeductible contributions imposed on the sponsor.

As a consequence of the delays, all the result of IRS failure to provide the necessary guidance, many employees participating in pension plans do not know the benefits to which they are entitled. Many plan sponsors have no way of determining the costs of the benefits they are providing. Most advisors to participants and plan sponsors are unable to provide coherent advice to their clients.

It seems strange that IRS can find the time and resources to launch a massive audit campaign against small defined benefit pension plans, but can not find the time and resources to develop the guidance necessary to permit employees and plan sponsors to know the benefits the are providing.

Administrative Simplification

Because the administration of the pension law is as important to the simplification process as the language in the statute, ASPA recommends the following procedures be adopted to better control the administrative process:

1. **Delay the effective date of the law.**

The effective date of pension legislation should be delayed until plan years beginning at least eleven months after the final regulations are issued. This will prevent the confusion and uncertainty which results when IRS is unable to complete regulations before the law is effective, and it will allow plan sponsors to know the rules which apply before they are effective. This will encourage new plan formation and benefit improvements during the period prior to the effective date of the law change by eliminating the fear that a new rule with retroactive effect will be radically difference than anticipated.

2. **Develop pension legislation independently from other law.**

Pension legislation must be developed on its own merits, and only after hearings are conducted and the public is given the opportunity to be heard. The piecemeal approach followed in recent years is automatically destructive since it develops neither consistent nor intelligible rules. The private pension system is becoming the most important element in the retirement income security of our populace, and modifications to that system must be given the attention so important a system deserves.

Pension legislation must not be lost in larger tax bills nor slipped into unrelated legislation. ASPA recommends that Congress specifically direct that pension legislation be proposed only after appropriate hearings have been conducted and full consideration has been given to the effect of the legislation.

3. **Conduct frequent oversight hearings.**

ASPA strongly recommends that frequent oversight hearings be conducted with reference to the administration of the pension law by the agencies charged with that responsibility. Congressional oversight will cause the administrative agencies to listen to the concerns of the private pension system and encourage intelligent and supportive responses. Congressional oversight will permit the early recognition of serious problems and assist in preventing such problems from becoming major roadblocks to the strengthening and growth of the private pension system. We recommend that such hearings be held at least twice a year.

CONCLUSION

In any attempt to develop a blueprint for simplicity in the rules governing qualified pension plans, the process must involve not only the repeal of too complex or overly broad legislation and its replacement by simpler and less all-encompassing rules, but also the exercise of a greater degree of control over the agencies administering the pension law.

A NATIONAL POLICY ON RETIREMENT INCOME

PART I: OVERVIEW

AMERICAN SOCIETY OF PENSION ACTUARIES

EXECUTIVE SUMMARY

There is no national policy on retirement income, even though it affects virtually all Americans and has great impact on the economy and the social stability of the nation.

Such a policy is urgently needed.

There are three challenges:

1. Achieve a consensus on the best policy in light of the many complexities and diverse factors involved.

2. Convince Congress of the necessity for such a policy and that it must make no more changes without having such a policy to follow.

3. Educate and persuade the public on the mutual advantages of this policy to all segments.

* * *

The goal of the National Retirement Income Policy should be: *Income from all sources throughout retirement that provides the same standard of living as that enjoyed in the later years of full-time employment.*

This requires a four-legged retirement structure:

1. Social Security.

2. Voluntary employer-sponsored retirement plans that are virtually universal, with incentives for small employers.

3. Personal savings (including use of home equity as a form of savings).

4. Availability of gradual retirement.

MEMORANDUM

TO: ALL RETIREMENT BENEFIT PROFESSIONALS

FROM: AMERICAN SOCIETY OF PENSION ACTUARIES

DATE: FEBRUARY 1, 1989

RE: A NATIONAL POLICY ON RETIREMENT INCOME

Practitioners in all aspects of retirement benefits share an awareness of the need for a single, cohesive national policy on retirement income. As legislation affecting retirement benefits becomes increasingly complex and seemingly irrational, our awareness of this need becomes increasingly acute.

We all share, as well, a consternation that the people making the laws do not always appear to see this need. Or, even worse, it appears at times they pretend that we do have a policy and that the morass of recent legislation reflects it.

What follows is PART 1 of a series of proposals. It presents an overview of a possible policy. It will be followed shortly by several other parts, to focus on the details.

In PART 1, we state that "the first challenge is to develop a statement of national retirement income policy and obtain a broad consensus of agreement on its appropriateness."

Then, we state that "the next challenge is to convince our legislators and public servants of its importance."

MEETING THE FIRST CHALLENGE: DEVELOPING A CONSENSUS

We must unify ourselves and those we serve regarding a national policy.

A considerable portion of this task will be educational. For example, we must address soberly and unemotionally the conventional wisdom among employers that full immediate vesting and cost of living indexation will increase costs prohibitively. We must measure the costs objectively and then determine whether they are prohibitive.

It is particularly important that the business oriented groups, consumer oriented groups, women's groups, and retired pensioner groups find a common ground. ASPA is proposing a policy. But adoption of ASPA's proposals doesn't come close to being the most important goal.

THE REALLY IMPORTANT GOAL IS A POLICY WHICH ENJOYS A BROAD CONSENSUS OF SUPPORT.

We offer ASPA's proposals as a first step.

MEETING THE SECOND CHALLENGE: CONVINCING CONGRESS OF ITS IMPORTANCE

Once we have a consensus, we must convince our elected legislators they cannot afford to ignore us.

We propose an important interim step in this second challenge. We propose that:

THERE SHOULD BE AN IMPACT STATEMENT REQUIREMENT
ASSOCIATED WITH EVERY LEGISLATIVE PROPOSAL
AFFECTING RETIREMENT INCOME.

This impact statement should undergo the same lawmaking scrutiny as every other aspect of the bill to which it is attached. It should be part of every introduced bill. It should be discussed in hearings. It should be addressed at markup time. And it should be fully subjected to the checks and balances of a bicameral legislative body.

But on a long term basis, we must be much more ambitious. We must reach out to the rank and file. We must sell the workers, the voters, on the importance of our policy.

Congress is not easily swayed by entrepreneurs. Congress is not easily swayed by the retirement plan industry. But Congress listens ever so closely to the voters. The fact of life, the essence of democracy, is also our biggest challenge.

WE MUST SELL RANK AND FILE AMERICA
ON THE IMPORTANCE OF OUR MISSION.

We would do well to treat this as a challenge to be attacked with the same resources and the same vigor that Madison Avenue brings to its public information assignments. We'll need to utilize all the media available to the modern communicator.

The job will require tremendous effort and a tremendous expenditure. It will be a selling job of the first magnitude. But the stakes are worth the effort.

* * *

First things first. Before we talk about large amounts for advertising, we must reach agreement on a policy. In the months to come, the American Society of Pension Actuaries will be reaching out to other professionals to offer — and to seek — help in accomplishing this important goal. We hope you will welcome our overtures as we shall welcome yours.

If we unify, we can achieve our goal. The issues are too critical for us to do anything but.

A NATIONAL POLICY ON RETIREMENT INCOME

PART 1: OVERVIEW

This is the first in a series of position papers by the American Society of Pension Actuaries (ASPA). This paper discusses the need for a national retirement income policy and outlines a proposed basic framework. Later papers will add detail to various portions of that framework.

THE NEED

ASPA believes it is time to acknowledge that our nation has been making decisions affecting retirement income without benefit of a consensus on policy. Indeed, acknowledgement is way overdue.

We seek an integrated, cohesive policy setting forth our nation's goals on retirement income for our citizens, and stating how we expect to achieve those goals. The longer we wait to define these goals, the more difficult (and painful) it will be to achieve them.

It is not acceptable to say, simply, that our nation should constantly strive to do more for its retired citizens. As with any society, we have limited resources. We must acknowledge that more resources spent on one need will inevitably mean fewer spent on another. As with any society, we must intelligently ration our resources.

This basic concept is made more critical by our rapidly changing demographic profile. In just a few decades, our birth rates have fallen dramatically. They have declined from levels sufficient to support continued population growth to levels not even sufficient to maintain current size. The inevitable impact of this change is an aging society. This process is already far advanced and its consequences abundantly evident. Experts predict that this trend will continue. They predict that in 30 years the average age of the U.S. population will increase by 24%.

The bottom line is clear: we can no longer be casual in our policymaking on retirement income. In earlier days, when we perceived needs among our retired citizens, we could take action to meet these needs. Most of us were so far from retirement that the funding to implement these actions could occur gradually — and painlessly.

This comfortable posture is being changed rapidly. Today, when we perceive needs, we can still take action. But funding is no longer painless. A large percentage of our population is closing in too rapidly on retirement. Our nation is approaching the day when making decisions and implementing them through gradual funding will be nothing more than a historical memory.

If we reach that day without having implemented a cohesive policy, the results will spell disaster for our older citizens. The younger ones will be asked to make the sacrifices which should have been spread evenly over many generations. They may refuse. The ultimate protective net of prior days, the extended family, will no longer exist. It has already disappeared. At least figuratively, we could end up placing our older citizens on ice flows, casting them off to die quietly and unobtrusively.

Do we not have a policy already? Yes, we have one, of sorts. But it is framed in broad generalities — so broad that virtually any legislative or regulatory action can be claimed to fit within it. And in many cases, even the broad generalities are ignored.

The current scene is pock marked with two types of legislation. Although at opposite extremes, they are equally destructive to coherent retirement income planning.

At one extreme,

WE HAVE BEEN ROCKED WITH LAWS AFFECTING
RETIREMENT INCOME WHICH DO NOT EVEN PRETEND
TO FIT INTO A LONG TERM POLICY.

These are the laws enacted solely to help control the federal deficit. The objective is to increase taxes without admitting it. Laws affecting future retirement income have proven to be easy, if irresponsible, ways to accomplish this.

At the other extreme, are laws aimed at buying the votes of rank and file America. These are the "get tough" laws. They tighten anti discrimination rules. They mandate benefit and vesting levels. They restrict the extent to which all sources of retirement income can be integrated to form a rational whole.

Some laws in this second category may be highly desirable. But many are counterproductive. The counterproductive ones share the same flaw. They were formulated without asking the crucial question: how does this proposal serve our long term national policy? They were formulated with the assumption that the only goal to be considered is doing more for rank and file workers. They ignore the limited nature of our resources.

We believe:

THE FIRST CHALLENGE IS TO DEVELOP A STATEMENT OF
NATIONAL RETIREMENT INCOME POLICY AND OBTAIN
A BROAD CONSENSUS OF AGREEMENT ON ITS APPROPRIATENESS.

THE NEXT CHALLENGE IS TO CONVINCE OUR LEGISLATORS
AND PUBLIC SERVANTS OF ITS IMPORTANCE.

THE TOTAL RETIREMENT INCOME GOAL

Probably the element on which a consensus will be easiest is the one describing our goals for total retirement income. We doubt there will be much disagreement over this:

INCOME FROM ALL SOURCES THROUGHOUT RETIREMENT SHOULD PROVIDE THE SAME STANDARD OF LIVING AS THAT ENJOYED IN THE LATER YEARS OF FULL TIME EMPLOYMENT.

We choose our words carefully:

- Medical needs, including long term care, could require greater income just to maintain an earlier standard. These medical needs must be considered in setting any National Retirement Income Policy.

- A reference to income throughout retirement is quite different from a reference to income immediately after cessation of full time employment. Inflation must be accepted as a fact of life.

- "The same" means "not better than" as well as "not worse than." There is poverty in our society which demands attention long before an individual reaches retirement age. Orderly solutions will not be fostered by the position that the disadvantaged person should receive more after retirement than before. Here, the fix should be aimed at the problem: inadequate education and training, leading to lost employment opportunities.

- The standard enjoyed in the later years of full time employment is likely to exceed that of earlier years, when child rearing sacrifices were being made. We do not believe an individual should be asked to step backwards, to the standards of those earlier years.

- Finally, we define full time employment to include unpaid child care, in those households which have elected to follow the more traditional single wage earner model. Where this traditional model has existed and is broken by death or divorce, survivors' shares should not depend on who was the wage earner and who was the child care provider. The thrust here is equity between the parties, not the doubling of their aggregate benefits.

In a separate paper, we shall explore the question of replacement ratios necessary to achieve this overall retirement income objective. In others, we shall discuss the potential mix of devices (such as social security, private plans, and personal savings) to produce these ratios.

MEETING THE GOAL

Much has been said of the three legged stool as a fundamental basis of our nation's retirement income policy. The three legs are social security, voluntary employer sponsored retirement plans, and personal savings. We embrace the concept of these three legs working together. However, we would add a fourth leg.

THE FOURTH LEG: AN END TO CLIFF RETIREMENT

With some trepidation, we refer to this fourth leg as "part time work after commencement of retirement." Our trepidation stems from our concern lest we be cast as ogres, advocating forced employment until death. We mean no such thing.

We address the question of work following retirement from the viewpoint of years spent observing the traditional approach. Traditionally, one works full time until retirement date, and then stops working. We call this cliff retirement. It would be difficult to overemphasize the emotional trauma wrought by this traditional approach.

CLIFF RETIREMENT CAN BE MENTALLY UNHEALTHY.

From the standpoint of health and well being, we believe gradual retirement is far better. Gradual retirement means cessation of full time employment followed by gradually reducing amounts of part time work.

Gradual retirement has other merits for today's society:

- As we move from a smokestack to a servi[illegible] we see a decline in those jobs which are both boring and phys[illegible]ueling. In their place, we see jobs where the worker is able and [illegible] continue on, past traditionally normal retirement ages. We see jo[illegible] where wisdom and experience are positive attributes. We see a society which needs this wisdom and experience.

  From the standpoint of human resource management, continued work by older employees is changing from a negative to a positive.

- As longevity and productivity continue to increase, we face both the ability and the desire to increase the portion of our lives spent in leisure activities. One approach would be to keep the years spent in full time employment unchanged, and lengthen the time spent in retirement.

  But the extent to which our leisure is enforced leisure — enforced by physical deterioration — is diminishing.

  So, we are experiencing increasing opportunity for leisure, and increasing control over when it is spent.

  Solid work for the first part of an adult lifetime followed by uninterrupted leisure for the remaining part is no longer the only possible model. As options become available, many of our citizens will find them more attractive. It will seem increasingly rational to intersperse work and play throughout the entire adult lifetime.

- Whether the stool has three legs or four, one of them is voluntary personal savings. But there will always be those among us who, although able, do not save in advance. With some, this will involve a rational, conscious decision. With others, it will simply reflect improvidence. Either way, the individual needs an optional plan. Work after retirement date facilitates this optional plan.

In a separate paper, we shall develop details of possible models for gradual retirement, and a rationale for offering work after retirement as a tradeoff for personal savings. We shall also make suggestions on steps to make part time work more readily available and more attractive to both workers and employers.

THE FIRST LEG: SOCIAL SECURITY

In a paper on Social Security, we shall develop detailed proposals for a drastic but very gradual reshaping of the program.

We shall be suggesting a transition, to occur over a 50 year period. Thence,

UNDER OUR PROPOSALS, THE ENTIRE FOCUS
WILL BE ON THE PROVISION OF A SAFETY NET
DESIGNED TO PROTECT ALL OLDER CITIZENS FROM POVERTY.

We believe benefits should be unrelated to wages. In fact, a wage history should not be a condition for benefit receipt.

In general, the ultimate arrangement would reflect a significant diminution in the social security program. But this diminution would affect only those workers with incomes comfortably above the poverty threshold. As at present, the program would avoid needs tests, with their demeaning implications. Yet, by its very structure, the program would be far more effective than the current arrangement in funneling benefits where they are most needed.

Viewed in combination with our other recommendations, our proposals on social security represent a significant change in approach to funding. Over a very long period, this change will substitute advance funding for non funded benefits. One consequence may be an increase in the formation of investment capital.

The current social security tax scheme is highly regressive. The tax, as a percentage of total wages, goes down as wages go up.

OUR PROPOSALS WILL ELIMINATE THIS HIGHLY
UNFAIR REGRESSIVE TAX.

By decoupling benefits from earnings histories,

OUR PROPOSALS WILL ELIMINATE TWO SERIOUS SOURCES OF
INEQUITY WHICH CURRENTLY FALL MOST HEAVILY ON WOMEN.

First is a relationship between taxes and benefits which is less attractive for two wage earner couples than where there is only one breadwinner. Second is the unfair impact of divorce on a non wage earning homemaker.

Our proposals will provide for benefits whether or not the individual works after retirement. This will give meaning to our proposals on part time employment.

By incorporating a very long transition period, our proposals will not be viewed as a threat to current generations of older workers.

Because they would scale back taxes, we believe our proposals will be welcomed by younger Americans. These younger Americans are becoming skeptical, in the extreme, over the continued viability of the existing arrangement.

Indeed, we shall make it clear that no generation will be asked to sacrifice, as the program is shifted to a more rational basis.

THE SECOND LEG: PERSONAL SAVINGS

It has become conventional wisdom that saving for retirement is almost impossible, in the face of the current demands of modern life. The facts speak differently. Indeed, many segments of our nation's most recent generations of retirees are enjoying unexpectedly comfortable life-styles. And the most decisive factor is personal savings.

But these generations were the beneficiaries of certain economic accidents of good fortune which may not be repeated for future retirees. In fact, statistics already point to declines in savings, in recent years, and the rate of decline appears to be steepening.

America's citizens are not, by and large, improvident spend-thrifts. Now, we must find ways to encouarge *and utilize* personal savings under all different economic and demographic circumstances.

We see three different levels of savings.

The first should be defined in terms of equivalency to a specified amount of post retirement wage income. This is the other side of the coin of personal choice already mentioned: you can save now or work later.

To help encourage saving now, we believe:

EVERY WORKER SHOULD BE GIVEN ACCESS TO A TAX SHELTERED VEHICLE FOR PERSONAL SAVINGS.

The structure, today, is a hodgepodge. It includes IRAs, tax sheltered annuities, 401(k) plans and personal Keogh plans. At present, some workers have access to many of these. Some are prohibited from making deductible contributions to any of them. In a paper on tax incented personal savings, we shall recommend a rational replacement for the current morass.

In a separate paper, we shall offer a possible basis for defining the degree of self sufficiency expected of each citizen. This will be defined in terms of savings before retirement or wage earning thereafter.

The second level of savings is one we believe should be expected only of persons of middle class stature or higher. At this stature,

HOME EQUITY OR ITS EQUIVALENT SHOULD BE VIEWED AS AN IMPORTANT SOURCE OF RETIREMENT INCOME.

Currently, it is not as easy as it should be to unlock this source. Many citizens have been trapped into frugality, in their final years, only to die leaving substantial home equity behind.

We shall be making proposals to mitigate this problem. One will bear the acronym HERO: Home Equity Roll Over. Working much like a rollover IRA, it would permit a tax sheltered conversion of home equity into a retirement spending account. Another would make the concept of a reverse annuity meaningful. Under this concept, retired individuals could remain in their homes and at the same time use their equity to meet current expenses. These proposals will be set forth in a paper on unlocking home equity.

The final level of savings reflects the inevitable differences among us. Some of us have greater retirement income needs than others. An example would be the cost of college education, where the worker formed a family late in his career. These individually different needs will also be well served by our proposals for tax sheltered savings.

THE THIRD LEG: VOLUNTARY EMPLOYER RETIREMENT PLANS

In a separate paper, we shall define the total retirement income goal. In other papers, we shall define the roles of part time work, social security, and personal savings in meeting this objective. We propose that voluntary employer retirement plans will constitute the balancing item. They will tie the whole to the sum of its parts.

When we talk about voluntary plans, we mean employer sponsored plans (whether or not collectively bargained) and jointly sponsored labor management plans. We do not mean employer financed plans which exist because of a mandatory pension law.

Voluntary plans have made great strides in recent history. Since the middle of this century, coverage percentages among U.S. workers has increased from less than 25% to roughly 50%.

But we must do more.

If the voluntary approach is to be viable,

VOLUNTARY PLANS WILL NEED TO BE VIRTUALLY UNIVERSAL.

This will require incentives stronger than those available today. It will require a more intelligent and rational approach to benefit standards and anti discrimination rules. And, it will require a regulatory climate which offers stability and freedom from political gamesmanship.

Satisfaction of these requirements will involve new approaches to:

- Vesting,
- Portability,
- Inflation protection,
- Protection for non working or lower earning spouses,
- Special incentives for smaller employers,
- Funding, and
- Plan termination insurance.

We shall treat these issues in separate papers.

We shall be devoting special attention to incentives. We believe:

THERE SHOULD BE SPECIAL INCENTIVES FOR SMALL EMPLOYERS.

Firms with fewer than 20 employees are generating more than 90% of the net new jobs created in this country. Unfortunately, these same firms account for a large portion of the jobs not yet protected by employer sponsored retirement plans.

Too much legislation in the past has involved provisions which served as disincentives to plan formation among these smaller employers. High on the list are complex rules which serve to increase administrative and actuarial costs. With elimination of these disincentives, a great deal will be possible *without* overemphazing tax favors for highly compensated employees.

We have emphasized the word "voluntary." We believe the diverse needs of various worker groups in various parts of our nation will be best served by strongly incented voluntary programs. And, we are impressed by the lack of success of mandatory arrangements, wherever they have been tried.

We must not give up on the voluntary approach. It must be given a fair chance. The endless stream of legislation in the years since 1981 has impeded opportunities for voluntary growth. We must clear away the impediments and restore incentives. Once this is done, once a fair chance for growth has been restored and given a reasonable period to work, we must rationally evaluate progress. We believe this rational review will lead to a conclusion that the voluntary approach does work.

Prepared Statement of Howard J. Golden

Mr. Chairman and members of the Subcommittee. My name is Howard J. Golden. I am a partner of Kwasha Lipton, an employee benefits consulting firm headquartered in Fort Lee, New Jersey. I also serve as chairman of the Retirement Savings Committee of the Association of Private Pension and Welfare Plans (APPWP) on whose behalf I appear today. The APPWP is a national trade association whose members include not only employers of all sizes who sponsor employee benefit plans for their employees, but also the leading support organizations for benefit plans such as banks, insurers, accounting, investment, actuarial and benefit consulting firms. Together, our members speak for employee benefit programs covering more than 100 million Americans.

We applaud you, Mr. Chairman, for holding these hearings to investigate the state of the nation's private retirement system and to determine whether there is a need for simplification of the laws and regulations governing this system. It is not overstating the case to tell you today that the retirement security of literally millions of America's current and future elderly depends on the Congress uncovering how the regulation of the nation's private pension system has gone awry and taking immediate steps to simplify it. By doing so, the impediments to maintaining qualified retirement plans created by needless complexity can be reduced and employers, who are frustrated and dispirited by rule changes which raise administrative costs, can be encouraged to continue to provide retirement income to their employees.

A MAGNIFICENT PENSION SYSTEM IN PERIL

The nation's pension system is a paradox. On one hand, it is a model of success thanks, in great measure, to tax incentives that Congress has wisely encouraged over many decades. On the other hand, the very survival of that system is threatened as never before. First, the good news.

Today, some 45 million Americans are covered by the private pension system and employers account for roughly 87 percent of the contributions to retirement plans. According to the U.S. Department of Labor Statistics, the private pension system has grown from $17 billion in assets in 1950 to $1.7 trillion today.

Moreover, the private pension system stands out as perhaps the only bright light in an otherwise dismal record of national savings. In 1986, pension and profit-sharing plan contributions accounted for roughly 51 percent of new savings. According to a study submitted by David Wise to the National Bureau of Economic Research, employees would have to save an average of 3 to 7 percent of their wages to make up for what employers put aside for them.

The best news, however, is that the private retirement system is one of the best bargains for retirees and for the Federal Treasury. Although the Federal revenue expenditure for private pensions is estimated at $47.4 billion in Fiscal Year 1990, the *benefits paid* to retirees by employer plans in 1988 (the most recent year for which data is available from the National Income Accounts of the U.S. Commerce Department) is approximately $200 billion. Benefits paid are 4.6 times the foregone Federal tax collected! And of course pension contributions are not tax excluded but, rather, tax deferred until benefits are paid.

While the good news is very good, the bad news is very bad. For those fortunate enough to participate in the system, employer plans are generous and fair. But employers—in truly alarming numbers are finding that it has become too costly, too cumbersome and too onerous to continue sponsoring retirement plans.

Data reported by the Internal Revenue Service for 1989 tells the story in graphic terms. Last year there were three times as many terminations of defined benefit pension plans—plans which are the bedrock of the American pension system—as there were new plan creations. That is even worse than in 1976 when the full impact of the Employee Retirement Income Security Act (ERISA) was felt and terminations doubled new plan establishments. (See Appendix A)

Regrettably, we can not even take comfort in the belief that the bad news last year was due solely to provisions of the 1986 Tax Reform Act (TRA) which required the termination of many plans in 1989. The really alarming news last year was that while terminations of existing plans rose by 37 percent, new plan creations *plunged by 67 percent.* American businesses are dissatisfied with the system and are canceling plans. And newer companies are concerned with the confusion, cost and complexity of the system and they are avoiding the formation of new plans which are essential if we are provide tomorrow's retirees with more than just a Social Security check to meet their income security needs.

THE CAUSES OF PENSION GRIDLOCK

What has caused all this complexity? Several factors. In great measure it has been the unrelenting legislation and regulation in the pension arena. Congress has significantly revised the rules governing the benefits system in 1980, 1981, 1982, 1984, twice in 1985, twice in 1986, 1987, 1988 and 1989.

Since 1986 alone, over 300 typewritten pages of proposed employee benefits regulations have been published by the Treasury Department. And that is the good news. What has really frustrated employers and employee benefits professionals is that the regulatory agencies are nowhere near completion of the issuance of regulations. For most employee benefits provisions of the 1986 Tax Reform Act, the Treasury Department was given until February 1, 1988 to issue final regulations so that plan changes could be made in 1989. Many of these regulations are not even yet published in proposed form. Employers are being forced to comply with many provisions of law with little or no guidance from the regulatory agencies. (See Appendix B)

What has caused this flood of legislation and regulation? Unquestionably, a desire to raise revenue is partially to blame. Fully 15 percent of the $280 billion in tax increases levied by the Tax Reform Act came from pension and other benefits changes. For too long pension law has been governed by revenue considerations, rather than retirement policy. But that is not the whole answer. Revenue alone does not explain why one third of the TRA's volume involved employee benefits provisions.

The reason for complexity, we believe, lies also to a great extent in two erroneous beliefs held by many lawmakers and regulators. The first is something we call "evil plan myopia." In short, it is the myopic view of many policymakers who believe that employers are intent upon cheating their employees out of a fair share of benefits and, therefore, the rules governing plans must take into account every theoretical kind of alleged abuse imaginable. Instead of focusing on actual abusive situations, form is elevated above substance. The result is that the vast majority of employers are compelled to comply with complicated rules that have little bearing on their practices.

The second erroneous belief is what we call "computer omnipotence." This is the equally unrealistic assumption that once employers are directed to make certain changes to their plans, or to apply certain tests, all the employer needs to do is press a button and magically compliance will be possible. Computer omnipotence totally overlooks the reality of corporate recordkeeping. Companies typically have different payroll systems—especially where there are separate lines of business or facilities in different geographic areas. Much of the compliance requires obtaining information from employees and former employees who are often reluctant to disclose this information. Even where accurate compliance is possible, the expense of engaging lawyers, accountants, actuaries and consultants—to say nothing of inside personnel—to cope with continually changing laws and regulations is driving employers away from their traditional support for the pension system.

More than a decade of legislation, delayed and voluminous regulations, a thirst for revenue from the private employee benefits system, "evil plan myopia" and "computer omnipotence" have all combined to cause total pension gridlock. Pension law—and along with it the future income security of America's retirees—is in crisis.

ROAD TO SIMPLIFICATION

The APPWP does not wish to dwell simply on the complexity of the private retirement system. We want to tell you that what can be done to achieve simplification. The APPWP's Retirement Savings Committee and its Board of Directors spent nearly a year developing a list of legislative changes that Congress could enact to erase much of the complexity that is due to duplicative, obsolete or simply unnecessary rules. Our report: "Gridlock: Pension Law in Crisis and The Road to Simplification" published in September 1989 contains 29 specific recommendations that, if adopted, would make the system simpler and more rational.

We are heartened that since the publication of "Gridlock" other organizations have endorsed the recommendations made in our report. Likewise, we are gratified that many on Capitol Hill and in the Administration have recognized that simplification of the Internal Revenue Code is a worthwhile goal. We commend Rep. Dan Rostenkowski for stating that simplification will be a personal priority for him and the Ways & Means Committee this year. We hope that proposals in the House of Representatives will include a number of the simplification recommendations we have made in the pension area.

It is not possible to describe today all 29 recommendations we have made. A copy of our "Gridlock" report has been sent to all members of the Senate Finance and House of Representatives Ways and Means committees and we submit it to you today for inclusion in the formal hearing record. I would just like to take this opportunity to list a few examples of egregious complexities in the pension system in need of simplification:

A. Excise Tax on Excess Distributions

A provision enacted by TRA, Section 4980A, imposes a 15 percent excise tax on individuals to the extent that annual aggregate distributions from tax-favored arrangements exceed the greater of $150,000 or $112,500, indexed.

This excise tax originally was intended during TRA to replace the complex combined plans limitations of section 415(e) with a simpler and more equitable scheme for limiting retirement income. However, as finally enacted, the excise tax does not replace the combined plans limitations but is applied in addition to them, and it is neither simple nor equitable. We believe, therefore, that tax should be eliminated.

B. Minimum Participation Rules

The minimum participation rule, Section 401(a)(26), was designed to prohibit discrimination in favor of highly compensated employees and employees with significant ownership interest in the employer. Its original focus was comparatively narrow: it was aimed at the elimination of individual defined benefit plans, plans which covered only the highest paid employee of the employer. However, the provision has grown a life of its own, and now appears so broad that nearly all plans will be affected by it, and so complex that compliance necessitates review of a large number of pages of regulations and expenditure of excessive amounts of time and money.

The regulations will prohibit small employers from using a variety of comparable plans to tailor their benefit packages to individual groups of employees. For many plan sponsors these rules are equivalent to Section 89 in pension clothing. While we understand that the Treasury and Internal Revenue Service are considering reproposing regulations under section 401(a)(26) Congress needs to reconsider the policy underlying the statute.

C. 401(k) Average Deferral Percentage (ADP) Tests

As we all know, the contribution limits for 401(k) plans, the most popular savings vehicle ever in a savings starved nation, were severely reduced by TRA from $30,000 to $7,000. But the TRA, in the name of greater equity, also further tightened the average deferral percentage test ("ADP") permitted under the law. The ADP test was originally designed to assure participation by nonhighly compensated employees (i.e. those who earn less than about $50,000 per year) by limiting 401(k) deferrals by highly compensated employees to a ratio based on deferrals by the lower paid.

The rules for calculating, returning and taxing deferrals in excess of the ADP limits are extremely complicated. In addition, the ADP tests include a multiple use test which make 401(k) contributions subject to still other test limitations under section 401(m) rules on lineal descendants, separate testing for ESOP portions of the plan, and an "adjusted balance" provision for determining income on excess amounts, all of which are examples of unnecessary complexity that far outweigh any possible utility.

While the ADP test may have made sense when the maximum 401(k) deferral was $30,000, its impact on senior management under the reduced limitation is negligible. Because of the interaction with the maximum limitation (once again, originally $7,000) on 401(k) deferrals, the ADP test only serves to penalize the lower end of the highly compensated group. In a typical situation, if an employee earning $50,000 contributes $7,000 to a 401(k) plan, the individual's deferral percentage will be 14 percent. If the firm president contributes $7,000 and earns $200,000 that person's deferral percentage is 3.50 percent. If the ADP tests are not met, the $50,000 employee's deferral must be reduced first, because of that person's higher deferral ratio, even though that individual's contribution was the same as the president's.

To assure compliance with the ADP tests, many plan sponsors enact rules limiting the amount that the highly-compensated can defer, unfairly penalizing the lower end of the highly compensated group to the advantage of the most highly paid employees. For example, if a company places a 3.5 percent ceiling on contributions by the highly compensated, a president earning $200,000 could defer $7,000, but an employee earning $50,000 could defer only $1,750. Another employee earning $49,000 could defer the full $7,000 simply because he or she is not deemed to be "highly compensated." Because of results like these, the incentives associated with

having senior management's level of contribution dependent on the contributions of lower paid individuals is dissipated.

It further frustrates private employers that the Federal Government recognizing that the degree of equity obtained versus the complexity introduced by these reduced limited was out of balance sought and obtained an exemption to the ADP tests In its own savings plan.

In sum, while the rules may have made some sense when the deferred limits applied to 401(k) plans were $30,000, they don't make much sense when the maximum limit is around $7,000. Given their complexity and the anomalous situation that many highly paid executives can put more money into 401(k) plans than lower paid executives, the additional costs associated with the tests are not warranted by any corresponding increase in equity. This test is unfair, inequitable and discourages employers from offering 401(k) savings plans to employees. These "ADP" rules must be eliminated.

D. Paperwork Burdens

The burdens of the various reporting and disclosure requirements that ERISA and the Internal Revenue Code impose upon retirement plans cannot be overstated. While many such requirements are valuable, and almost all are well-intentioned, many of these requirements are costly and serve to confuse plan participants. Employers are deluged with paperwork requirements which include Annual Reports, Summary Annual Reports, Summary Plan Descriptions, Summary of Material Modifications, IRS forms 5300, 5301, 5302 and so on, PBGC Form 1, etc. Following 1987 tax and accounting changes, employers who previously could meet ERISA requirements by paying an actuary to do a single valuation, must do at least four valuations.

Much of this required paperwork is duplicative and unnecessary. The Summary Annual Report, which is distributed for all ERISA plans to employees, is a good example. Employers are required to use a format dictated by the Department of Labor which is intended to insure uniformity and clarity. This requirement needs to be eliminated.

Reporting requirements, should be reviewed so that they only require disclosure of information that is truly useful to either participants or the government. The APPWP urges that any changes in required reports or forms only be made if the changes are substantial and made at one time. Typically, it costs more to reprogram computers, retrain employees and set up new filing systems than is saved by just minor changes.

E. Rational Effective Dates

As I described above, many employers and others who provide services to retirement plans find that compliance with the law is made infinitely more difficult by the enormous delay of the regulatory agencies in issuing regulations. Sometimes the delay is caused by the regulators' overly-complex evaluation of Congressional intent. Other times, Congress, itself, has not given clear guidance or has simply legislated so much that those who write the implementing rules are overwhelmed.

In either case, employers should not have to squander resources simply because regulations are issued years late. Retirees should not suffer because employers are forced to freeze benefit accruals due to a lack of guidance from the government.

We propose that, henceforth, Congress make clear whenever it is adopting new benefits legislation, that the effective date of the changes made be delayed until some reasonable period (perhaps eleven months as envisioned in TRA) after the issuance of final regulations. This period should give plan sponsors an adequate period of time to make any necessary plan changes and communicate those changes to plan participants. Congress must also step-up its oversight of the regulatory agencies to ensure that they meet the deadlines set for them by law.

On a very specific and immediate level, we urge Congress to adopt new effective date relief for implementation of the vast changes made to the pension system under the TRA. Attached to Appendix B, the aforementioned list of the status of regulations to implement TRA's provisions, is a letter the APPWP sent to Secretary of Treasury Nicholas Brady urging his assistance in granting whatever administrative relief possible in the area of effective dates. (See Appendix C) We urge you to work with the Administration to achieve this goal which will benefit Congress, the Administration and employees, retirees and sponsors of pension plans.

PENSION SIMPLIFICATION IS COST-EFFECTIVE

We are mindful that two charges may be made by some against an effort to achieve major simplification. The first, is that simplification, itself, may cause addi-

tional administrative expense if it necessitates plan or operational changes. Of course we oppose change for the sake of change. When the APPWP developed "Gridlock" we considered and rejected a number of changes that, while furthering simplification, might have caused additional administrative changes that were not worth the level of simplification achieved. The APPWP has taken great care to ensure that the enactment of the changes meet the test of common sense practicality. These are changes that real corporate benefits managers will find helpful and worthwhile.

Most of our recommendations involve specific elimination or modification of unnecessary, obsolete or duplicative rules—or at least giving plan sponsors options from which to choose. Hence, Congressional enactment of these recommendations will for the most part not necessitate additional regulations nor plan or operational changes by benefits managers.

The APPWP strongly believes that those who may contend that adopting simplification recommendations will somehow cause more complexity and expense because employers would then have to comply with new albeit simpler—rules, are applying the same kind of tortured reasoning that regulators sometimes use in justifying pages and pages of regulations on the basis of a few simple lines of statutory language. Benefit managers who are on the front lines of administering plans are the ones who developed these recommendations. Even where additional plan or operational changes might be necessary, they believe that the overall resulting simplification and long-term cost savings will be well worth the immediate changes made.

The second concern that may be raised regarding pension simplification, is that some important changes may result in lost Federal revenues. In the current budget deficit climate, it is vital to squarely address this matter. It is ironic that so much pension complexity has been championed over the years in the name of achieving equity—while the sponsors of pension plans have long suspected that raising revenue was often the real culprit. Now that virtually everyone acknowledges that the pension system is a complex mess, revenue loss is mentioned as an obstacle to making changes that are essential to simplifying the system so that its benefits can more equitably be enjoyed by more Americans.

In calling for pension simplification, the APPWP is not urging new revenue expenditures. Congress has already wisely concluded that certain revenue expenditures are appropriate to encourage the growth of the private sector pension system. What we do urge is that the system be allowed to work. overly complex and technical rules that constrain the growth of the system and that require employers to waste money on needless plan administration—rather than on benefits—should be corrected or eliminated.

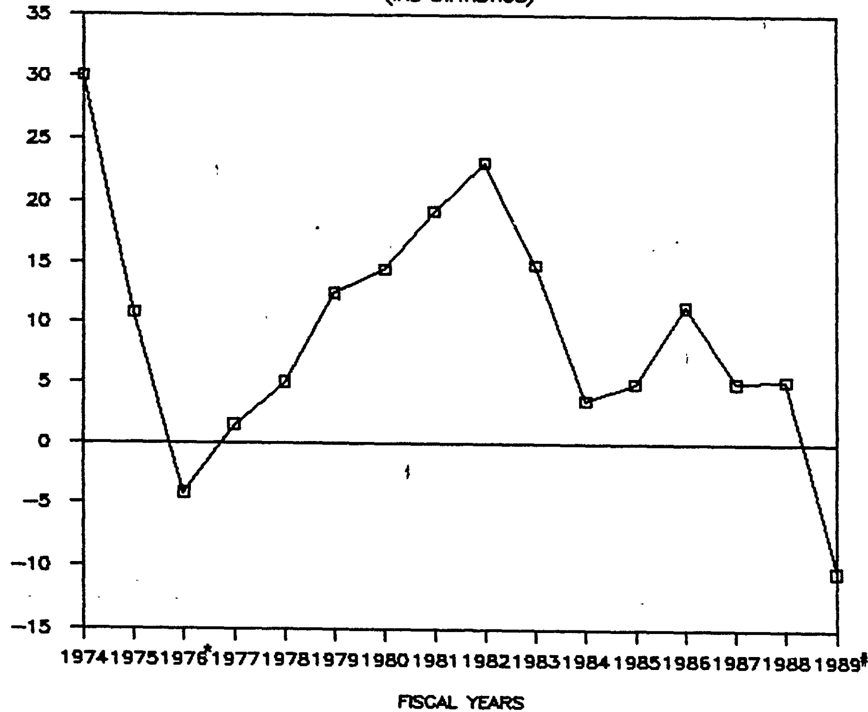
At the same time, we urge the Congress to keep in mind not just the cost of the private pension system—but its value as well. We discussed above the enormously positive cost/benefit ratio of the pension system in terms of tax revenues deferred in exchange for benefits paid. Congress must consider how much more expensive it would be for taxpayers to directly subsidize—either through increased Social Security benefits or other programs—the same level of retirement benefits now provided by private pensions.

CONCLUSION

The need to simplify the nation's private pension system in order to save it is apparent. The APPWP offers 29 specific recommendations for simplification. We stand ready to work with Congress to enact these and other measures that will help continue the vibrancy of the private retirement system. Thank you.

Enclosures.

NET NEW DEFINED BENEFIT PLANS



*ERISA changes effective

#Tax Reform changes effective

APPENDIX B

**REGULATIONS REQUIRED TO BE ISSUED BEFORE FEBRUARY 1, 1988
BY SECTION 1141 OF THE TAX REFORM ACT OF 1986**

STATUS AS OF FEBRUARY 23, 1990

TRA 86 SECTION	SUBJECT	PROPOSED REGS.	FINAL REGS.
1111	Application of nondiscrimination rules to integrated plans	Published 11/15/88	Not issued
1112	Coverage requirements for qualified plans	Portion published 5/18/89	Not issued
1113	Minimum vesting standards	Published 1/6/88	Temporary Regulations issued 1/6/88
1114	Definition of highly compensated employee	Published 2/19/88	Temporary Regulations issued 2/19/88
1115	(1) Separate lines of business	Not published	Not issued
	(2) Definition of compensation	Published 2/19/88	Temporary Regulations issued 2/19/88
1116	Rules for 401(k) plans	Published 8/8/88	Not issued
1117	Nondiscrimination requirements for employer matching and employee contributions	Published 8/8/88	Not issued
1120	Nondiscrimination requirements for tax sheltered annuities	Not published	Not issued
1133	Tax on excess distributions	Published 12/10/87	Temporary Regulations issued 12/10/87

APPWP
Association of Private Pension and Welfare Plans

APPENDIX C

Howard C. Weizmann
Executive Director

October 19, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Brady:

The Tax Reform Act of 1986 ("TRA") brought profound changes to the rules regarding employee retirement plans. Recognizing that these changes would revolutionize the way in which employers design and administer retirement plans and would affect huge numbers of employees, Congress mandated that the Treasury Department issue final regulations in most of these areas by February 1, 1988 (TRA Section 1141). We are writing to express our concern that, nearly three years after the statute was passed, regulatory guidance from the Treasury Department is still incomplete and the private retirement system is in disarray. Our specific areas of concern include:

Section 401(a)(26). The TRA added the requirement that tax qualified pension and profit sharing plans benefit a specified number of participants. On February 13, 1989, the Treasury Department issued over 120 pages of proposed regulations which many feel go significantly beyond the intent of the statute. Many of the requirements contained in the proposed regulations are new to employers and, like section 89 which was enacted at the same time, will require employers to dissect plans and test different levels of benefits against the statutory requirements.

Section 401(l). This section concerns the integration of private employer retirement plans with social security and railroad retirement benefits. These proposed regulations were originally issued on November 15, 1988 and have been supplemented by three subsequent notices. Virtually all retirement plans using a formula which coordinates benefits with social security or railroad retirement benefits will have to be studied and redesigned to comply with the regulations. Because guidance is still unclear and incomplete, employers cannot compute the retirement checks for employees retiring in 1989. As a result, both employers and employees alike are uncertain and confused as to how much retirement income they will receive.

Section 410(b). These proposed regulations which provide minimum coverage rules for retirement plans were issued on May 17, 1989. They are incomplete as to key requirements for compliance and provide no guidance as to the most difficult

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of the statutory tests. Without this information, employers cannot determine whether they comply with the new coverage requirements.

Section 414(r). This section deals with the definition of separate lines of business. These regulations are necessary to determine compliance under most of the above regulations. We are informed that proposed regulations under this section will be issued no earlier than late this year.

The provisions cited above create additional burdens because they are interrelated. Thus it is impossible to be assured that compliance with one set of regulations will also mean compliance with others when they are issued. For example, it is unreasonable to expect employers to redesign benefit formulas under section 401(l) while guessing at regulations which have been promised but are yet to be issued under the forty year old general rule of non-discrimination under section 401(a)(4). Likewise, it is inequitable to require compliance with the minimum coverage standards without guidance on appropriate lines of business under section 414(r).

We are sympathetic to the enormous burden the TRA has placed upon Treasury. But as Congress initially recognized, it is unfair and needlessly costly to require employers to commit millions of dollars to comply under incomplete regulations which themselves are subject to change. It should also not be overlooked that in addition to these statutes, employers are racing to comply with final and proposed regulations on 401(k) plans, fringe benefits and plan loans. The system is simply overloaded. The complexity and sheer volume of the proposed regulations issued to date under the above Code sections (nearly 300 pages) alone suggests that a reasonable period of time for compliance should be permitted.

On behalf of the APPWP's over 400 members who sponsor or represent plans covering tens of millions of workers, dependents, and retirees, we urge you to delay the effective dates of these rules to the earlier of plan years beginning after 1992 or 11 months after the issuance of the last of the above tax reform regulations (i.e., the time originally allotted by Congress). We believe that both authority and precedent exists for such action. Except for certain plans permitted under prior integration rules, such a deferral would have little or no negative impact on plan participants or federal revenues. In the case of the relatively few situations necessitating corrective action, we would suggest that appropriate interim rules could be issued which would carry out Congressional intent in these narrow areas while final regulations are being developed.

We will be happy to provide additional information concerning these issues and to work with your staff in fashioning appropriate relief.

Sincerely yours,

/s/

Howard C. Weizmann
Executive Director

BOOKE & COMPANY,
Winston-Salem, NC, April 4, 1990.

Mr. HOWARD C. WEIZMANN, *Executive Director,*
Association of Private Pension and Welfare Plans,
1212 New York Ave., N.W.,
Suite 1250,
Washington, DC

Dear Howie: We applaud the efforts Senator Pryor is making towards the goal of simplifying the rules governing qualified retirement plans. As pointed out in the APPWP's paper entitled, Gridlock: Pension Law in Crisis and the Road to Simplification, the private pension system is in jeopardy.

Although I currently serve as Chairman of the APPWP, the purpose of this letter is to give you the views of Booke & Company.

The vast majority of our clients truly want to assist in providing an adequate retirement income for their employees, but have become frustrated over the ever-increasing complexity in the system. Some have even terminated plans, both defined benefit and defined contribution plans, because of the costs and other burdens of administration. Further, many clients have expressed the frustration their employees have felt when trying to understand their own retirement plans.

The major causes of this complexity are twofold:

- First, the frequency and inherent complexity of legislative changes.
- Second, the degree to which regulations issued by various agencies have become not only complex, but often in conflict with other laws or regulations.

It is no wonder that plan sponsors are frustrated with the private retirement system.

We need to support the private system and help plan sponsors and their employees work together to plan for retirement. Millions of workers rely on the benefits provided by employer sponsored plans as an important part of their retirement income.

Again we applaud the APPWP's and Senator Pryor's efforts to simplify the rules governing qualified retirement plans. We hope that the suggestions made in the APPWP's Gridlock paper will receive serious attention.

Sincerely,

DONALD C. INGRAM, *President.*

Enclosure.

GRIDLOCK: PENSION LAW IN CRISIS AND THE ROAD TO SIMPLIFICATION

[The Association of Private Pension and Welfare Plans, Washington, DC, September 1989]

FOREWORD

Legislative and regulatory assaults launched on pension plans in the last decade have hit plan sponsors with rules and requirements that have them running hard to stay in the same place. Expansion of defined benefit plans has come to a halt in the 1980's and complexity imposed from Washington, no matter what the motivation, is largely to blame.

Unsnarling pension plan gridlock should be a goal of Washington policy makers who have their eyes on America's biological clock. We must aggressively expand pension plan coverage in the waning days of this century to better meet the retirement needs of the baby boom retirees early in the next century.

The driving force behind this prodigious undertaking was Howard Golden, from Kwasha Lipton, who has served as the Chairman of the APPWP Retirement Savings Committee for many years. Without his determination and patience, the contributions and concerns of his committee colleagues, and the scholarship of Birgit Anne Waidmann and Victoria Judson of Steptoe & Johnson, this paper would not have been possible. I also want to add my thanks to Larry Kirby and Booke & Co. for the wonderful artwork and support.

The next steps on the road to simplification belong to all of us. We must take this policy document and use all the resources available to us to achieve the very "doable" recommendations contained herein.

HOWARD C. WEIZMANN,
Washington, DC.

INTRODUCTION

The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 ("ERISA") was a landmark piece of legislation. It constituted an important step in achieving the national goal of fostering retirement income security. ERISA was intended to protect participant benefits and strengthen the private pension system by subjecting retirement plans to minimum standards. Unfortunately, subsequent efforts to improve the law through changes to ERISA and the Internal Revenue Code ("the Code") have needlessly overburdened plans to the detriment of sponsors, participants, and government regulators, actually working against their best interests. Furthermore, the statutes are not the sole source of the host of dysfunctional requirements. The agencies responsible for the implementation and administration of the pension laws—principally the Internal Revenue Service ("IRS") and the Department of Labor ("DOL")—have added to the burden through the regulatory process.

Key problems have been created both by the frequency of legislative change and the general approach to regulation. Too often, the dominant philosophy has been that it is best to restrict all plans by setting up elaborately structured exceptions and limitations in order to eliminate any possibility of abuse. Little effort is made to advance the beneficial aspects of ERISA and the Code by focusing (through a minimal regulatory framework of qualification, reporting and disclosure requirements) on encouraging plan sponsors to provide fair, secure and adequate retirement income. In addition, the regulatory pattern has been characterized by constant changes and insensitivity to the enormous compliance costs and burdens such changes impose.

The nature and frequency of change in the laws and regulations governing private retirement plans have resulted in a system that is so complex that it consumes enormous amounts of resources in compliance costs which could be better directed to the provision of benefits. Consequently, overburdened plan sponsors are discouraged from establishing, maintaining, or strengthening the private retirement system. Moreover, vast regulatory resources are expended on efforts to understand and implement the complicated rules rather than developing policies to promote retirement goals or undertaking enforcement efforts. The time has come for a complete overhaul and simplification. Otherwise, we will find a growing older population without adequate resources to meet its retirement needs.

A. Reasons for Complexity

The complexity in the current rules governing private retirement plans is caused by the frequency of legislative change and lack of an overview, misconceptions which lead to enactment of rules that are difficult to implement, and lack of regulatory coordination, as well as by the nature of retirement plans themselves.

1. Frequency of Legislative Change and Lack of an Overview

A major cause of complexity in the private pension system is the constant change imposed by new legislation.

ERISA was enacted in 1974. From 1975 through 1980, various revenue acts amended retirement plan provisions of the Code but not Title I of ERISA. Since 1980, an average of one statute per year has been enacted to extensively change the laws governing private pension plans.[1] In fact, since October 1986 four new statutes have been enacted to change the pension laws: the Tax Reform Act of 1986 ("TRA '86"), the Omnibus Budget Reconciliation Act of 1986 ("OBRA '86"), the Omnibus Budget Reconciliation Act of 1987 ("OBRA '87"), and the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA").

This plethora of legislation has lead to a mass of confusion due to the additive effect of new laws, passed at a tremendous pace, and the detail in each set of amendments. The complexity has snowballed as new laws were enacted before regulations implementing existing laws were promulgated. Confusion has been caused in

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[1] See Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 98 Stat. 899 (MPPAA); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (ERTA); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (TEFRA); Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (DEFRA); Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (REA); Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82 (COBRA) Single Employer Pension Plan Amendments Act of 1986 Pub. L. No. 99-272, 100 Stat. 237 (SEPPAA); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (TRA '86); Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (OBRA '86); Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (OBRA '87); Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (TAMPA).

part as this vehicle for social policy has been used to raise revenues. Further, there has been no concern for simplicity, nor has there been an attempt to create a logical structure of the law. Often, new legislative proposals fail to recognize prior provisions addressing the same issue, resulting in an incomprehensible array of irrational rules. As a result of this failure to consider overall structure, efforts to strengthen the laws have simply led to a patchwork of overlapping, duplicative or inconsistent provisions creating an environment in which compliance is nearly impossible and in which penalties for failure to comply with all of the rules are substantial.

It is as if planners first set up a city on a grid with streets and services laid out in a logical order, but then dealt with all new needs and demands by building additions willy-nilly, on top of roads and on top of each other. The resulting city would have facilities to address different needs, but no one would be able to reach them or use them. Similarly, new laws and regulations have abounded to address often legitimate concerns, but they have been enacted or promulgated without adequate consideration of their effect on each other, or the ability for the over-all private retirement system to function. The result has been chaos rather than improvement. For example, under the rules affecting benefits of individuals working beyond normal retirement age, it is nearly impossible to reconcile required accruals after normal retirement age with the suspension of benefits rules and minimum distribution requirements. See Recommendations Section B.1.

Similarly, the regulatory structure lacks workable rules with respect to basic concepts that underlie all pension plans. For example, the Code lacks a clear, consistent definition of who is an employer, who is an employee, and what is compensation, all of which are absolutely basic to retirement planning strategy. The determination of who is an employer and who is an employee involves application of a multitude of rules concerning predecessor employers (Code section 414(a)), employees of a controlled group of corporations (Code section 414(b) with regulatory cross-reference to Code section 1563(a)), employees of partnerships under common control (Code section 414(c) with regulatory cross-reference to Treas. Reg. section 1.1563-1(d)), employees of affiliated service groups (Code section 414(m)), leased employees (Code section 414(n)), and Code section 414(o) which permits adoption of additional regulations to treat employees of different organizations as employees of the same employer. Similarly, the Code lacks a uniform definition of compensation. Compensation is defined differently under 414(s), 414(q)(7), and 415(c)(3).

Once the thorny questions of who is an employer, who is an employee, and what is compensation have been decided with respect to a plan, highly compensated employees must be identified for discrimination purposes. The rules for making such a determination exemplify the problem created by excessive regulatory detail. TRA '86 contained a new definition of highly compensated employees under Code section 414(q), which includes a myriad of alternative definitions, involving numerous tests, including some which require treatment of two or more family members as one employee. The salary levels that must be considered include $75,000, $50,000, and $45,000, each of which are indexed annually.

The highly compensated employee definition has so many tests that it will require expenditure of significant resources to implement. Furthermore, the requirement that all employees within an employer's controlled group be tested together adds significant cost with little benefit. Employers usually do not aggregate employee salary information in one system, but keep separate employee records for each company. Moreover, where companies change hands during the year, it is difficult to determine the proper universe of employees who must be included in the calculations. While limiting discrimination is laudable, this approach imposes a tremendous burden of compliance requirements and expense on all plans, including those unlikely to have any discrimination problems.

When statutes and regulations are constantly changing, lack a clear structure and include excessive detail, sponsors, participants, and recordkeepers are unable to keep up with the law.

2. Misconceptions That Impede Enactment of Functional Rules

The complexity in ERISA and the Code may be attributable to two fundamental misconceptions that underlie the current legislative approach. We call these misconceptions "evil plan myopia" and "computer omnipotence."

Evil plan myopia is regulators' tendency to formulate general rules by (1) considering only those few plan sponsors with abusive intent, and (2) failing to consider the effect of the regulation on the vast majority of sponsors, who have no such intent. Plan sponsors and administrators generally will not take advantage of the rules. The view that it is less important to encourage the continuance and growth of responsible pension plans than it is to ensure that the potential for abuse is totally

eliminated poses a serious threat to employers' willingness to maintain and institute these programs. Priorities appear to be skewed—the focus is on the few small plans which may seek to take advantage of the rules, and not on the majority of plans, which generate most of the retirement income security in this country. As a result of evil plan myopia, all sponsors are forced to expend enormous sums complying with regulations which are aimed at an abuse in which they do not engage.

Computer omnipotence describes the regulators' assumption that all compliance problems can be easily solved by pushing a few buttons on a computer. Regulators' cavalier attitude with respect to the compliance burden may well be due to a good faith but faulty understanding of how businesses are run. Much of such data needed to comply with new rules is not kept in one place for any legitimate business purposes and is not in a form that can be reorganized and aggregated to meet new regulatory requirements.

For example, in many cases salary data for different companies under common control, or even for different divisions, may be kept in different data bases and on different computer systems. Accordingly, such tasks as ranking employees in the top twenty percent based on compensation, as is required for highly compensated employee determinations, can be difficult and expensive.

Also, historic information may not be retained in an easily accessible form because of the high cost of retaining such information on the computer system itself. Each time a regulation requires use of old data or storing a new type of data, the regulation imposes substantial compliance costs and difficulties.

Furthermore, creating the software necessary to do the calculations required by new laws and regulations is a very time consuming process, yet regulations and IRS Forms usually are not issued in final form until well beyond the effective date of new statutory provisions. For example, the revised 5500 (Annual Report) Forms for 1988 were not released until March 1, 1989. See 54 Fed. Reg. 8631. Compliance is rendered extraordinarily difficult where forms and requirements are not released well in advance of the period for which a report is due.

In summary, because regulators do not have a realistic sense of the way businesses are organized and the barriers to data collection, retention, and aggregation, they impose tremendous compliance costs on all plans, including those of small businesses.

3. Complexity Due to Lack of Regulatory Coordination

The regulatory framework within which the nation's pension system operates has become such a morass that even the regulators cannot keep track of requirements. So many different highly specialized individuals work on these laws and regulations that the drafters are unaware of apparent conflicts they create. For example, in August of 1988, the Treasury issued regulations which permit sponsors to hold elective deferral contributions for up to twelve months after the plan year to which the contribution relates, before transferring them to a trust; however, final regulations issued by the Department of Labor (DOL) in May of 1988 permit employers to hold such contributions only until the earliest date on which the contribution may be segregated from employer assets, but in no event for more than 90 days after they were received by the employer.[2] While each agency had its own purpose in formulating its rules, any such overlay on particular subject matters should be better coordinated, so that a uniform standard is adopted, or it is clear that different standards apply for different purposes. Individual plan sponsors and participants should not have to try to determine the intention of each of the regulatory agencies or reconcile conflicting regulatory requirements.

In other cases, major delays have resulted from agencies' failure to reach a consensus. For example, while the minimum funding standards were changed in 1987, the PBGC and the IRS have not yet agreed on whether the term "current liability," a concept which is crucial to funding determinations, includes all accrued benefits as defined for purposes of Title IV of ERISA, or something less.

While many other examples of failure to coordinate exist, it is clear that the agencies can work together and make rules that do not overstep their jurisdictions. In promulgating proposed and temporary regulations defining "highly compensated employee" under Code section 414(q), the IRS specifically stated the relationship of section 414(q) to Title I of ERISA, the purposes for which this definition might apply, and the provisions over which the DOL has jurisdiction.

Over the years, many have argued for a single agency which would have jurisdiction over all aspects of employee benefits, to avoid problems with lack of coordina-

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[2] *Compare* Treas. Reg. section 1.401(k)-1(b)(6)(i)(B), 53 Fed. Reg. 29658, 29666 (Aug. 8, 1988) with DOL Reg. section 2510.3-102 53 Fed. Reg. 17628, 17630 (May 17, 1988).

tion and jurisdictional battles. We believe similar results could be achieved, however, without abandoning DOL and IRS jurisdiction, simply by maintaining open lines of communication between the agencies and committees involved in pension regulation and by clarifying policy goals.

4. Complex Nature of Subject Matter

The complexity of the rules governing private pension plans is not entirely due to the legislative and regulatory process. Funding retirement benefits over the working life of an employee is by its nature a complex task. Moreover, complexity is also inherent in a system which permits diversity and employer discretion with regard to plan design. This diversity is beneficial because it allows creation of plans that better suit the needs of different employees and retirees.

Simplification, then, should not be sought by mandating a uniform retirement plan for all employers and all employees regardless of their situations. Permitting diversity is essential for plans to be tailored to fit the specific needs of the employees and retirees they cover.

It should be possible to achieve a simpler, more workable structure without jeopardizing beneficial flexibility and diversity, by recognizing the misconceptions we have identified, adopting an overall retirement income policy, maintaining communication among those charged with its management, and emphasizing development of a regulatory framework which encourages the responsible maintenance of fair, secure and adequate retirement benefits.

B. Complexity Impedes Goals of Retirement Security

1. Effect of Complexity on Adoption, Maintenance. and Compliance of Plans

As a result of the complexity we have discussed, plan sponsors either (1) abandon attempts to comply with the law, (2) terminate their retirement plans, or (3) spend ever-increasing amounts of time and resources designing and operating these plans, which may result in reductions in the amounts available for benefits.

It is enormously costly to repeatedly amend plans, constantly change software and allocate significant staff time in plan design and administration. These staffing requirements are particularly onerous on the plans with fewer than 100 participants, which comprise a large proportion of existing plans. The additional recordkeeping costs may reduce benefits available to all participants. Moreover, the complexity results in a nation of non-compliers, as sponsors either erroneously believe they are meeting requirements or give up attempts to comply.

This complexity imposes significant costs on the government agencies as well. For example, there are inconsistencies in the plan qualification process and enforcement efforts are haphazard because the current rules are too complicated for IRS agents to understand and apply. This results in inadequate review of determination letter requests, imposing unfair burdens on the agents and leaving sponsors unsure whether the determination letters have any value.

Finally, the complexity also imposes enormous costs on the economy, retirement savings system, and the nation's fiscal resources as an incalculable number of staff hours, computer hours, and other resources are spent on the intricacies of compliance.

All these burdens discourage private employers from adopting new plans or maintaining existing plans, and deprive the public and private economy of needed capital resources.

2. Effect of Complexity on Participants

The complexity of the rules and regulations also imposes severe burdens on plan participants who lack the training to adequately assess the options available with respect to plan contributions and distributions. Despite valiant efforts of employers and service providers to disseminate clear information and assist employees, there remains a significant risk that individuals will err out of ignorance, and thereby will lose important retirement savings through penalties that they cannot understand.

Take, for instance, the ordinary act of electing a distribution from a tax-qualified retirement plan. In this situation, if the participant/taxpayer elects to receive a distribution too early—generally before age 59½ with numerous exceptions—there is an additional 10 percent tax on the amount includable in gross income. *See* Code section 72(t).

On the other hand, if the participant/taxpayer defers the payment of benefits to a date which is too late—generally, after age 70½ even for individuals who have not yet retired there is an excise tax of 50 percent of the amount which should have been distributed. And, even if the participant begins receiving benefits by age 70½,

the 50 percent excise tax will be imposed if the amount received in any year is less than a prescribed amount, or is paid out over longer than a prescribed period, determined under regulations that exceed 200 pages with multiple references to lengthy tables. *See* Code sections 401(a)(9) and 4974.

Finally, even if the participant/taxpayer correctly handles the timing—that is, the distribution begins neither too early nor too late and is spread over the correct period so each distribution is not too small—the participant/taxpayer faces an excise tax of 15 percent if the benefit is too large. *See* Code section 4980A. This is the case even where the "too large" is attributable solely to good investment returns. Like Goldilocks and her porridge, every participant/taxpayer must find the distribution which is "just right." One can't help but conclude that there is something fundamentally wrong with a regulatory system which requires that a 72-year-old working secretary who inadvertently fails to take a minimum distribution from an IRA will lose an amount equal to 50 percent of the minimum required distribution.

This complex structure of penalty provisions is symptomatic of the real problem, which is the underlying complex series of minimum standards for qualified plans. The complexity exists not only with respect to distributions but with respect to rollovers, lump-sum averaging and basis recovery as well. Average citizens who must struggle to understand these rules are provided with IRS Publication 575, which includes almost 40 pages of single-spaced text and over 60 pages of tables, but still fails to answer numerous questions. The land mines abound for the unwary. The rules are so complex that individuals cannot properly plan for retirement, or determine the best way to take pension distributions.

C. Call to Simplification

The time has come to stop adding layer upon layer of special provisions to a private retirement regulatory structure which is already hamstrung by complicated rules. Instead, an effort must be made to simplify the law and regulations. While there will be many different views of what constitutes simplification, there should be no dispute concerning the need to begin the task.

To this end, we offer the following suggestions on how to begin. In producing this list of suggestions, we have targeted the following problems:

1. Redundancy—provisions which duplicate other rules, supersede older provisions, or accomplish the same policy goal as another rule should be eliminated.
2. Obsolescence —outdated provisions should be deleted.
3. Evil plan myopia —provisions with broad impact which were intended to eliminate a narrow abuse should be redirected.
4. Administrative complexity—plan administration and rules affecting participants should be simplified, particularly because in many instances the cost of compliance far outweighs the benefit.

Each of the recommendations made below is proposed in order to solve one or more of these problems. In making our recommendations, we have sought to maintain the diversity and flexibility in the nation's retirement system, rather than mandating adoption of a uniform plan for employers. Our recommendations are set forth by type of provision (thus, for example, suggested changes to rules designed to prohibit discrimination are grouped together) but each suggestion is independent of the rest.

We look forward to working with the Congress and the regulatory agencies on these and other changes in an effort to restructure the regulatory requirements so that they are understandable, enforceable, and equitable.

RECOMMENDATIONS

A. Rules Designed to Prohibit Discrimination

Simplify Definition of Highly Compensated Employee (Code Section 414(q))

In a laudable effort to simplify the law, TRA '86 instituted a new *uniform* definition of "highly compensated employee," and changed many rules to refer to this term in determining the existence or absence of discrimination. Thus eliminated, for example, were the "top ⅓-lower ⅔" distinctions for the nondiscrimination tests under section 401(k), and the notion of the "prohibited group" under Section 401(a)(4). However, the definition of highly compensated employee as enacted and elaborated in Treas. Temporary Reg. section 1.414(q)-1T is far too complicated.

The definition of highly compensated employee should be simplified by replacing the $75,000 rule, the $50,000 top paid group rule, and the officer earning 50 percent of the defined benefit limit rule, with a single rule making any employee earning

over some specific amount (between $45,000 and $75,000 (indexed)) a highly compensated employee. Five-percent owners would continue to be treated as highly compensated employees. The rule should allow the plan administrator to decide which period to use as the determination period (plan year, tax year or calendar year) In addition, the plan administrator should be allowed to choose whether to use prior year compensation or current year compensation (with compensation annualized for employees hired during the year) so long as these choices are consistently applied and may only be changed by filing for approval of the change. This would allow employers the opportunity to use their existing data bases and systems, without sacrificing any compliance goals.

2. Institute Uniform Definition of Compensation (Code Sections 414(s), 414(a), 415 and 401(a)(17))

The new definition of compensation in Code section 414(s) and the definitions in section 415 and section 414(q)(7) should be amended to institute a uniform definition which should apply for all pension discrimination testing purposes (but not for purposes of the plan benefit formula) Under this uniform definition, compensation would mean W-2 earnings, with elective contributions under Code sections 125, 401(k), 402(h), 403(b), 457 and 501(c)(18) added back at the option of the employer. In addition, clarification is needed concerning the specific Code sections and plan calculations for which the $200,000 limit of Code section 401(a)(17) applies.

3. Eliminate Limitation on Benefits in the Event of Early Termination (Reg. Section 1.401-4(c))

The rules of Treasury Regulation section 1.401-4(c), promulgated in 1956, are obsolete and should be eliminated. ERISA's requirements for the allocation of assets upon termination, the provisions of SEPPAA, the TRA '86 vesting rules, the strengthened funding requirements of the Pension Protection Act (a part of OBRA '87), and the phase-in of the section 415 limitations over years of participation adequately protect participants and make it impossible for the owners of a business to walk away from a plan with all of its assets. Thus, section 1.401-4(c) is unnecessary.

Moreover, the rule creates substantial complexity, both in plan drafting and administration. Treasury Regulation section 1.401-4(c) requires that all defined benefit plans contain language which limits the benefits payable to the 25 highest paid employees of the employer in certain cases. Boiler-plate language which is not understood by most plan administrators must be included in the plan document. Because the language is arcane and its purpose obscure, there is massive noncompliance with these rules. Where a reasonable attempt is made to comply, plan sponsors are required to get private ruling letters in order to pay benefits to some participants—an inefficient and ineffective method of plan management. There is no reason to retain such complicated rules when their objectives are accomplished through other provisions.

4. Eliminate or Modify the Minimum Participation Rule (Code Section 401(a)(26))

The minimum participation rule was designed to prohibit discrimination in favor of highly compensated employees' and employees with significant ownership interest in the employer. Its original focus was comparatively narrow: it was aimed at the elimination of individual defined benefit plans, plans which covered only the highest paid employee of the employer. However, the provision has grown a life of its own, and now appears so broad that nearly all plans will be affected by it, and so complex that compliance necessitates review of a large number of pages of regulations and expenditure of excessive amounts of time and money.

The regulations will prohibit small employers from using a variety of comparable plans to tailor their benefit packages to individual groups of employees—an option which will continue to be available to larger employers (those who can assure that at least 50 employees participate in each plan). However, all employers, both large and small, will be required to divide their benefit programs into "separate benefit structures," treating every variation in terms or benefits as a separate plan subject to these rules. The complications are enormous, and the goals have been obscured. This epitomizes evil plan myopia, as it is apparently based on the assumption that any business which employs fewer than 125 employees (the rule requires coverage of at least 50 employees or 40 percent of all employees, and 40 percent of 125 is 50) or provides any variety in benefits or options is seeking to take advantage of the rules to the detriment of its rank and file employees.

The rules set forth in the proposed regulations add significant compliance costs and produce very little benefit. In lieu of these rules, a simple rule designed to prohibit clearly abusive behavior should be crafted. For example, such a rule generally

could apply only to plans covering a nominal number of employees (e.g., 5 or fewer) and would exempt arrangements such as frozen plans, plans for retirees only, wasting trusts, plans maintained for an employer's former employees upon the sale of a division, and plans maintained for employees of an acquired business, because other provisions will ensure that such arrangements are non-discriminatory. Because the abuse at which section 401(a)(26) was directed involved only defined benefit plans, the law could exempt defined contribution plans, or at least treat each such plan as a single benefit structure. Furthermore, the law should operate in accordance with reasonable rules for determining comparability of plans and benefits rules which the Treasury has been directed to promulgate to replace those of Rev. Rul. 81-202, 1981-2 C.B. 93. When such rules have been designed, there will be no need for the complexities of section 401(a)(26) as it is now interpreted.

5. Eliminate the ADP Tests of Section 401(k)

The average deferral percentage ("ADP") tests of Code section 401(k) are too complex, and are unnecessary, as well as unfair to those at the low end of the group of highly compensated employees. Accordingly, these tests should be eliminated.

The ADP tests are designed to assure participation by the low paid and to limit deferrals by the high paid. The rules for calculating, returning and taxing deferrals in excess of the ADP limits are extremely complicated. In addition, the ADP tests include a multiple use test, rules for treating amounts which were elective deferrals as contributions subject to the tests of Code section 401(m), or vice versa, rules on lineal descendants, separate testing for ESOP portions of the plan, and an "adjusted balance" provision for determining income on excess amounts, all of which are examples of unnecessary complexity that far outweigh any possible utility.

The tests were found unnecessary for the Federal Employees Thrift Plan and, therefore, they should not be required for private sector plans. The Federal Government successfully lobbied Congress to exempt the Federal Employees Thrift Plan from the ADP requirements, because the $7,000 limit on elective deferrals of Code section 402(g) adequately limits participation by the highly compensated. In section 401(k) plans, elective deferrals are available to all participants, up to the section 402(g) limit, in the same way that IRA or SEP contributions are available to employed individuals. However, the participant in the section 401(k) arrangement has the advantage of being in an employer-sponsored plan which must meet the coverage requirements and offers economies of scale and possibly employer contributions as well.

Not only are the ADP tests unnecessary, but they also interact with the Code section 402(g) limitation in such a way as to penalize the lower end of the highly-compensated group. In a typical situation, if a store manager earning $50,000 contributes $7,000, her deferral percentage will be 14 percent. If the firm president contributes $7,000 and earns $200,000, his deferral percentage is 3.50 percent. If the ADP tests are not met, the store manager's deferral must be reduced first, because of her higher deferral ratio, even though her contribution was the same as the president's. Moreover, in order to assure compliance with the ADP tests, many plan sponsors enact rules limiting the amount that the highly-compensated can defer, unfairly penalizing the lower end of the highly-compensated group to the advantage of the most highly paid employees. For example, if a company places a 3.5 percent ceiling on contributions by the highly compensated, a president earning $200,000 could defer $7,000, but a store manager earning $50,000 could defer only $1,750. Another store manager earning $48,000 could defer the full $7,000 simply because he or she is not deemed to be "highly compensated."

We suggest that the section 401(k) rules be simplified by eliminating the ADP test and adopting the requirements governing elective deferrals under section 403(b) annuities. Section 403(b) does not impose an average deferral percentage test, but, instead, requires that all non-excludable employees be eligible to make a salary deferral of at least $200, but not more than an annual maximum amount of $9,500. If all employees are eligible for salary reduction contributions, no further testing is necessary.

6. Simplify Rules for Aggregation of Employers and Employees (Code Sections 414(b), (c), (m), (n), and (o))

As discussed in Section A.1 of the Introduction, the rules for determining who is an employer and who is an employee involve complicated tests and cross-references and should be totally re-examined and simplified.

The leased employee rules are so complex that they are impossible to apply and so broad that they defy logic. The perils involved in these requirements, as interpreted in voluminous proposed regulations (Prop. Reg. sections 1.414(m)-5, 1.414(m)-6, 1.414(n)-1 through 1.414(n)-4 and 1.414(o)-1), have been well documented. Under

these regulations, even a professional service provider, such as a lawyer or accountant, who spends a substantial amount of time working on one client's matters could be deemed to be an employee of the client. Moreover, contract employees, such as those employed by a food service organization, may be deemed to be employees of the business which hired the food service organization to run its cafeteria. Office cleaning personnel and security personnel and even construction employees fall into this category.

These rules go far beyond curing any conceivable abuse and should be simplified. We recommend that the Code define employees to include individuals who (1) would be considered employees under common law standards, or (2) are considered employees under the Federal Insurance Contributions Act (FICA), see Code section 3121(d).

We have not offered a specific recommendation on how the rules for aggregating employers and businesses should be changed because the rules and policy objectives behind them are particularly complex and merit further study. Yet, we are convinced that these rules can be improved. We look forward to working with Congress and the regulatory agencies in efforts to formulate simpler methods for identifying the "employer" for the purpose of applying the laws and regulations governing retirement plans.

7. Eliminate or Simplify Top-Heavy Rules (Code Section 416)

Code section 416 sets forth complicated testing and definitional rules for determining whether or not a plan is top-heavy. Top-heavy plans are required to satisfy a special vesting schedule and make minimum contributions or accruals for "non-key employees." Plans which are "super top-heavy" must make additional minimum contributions or accruals and are subject to a lowered aggregate limitation under Code section 415.

The law requires that top-heavy provisions be included in all plans, even those which can never conceivably become top-heavy. Eliminating this requirement alone would be a major step forward for simplicity. Even wiser would be the elimination of the top-heavy rules altogether. Because of the changes enacted as part of TRA '86, including the new coverage and participation rules, new vesting standards, strengthened integration requirements, and new limits under sections 401(a)(17), 402(g), and 415, the top-heavy rules are unnecessary and redundant. The TRA '86 rules will ensure that the objectives which led to imposition of the top-heavy rules are met; that is, benefits are limited for the highly compensated, and rank and file employees receive minimum benefits with early vesting. Therefore, these rules should be eliminated, or, at a minimum, simplified. For example, the rules might be simplified by eliminating the five-year look-back for key employee determinations, by deleting the special top-heavy vesting schedule and by keeping only the "super top heavy" test, instead of having two sets of tests and rules.

B. Benefit Limitations

1. Simplify Rules on Minimum Distribution of Benefits (Code Section 401(a)(9)

In general, distributions from all qualified plans, IRAs, tax-qualified annuities, and custodial accounts must begin by April 1 of the calendar year following the calendar year in which the employee attains age 70½ ("the required beginning date") regardless of when the employee retires. The distributions must be made over the life of the employee or over the lives of the employee and designated beneficiary, or over a period not extending beyond the life expectancy of the employee or the life expectancy of the employee and designated beneficiary. The "incidental death benefit requirement" of Treas. Reg. section 1.401-1(b) imposes additional restrictions on the distribution unless the employee's designated beneficiary is a spouse or no more than ten years younger than the employee.

As we discussed in Section B.2 of the Introduction, to apply the minimum distribution rules, it is necessary to refer to voluminous proposed regulations and make computations using various IRS actuarial tables. See Prop. Treas. Reg. sections 1.401(a)(9)-1 and 2. In one large employer's case, a significant amount of time and energy was spent on understanding and implementing these proposed rules, but only two out of approximately 64,000 employees were affected when the first payment was finally required, in April 1989. Moreover, these two employees were not high-paid executives attempting to build up their estates or extend indefinitely the tax deferral advantage of their pension funds, but rank-and-file employees who continued to work past age 70 in order to continue receiving a paycheck.

The minimum distribution rules are detailed and fairly rigid. Generally, no credit is provided with respect to distributions made prior to the required beginning date. Therefore, an individual who takes a large distribution at age 70 to purchase a re-

tirement home could not forego distributions from age 71 through 75 to save plan resources for other needs, such as anticipated medical expenses.

Not only are the minimum distribution rules themselves complex and rigid, but also, these rules add substantial complexity when combined with the suspension of benefit rules and the rules prohibiting cessation of accruals for employees working beyond normal retirement age. For years, ERISA and DOL regulations have permitted certain suspensions of plan benefits when an employee works beyond normal retirement age. Generally, such an employee is not entitled to receive pension distributions (which are derived from employer contributions) until after actual retirement.[8] When TRA '86 amended Code section 401(a)(9) no exception to the minimum distribution requirement was provided for benefits that are suspended. Furthermore, after enactment of TRA '86, OBRA '86 amended the Code to prohibit cessation of benefit accruals because an employee attains a specified age, thereby mandating that pension accruals continue past normal retirement age. See Code section 411(b)(1)(H) and (b)(2). Accordingly, employees must continue accruing benefits even if distribution of benefits may be suspended, and even if minimum benefits must be paid. Proposed regulations provide some guidance on the interrelationship between the accrual and suspension rules, including permissible offsets. Yet, the rules are complicated to apply and administer. *See* Prop. Treas. Reg. section 1.411(b)-2, 53 Fed. Reg. 11876, 11879 (April 11, 1988). Imposing the minimum distribution requirements on top of this structure of suspensions and accruals adds complexity which far outweighs any conceivable benefit, and is likely to become a trap for the unwary.

The distribution rules are not only overly complex but also unnecessary. The minimum distribution rules were initially included in order to prevent the wealthy from using qualified plans as an estate planning device. However, this risk generally was removed when the estate tax exclusion for distributions from qualified plans was repealed. See former Code section 2039(c) (repealed by the Deficit Reduction Act of 1984, P.L. 98-369, section 525 and TRA '86, section 1852(e)).

The minimum distribution rules should be reviewed and changed to limit the administrative burden they impose. These rules are unnecessary for the majority of plan participants, because these participants will use their benefits for retirement purposes regardless of whether or not minimum distributions are required by law. Options for simplifying the minimum distribution rules include their:

(a) repeal;

(b) modification to apply only on a participant rather than a plan—basis, and to apply only with respect to individuals who have total account balances over a specified amount, such as $750,000 (representing a benefit of $50,000 per year for 15 years);

(c) modification to apply only on a participant rather than a plan—basis, and to apply only with respect to five-percent owners; or

(d) modification to return to a rule similar to the one in effect prior to TRA '86: requiring that distributions begin by the April 1 of the year following the later of (i) the year in which the employee attains age 71 or (ii) the year in which the employee retires, except that distributions of five-percent owners must begin by the April 1 following the year in which the participant attains age 71; but simplifying rules with respect to calculating the minimum amount of the distribution (e.g., requiring that the full amount be distributed in 25 years, which is the expected return multiple for an ordinary joint and last survivor annuity for a 71 and 61 year-old individual).

2. Eliminate Excise Tax on Excess Distributions and Modify Limitations on Contributions and Benefits (Code Sections 4980A and 415)

A 15 percent excise tax is imposed on individuals to the extent that annual aggregate distributions from tax-favored arrangements exceed the greater of $150,000 or $112,500, indexed. where an individual elects five-year income averaging with respect to a lump sum distribution, the excise tax will be imposed on the amount of the distribution that exceeds $750,000 or five times $112,500, as indexed. Individuals could have elected to exclude benefits accrued as of August 1, 1986 from the tax, if these accrued benefits exceeded $562,500 and an election was made with, or prior to, the 1988 income tax return filing. However, those who made such a grandfather

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[8] ERISA indicates that a suspension occurs if benefits are suspended after their payment has commenced, *i.e.*, with respect to retirees who are re-employed. *See* ERISA section 203(a)(3)(B). The DOL, however, has taken the position that a suspension can occur even with respect to an employee who has never begun receiving benefits but works beyond his or her normal retirement date. See DOL Reg. section 2530.203-3.

election are subject to the threshold of $112,500, indexed, not the $150,000 (or $750,000 for lump sum) threshold, when determining the amount of excess distributions after the grandfathered amount is recovered.

This excise tax originally was intended to replace the complex combined plans limitations of section 415(e) with a simpler and more equitable scheme for limiting retirement income. However, as finally enacted, the excise tax does not replace the combined plans limitations but is applied in addition to them, and it is neither simple nor equitable. Therefore, this excise tax should be eliminated.

While one of the purposes of the excise tax was to prohibit the accumulation of multiple maximum benefits from several employers as well as individual savings in an IRA, no additional tax is needed to accomplish that goal. There is no need to encompass IRA benefits in an overall limitation because IRA deductions are eliminated for employees earning over a threshold amount who participate in employer plans. Similarly, contributions to section 403(b) annuities are coordinated with other elective deferrals and with the section 415 limits. Thus, the only conceivable gap in this system of limitations involves the high-paid individual employed by several completely unrelated employers, who earns maximum benefits under plans of each employer. This situation is so rare that the imposition of the excise tax only to cover it is completely unwarranted. Furthermore, even where a high-paid individual works for multiple employers, his ability to defer income in qualified plans is not unfettered because: (1) section 415(c) limits contributions to defined contribution plans each year, (2) the defined benefit limit is now phased in over 10 years of participation rather than service, and (3) compensation taken into account under plans is limited to $200,000. There is, therefore, very little policy reason to justify this excise tax.

Also, because the excise tax is imposed on the dollar value of retirement distributions, it acts as a penalty on investment success. Such a penalty, even if it were necessary, contravenes so much other valid policy that it bears close re-examination. While we believe the excise tax itself is unnecessary, if it proves impossible to eliminate altogether, it should be applied only to excess distributions from qualified defined benefit plans so as not to penalize capital investments. Moreover, this tax serves as a disincentive for owners to continue to contribute to plans on behalf of their rank-and-file employers once their own benefits have reached the section 4980A threshold.

Not only is the excise tax redundant and contrary to other policies, the structure of the tax is so complex that compliance is extremely difficult. There are major unanswered questions concerning the application of both the tax on retirement income and the estate tax, so that even tax professionals and IRS personnel may misconstrue the rules, and the excise tax poses severe difficulties for any individual potentially subject to it.

For all the reasons given above, this tax should be eliminated. If, however, the tax is preserved in anything resembling its present form, the combined plans limitation of section 415(e) should be deleted. The recordkeeping requirements of this test are enormous, and if the excise tax is retained, the section 415(e) limitation is redundant.

A final change which should be made in section 415 is to eliminate the 25 percent of compensation limit on annual additions. See Code section 415(c). This limitation simply harms the lower-paid and is unnecessary in view of the dollar limitation and the deduction limits under Code section 404.

3. Simplify Basis Recovery Rules (Code Section 72)

TRA '86 repealed the three-year basis recovery rule of section 72, under which an employee's investment in the contract was deemed to be recovered before any taxable amounts, if the full amount of the basis could be recovered within the first three years of annuity payments. The new rule requires pro-rata recovery of basis, involving calculation of an exclusion ratio which is applied to each payment until the entire basis is recovered. This rule should be repealed, and the three-year rule reinstated, because any potential benefit of pro-rata recovery of basis is outweighed by the administrative cost of compliance.

4. Permit Rollovers of Employee Contributions and Partial Rollovers of Any Amount (Code Section 402(a)(5))

Under current law, an employee may not roll over employee contributions. The prohibition on rollovers of employee contributions should be removed since employees may now make non-deductible contributions to IRAs and may exclude from tax that portion of an IRA distribution that constitutes a return of properly reported non-deductible contributions. Thus, IRAs must now account for after-tax contribu-

tions, and there is no reason not to allow them to accept such contributions through rollovers as well as annual contributions.

A participant should be permitted to rollover *any* amount into an IRA, including partial distributions of less than 50 percent of the balance to the credit of the employee (but excluding any minimum required distribution) The current restrictions on partial rollovers and rollovers of employee contributions add complexity and limit portability. In fact, these restrictions create an incentive for participants to spend distributions rather than saving them for retirement, contrary to the explicit recommendation of the President's Commission on Pension Policy, and the provisions of proposals on portability being considered in Congress.[4]

5. Eliminate Hardship Rules of Section 401(k)

Code section 401(k)(2)(B) restricts distributions of amounts attributable to employee elective deferrals. These amounts may be distributed only upon separation from service, death, disability, termination of the plan, attainment of age 59 and 1/2, or hardship. Treasury regulations concerning the hardship standards under section 401(k) appear to be more stringent than the standards which generally apply to profit-sharing plans. While profit-sharing plans may permit hardship distributions only in accordance with objective criteria set forth in the plan, sponsors are not required to make inquiries with respect to the participant's other resources available to meet a heavy and immediate financial need. In contrast, the 401(k) regulations require that plan sponsors determine whether (1) an employee has an immediate and heavy financial need and (2) the distribution is necessary to satisfy such a need. The determination of whether a distribution is necessary to satisfy a financial need may be satisfied by using a safe harbor that imposes significant restrictions or through "reasonable reliance" on a detailed employee representation. *Compare* Treas. Reg. section 1.401(k)-1(d)(2) with Treas. Reg. section 1.411 (d)-4, Q&A 4(b) and 6 *and* Rev. Rul. 71-224.

The requirement that administrators determine whether a participant has other resources available to meet a financial need is administratively burdensome, intrusive on employee privacy, and unnecessary. The Code section 72(t) ten percent penalty on early withdrawals adequately assures that an employee will seek to satisfy financial needs from other sources before taking withdrawals from retirement plans.

Moreover, imposing rules with respect to elective deferrals and earnings as of December 31, 1988 (but not earnings after such date, and not amounts treated as elective contributions) which differ from the rules imposed with respect to withdrawals of employer contributions and earnings adds unnecessary recordkeeping complexity. See Prop. Treas. Reg. section 1.401(k)-1(d)(1)(iii). Under current law, a profit-sharing plan may permit distributions after a fixed number of years, the attainment of a stated age, or the prior occurrence of some event such as separation from service, illness, disability, retirement, death, or hardship. See Treas. Reg. section 1.401(b)(1)(ii) Rev. Rul. 71-224. There is little reason why the rules governing certain distributions from section 401(k) plans should be any different than the general rules governing distributions from profit-sharing plans. For all these reasons, we recommend that Code section 401(k)(2)(B) be deleted.

C. Reporting and Disclosure Requirements

ERISA and the Code require that so many forms be prepared, distributed to participants and filed with the government that the resulting costs and burdens imposed upon plans and plan sponsors have been enormous. This paperwork burden is not, as some suggest, an unqualified benefit to participants. Not only are the costs of the reporting and disclosure requirements borne in part by current plan participants; they also discourage small employers from establishing new plans for employees not now covered.

Despite the negative impact on plans, new reporting obligations have been added, often without adequate consideration of their usefulness or practical application. (*See, e.g.*, the discussion of ERISA section 204(h) below). The time has come to carefully weigh, in light of nearly fifteen years' experience under ERISA and parallel Code provisions, the costs and benefits of applicable reporting and disclosure requirements, and improve or eliminate those requirements that have not proven cost-effective.

[4] See President's Commission on Pension Policy, Coming of Age: Toward a National Retirement Income Policy, at 45 (1981) *and, e.g., H.R. 1961 §3, 100th Cong., 2d Sess. (1988) (portability act expected to be reintroduced in 101st Congress).*

It should be pointed out, however, that it is essential that changes not be made in any required report, form, or document unless those changes are substantial and made at one time, after adequate public notice and participation, rather than seriatim. Typically, it costs more to reprogram computers, retrain employees, and set up new filing systems than is saved by small changes.

1. Simplify Annual Report

ERISA section 103 requires each plan to prepare and file with the Secretary of Labor an Annual Report (currently the Form 5500 series) Much of the information required in the Annual Report is of minimal use to participants or the government: *e.g.*, the detailed listing of plan investments and all 5 percent transactions.[5] Submission of this data is enormously burdensome and costly; yet it is inappropriate for plans funded through bank trust funds or pooled insurance accounts, provides little useful information to participants generally, and is rarely, if ever, scrutinized by the DOL absent other problems which would suggest a more thorough investigation of plan asset investment.

ERISA section 103 should be amended to reduce the amount and detail of data required in the Annual Report. The Annual Report should contain only information useful to participants and necessary to the agencies in identifying problem areas. Despite efforts to streamline these Forms, they still require much information that cannot possibly be truly useful. Therefore, 'the government should pare down the Forms to include only items it actually uses in a meaningful way, and eliminate all others. In the alternative, the simplified Forms 5500C and 5500R should be used for all plans. If problems are indicated, the agencies may then require more specific information.

2. Eliminate Summary Annual Report and Plan Description

The summary annual report (SAR) requirement of ERISA section 104(b)(3) should be eliminated. The SAR is widely regarded as a document with more form than substance. It tells a participant virtually nothing of value, and serves only as a reminder that there is a plan, the details of which must be found elsewhere. At the same time, it is expensive to prepare and mail, and because of its brevity, it may often be misleading or raise questions which would be far more efficiently answered by reference to actual plan documents, the summary plan description, or the annual report itself. Therefore it should be eliminated, or the requirement should be limited to posting a notice in a prominent site in the work place.

Moreover, the requirement of ERISA section 102(a)(2) and (b) that a "plan description" be filed with the Labor Department should be eliminated, with appropriate changes to DOL regulations.

3. Simplify and Clarify Reporting Obligations With Respect to Distributions

Currently, confusion abounds regarding the reporting obligations of plan administrators, payors, and participants. First, the reporting rules generally are not contained in regulations, but only on Forms and Instructions, so it is often difficult for recordkeepers to determine their obligations. Second, the same information is often required from different sources (such as the plan recordkeeper and the participant), resulting in additional costs and unnecessary duplication. Third, guidance on reporting items affected by changes in the law is often insufficient, unclear, or provided too late. A thorough revision of reporting requirements to eliminate duplication and clarify obligations is needed.

An example of the confusion regarding reporting requirements is the situation which led to publication of Notice 89-32, 1989-12 I.R.B. 76, retroactively correcting the positions taken in IRS Notice 87-77, 1987-2 C.B. 385 and Notice 88-33, 1988-13 I.R.B. 23. These Notices all concern the proper reporting of corrective distributions of excess deferrals, excess contributions and excess aggregate contributions. Congress retroactively changed the treatment of these amounts in TAMRA, generating considerable confusion. The rules add complexity by distinguishing between various excess amounts, splitting the excess and its earnings into two separate years and treating refunds of less than $100 differently from refunds in excess of $100. There should be one simple rule—all refunds of excess amounts and income thereon should be treated as income in either the year of contribution or the year of receipt. Regardless of the action taken on the underlying provision, however, when the gov-

[5] Recently, the DOL did change the reportable transaction threshold from 3 percent to 5 percent and eliminated the requirement of reporting the dates of reportable transactions. See DOL Reg. section 2520.103-6 as amended in 54 Fed. Reg. 8624 (Mar. 1, 1989). While this constitutes an improvement, it does not go far enough in eliminating unnecessary detail from required reports.

ernment position regarding the reporting and treatment of distributions shifts in a manner such as we have described, the government should provide sample language which may be used by payors to notify participants of their reporting options and regulatory requirements.

With respect to a more general problem, it is very difficult for payors to properly report distributions, not only because of constant changes in the law and IRS guidance, but also because of the use of multiple forms by the IRS and because of lack of clear regulatory guidance on reporting. The IRS should combine the Form W-2P (which is required for reporting of retirement distributions other than total distributions) with the Form 1099R (which is required for reporting of total distributions) There is no statutory basis for requiring use of the two different forms. Prior to adopting a new combined form, however, the IRS should provide time for comment by payors. Furthermore, the IRS should recognize that significant time will be needed to reprogram computer reporting systems to comply with a new format. Accordingly, the final version of the new form should be released well in advance of its adoption.

Also, in order to reduce the unnecessary paperwork burden imposed on plan payors and administrators, the procedures for electing out of withholding could be simplified. The IRS should explicitly permit participants to elect out of withholding on their benefit applications, and should provide a short sample notice of election rights which could be provided to participants at the time they complete their benefit applications.

4. Simplify REA Consent Requirements

The requirements for consent to receive a distribution are far too complicated. If the rules themselves were simplified, the required notices to employees could be simplified. Specific situations where the rules could be simplified include the following:

a. Section 1.411(a)-11(c) of the regulations requires that plans give participants a general description of the material features, and an explanation of the relative values, of the optional forms of benefit available under the plan at least 30 days prior to the annuity starting date. The term "annuity starting date" is defined to mean the first day on which a benefit is payable. This requirement appears to preclude a plan from paying benefits any earlier than 30 days after a special notice is given, even if, for example, under the plan, the benefit is payable in any form and a surviving spouse requests an immediate distribution to pay funeral expenses. At minimum, the rules should be modified to allow payment to begin when it is requested.

b. The rules for consent to receipt of benefits prior to normal retirement age (or 62, if later) require that consent be given if the benefit is "immediately distributable" and provide that a benefit which is distributable immediately upon the attainment of normal retirement age or age 62, if later, is not immediately distributable, so no consent is required. While the policy behind this convoluted language may be appropriate, the regulations are so complicated that plan administrators cannot understand them. These regulations should be amended to clearly state that consent is not required for distributions made after the later of the plan's normal retirement age or age 62.

c. The age 35 threshold for waiver of the QPSA should be eliminated, in favor of a rule allowing waivers to be made upon commencement of participation, and withdrawn and remade at any time thereafter. Notices and explanatory material should be required upon commencement of participation, and when requested thereafter (but not more frequently than once a year). The current complicated rules add significant administrative expense and reflect an erroneous attitude that anyone under age 35 is simply too young to know what he is doing.

5. Limit Scope of Requirement of Notice of Reduction in Future Accruals (ERISA Section 204(h))

ERISA section 204(h) added a requirement prohibiting any significant reductions in future accruals under plans subject to the minimum funding standards unless written notice of the amendment is provided to all plan participants, certain beneficiaries, and certain employee organizations, at least 15 days prior to the effective date of the amendment.

The intent of this requirement was to provide prior notice to employees when an employer, on its own initiative, seeks to significantly cut back on plan benefit formulas. However, the provision, as written, imposes the same notice requirement where an employer must change accruals to comply with federally mandated changes in the law.

Recently, sponsors were in a quandary whether to provide cut-back notices in face of the tardy release of integration regulations which will require significant changes in plan design. Plan amendments effecting these changes are not required, generally, until the due date, with extensions, for filing the employer's tax return for the 1989 plan year. In Notice 88-131, 1988-52 I.R.B. 15, the IRS provided some relief from the ERISA notice requirement, but this relief was not provided until the day before sponsors would otherwise have been required to notify all employees of unknown changes in accruals.

In order to prevent such situations in the future, ERISA section 204(h) should be amended to exclude from the notice requirement any future accrual changes made to comply with changes in the Federal law governing qualified plans, or to require such notice not earlier than a reasonable time after the amendment is actually adopted.

6. Eliminate Requirement of Notice to Interested Parties

The IRS requires the notification of all "interested parties" prior to the filing with the IRS of a request for a determination letter. See Treas Reg. section 601.201(o)(3)(xvi) Rev. Proc. 80-30, 1980-1 C.B. 685, as modified. Determination letters are routinely sought by plan sponsors when a plan is adopted, materially amended or terminated. The notification requirement is unduly burdensome and expensive, serves no useful purpose, and is generally ignored or misunderstood by participants. Therefore, the notice to interested parties should be eliminated.

7. Delete Requirement of Submission of Annual Statement of Collective Trust or Insurance Carrier Account (ERISA Sections 103(b)(3)(G) and 103(b)(4))

The statutory provision requiring the submission with the plan's annual report of an additional report for plans held in common or collective trust funds or separate accounts of insurance carriers should be deleted.

ERISA section 103(b)(3)(G) provides that if some or all of a plan's assets are held in a bank common or collective trust fund, or separate bank trust, or insurance carrier separate account, the plan's annual report must include the most recent annual statement of the trust or account. ERISA section 103(b)(4) and DOL Regs. section 2520.103-9 permits direct filing with the DOL by the common or commingled trust of the account involved.

This requirement of filing the statement of the underlying collective fund should be deleted. For reporting purposes, a plan's investment in a bank's collective trust fund should not be treated differently from its investment in mutual funds or in an insured separate account, which do not require reports of the underlying investment medium. As a result, no filing of such information should be required, although it could be made available to the Department of Labor upon request.

D. Funding Limitations

1. Amend the Full Funding Limitation (Code Section 412(c)(7))

Code section 412(c)(7) was amended by OBRA '87 to redefine the full funding limitation as 150 percent of termination liability. Contributions in excess of this limitation are not deductible and are subject to a 10 percent excise tax. The calculation of this limitation requires a separate actuarial valuation each year, which adds to the cost and complexity of maintaining a defined benefit plan. This, alone, may be sufficient justification for calling for a return to the limitation as it existed prior to OBRA '87. Moreover, there are policy issues surrounding this limitation which overwhelm the simplification argument for its removal. While the limit may appear reasonable—why should a plan need assets in excess of 100 percent of "termination" liability—it is very misleading. "Termination liability" is often less than the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. The effect of the current full funding limitation is that a plan's actual funding will always lag behind in the funding needed for "real" benefits at retirement where such benefits are based on final average pay, and level funding over the life of a plan is impossible.

In effect, current law inappropriately mortgages benefit promises by prohibiting the level funding that is the reasonable way for plan sponsors to fulfill their benefit obligations and, instead, requires plans to be funded with payments which escalate in later years. This results in tremendous cost in terms of plan benefit security. Ironically, this is the type of funding which Code section 412 was designed to eliminate, not require. Therefore, the full funding limitation should be based on ongoing (projected) liabilities, not on termination liability.

2. Eliminate Tax on Nondeductible Contributions (Code Section 4972)

A 10 percent excise tax is imposed on employers making nondeductible contributions to qualified plans. The purported abuse at which this penalty is directed—placing large amounts of funds into plans in order to obtain the advantage of tax deferral on the income generated—is simply not a common occurrence.

There are numerous reasons why employers do not, as a general rule, make unnecessary contributions to plans. First, Code section 412(c)(3) requires that actuarial assumptions must be reasonable, and an excise tax is imposed for the overstatement of pension liabilities. *See* Code section 6659A. Second, it is impossible to recoup excess amounts contributed to a plan without terminating the plan (unless a mistake of fact can be established). Third, amounts recovered at plan termination are themselves subject to a 15 percent excise tax. Fourth, contributions in excess of those needed to fund the plan may not be deducted. Fifth, businesses cannot tie up funds indefinitely, but have other uses for their money.

Not only is the tax not needed to accomplish its intended purpose, but also it may result in imposition of inappropriate penalties. After the recently enacted funding rule changes, many employers will be subjected to this excise tax, not because they have any abusive intent, but because they made reasonable and, in some cases, legally required contributions which are no longer deductible. For example, the change in the full funding limitation, which eliminates the deduction for contributions in excess of those needed to provide 150 percent of termination liability, will cause significant year-to-year variations in the deductible amount. An employer who makes level contributions for budgetary reasons may incur the excess tax periodically, because of swings in termination liability due to variations in interest rates and the composition of its work force. Furthermore, the new funding provisions require quarterly payment of estimated contributions. If the estimate exceeds the full funding limitation, the excise tax will be incurred despite the fact that the contributions were required to be made before valuation results were available, and once made cannot generally be withdrawn. Finally, where an employer is required by the terms of a collective bargaining agreement to make certain contributions to a multiemployer plan which is or becomes overfunded, the employer may incur the excise tax although it cannot reduce its level of contributions and has no control over the terms of the plan. For all these reasons, this excise tax should be eliminated.

E. Fiduciary Rules

1. Modify Prohibited Transaction Exemption Procedure (Code Section 4975 and ERISA Section 408)

The current procedures for receiving an exemption from the prohibited transaction rules of ERISA section 408 and Code section 4975 take much too long to complete. Many investment options which would benefit participants and plans are foreclosed because of the delays created by these procedures, particularly the requirement that the notice of a proposed exemption--and the decision to grant an exemption—must be published in the *Federal Register*. *See* DOL Prop. Reg. section 2570.30 *et. seq.* 53 Fed. Reg. 24422 (June 28, 1988).

The prohibited transaction exemption procedures should be modified to provide the Department of Labor with a specified time, such as 20 days, in which to deny an application. If no denial is issued within that period, the application for exemption should be deemed to be granted. This suggested procedure is similar to the procedure used with respect to securities registration statements under section 8 of the Securities Act of 1933, as amended, 15 U.S.C. section 77(h).

2. Revise and Consolidate the Excise Taxes on Prohibited Transactions (Code Section 4975(a) and (b) and ERISA Section 502(i))

Under current law, Code section 4975 imposes a 5 percent excise tax on disqualified persons engaging in prohibited transactions with respect to tax-qualified plans, and ERISA section 502(i) permits imposition of a 5 percent civil penalty with respect to other plans. Both the Code section 4975(a) tax and the ERISA section 502(i) penalty are imposed on the amount involved in any prohibited transaction, but the Code excise tax is automatic, and applies regardless of knowledge or intent. Because of the automatic nature of this tax, it reaches too broadly, and applies to innocent errors where no losses occurred. In contrast, under ERISA section 502(i), the DOL has the right to impose a 5 percent penalty for the commission of a prohibited transaction, but is not required to do so.

Under Code section 4975(b), an excise tax of 100 percent is imposed where a prohibited transaction is not corrected. See Code section 4975(b) and ERISA section 3003(a) (permitting waiver of tax in appropriate cases). Similarly, under ERISA sec-

tion 502(i), the DOL may assess a civil penalty of 100 percent for uncorrected transactions.

Under Reorganization Plan No. 4 of 1978, the general authority to issue regulations, rulings, opinions, and exemptions for prohibited transactions under Code section 4975 was transferred to the Department of Labor. See Executive Order No. 12108, 44 Fed. Reg. 1065 (December 28, 1978). The provisions relating to taxes on disqualified persons under Code section 4975(a) and (b), however, and exemptions on certain limited transactions, were not included in this transfer of authority. In order to minimize administrative complexity, and prevent the anomaly of having one agency determine whether a transaction constitutes a violation of the prohibited transaction rules while another agency enforces penalties for such a violation, the power to impose penalties should be shifted to the Department of Labor. Accordingly, the prohibited transaction excise taxes of Code section 4975(a) and (b) should be repealed and the DOL should be given authority to impose civil penalties for prohibited transactions with respect to all plans under ERISA section 502(i). In addition, the DOL should retain flexibility not to impose the 5 percent penalty in appropriate cases.

F. Miscellaneous

1. Eliminate Half-Years in Code Provisions (Code Sections 72, 219, 401(a)(9), 402(e), 403(b))

Several provisions in the Code relate to the age of the employee at a certain time. Using half-year ages for these determinations is confusing and adds complexity for no apparent reason. For example, if an individual turns age 70 on July 1, 1989, he or she must pour through voluminous regulations to determine if he or she is 70½ in 1989 or in 1990. In contrast, everyone knows his or her birth date, and this date is already included in plan and employer records. Basing rules on half birthdays requires additional records and adds confusion. All half-years should be eliminated.

2. Delete Extension of Amortization Period (Code Section 412(e))

Code section 412(e) should be deleted. The Secretary's authority to extend the amortization period has rarely, if ever', been used. The minimum funding waiver procedure of section 412(d) is sufficient for the intended purpose.

3. Replace Five-Year Phase-In of Benefit Guarantee With Three-Year Cliff Guarantees (ERISA Section 4022(b)(7))

ERISA section 4022(b)(7) provides that benefits are guaranteed only to the extent of the greater of 20 percent of the amount which, but for the fact that the plan or amendment has not been in effect for 60 months or more, would be guaranteed, or $20 per month, multiplied by the number of years (up to five) the plan or amendment has been in effect. This rule unnecessarily complicates the determination of guaranteed benefits, and should be replaced with a rule guaranteeing all benefits (up to the general limit on guaranteed benefits) which have been in effect for three years or more.

The purpose of ERISA section 4022(b)(7) has been largely accomplished with the changes enacted in SEPPAA. It is no longer possible for a solvent employer to enact large benefit increases and dump the liabilities on the PBGC. A three-year waiting period for coverage would assure that an employer in distress could not dump new liability on the PBGC, and would be much easier to implement.

4. Narrow the Definition of Participant (ERISA Section 3(7))

The definition of "participant" in ERISA section 3(7) should be narrowed to exclude any non-employee who is not receiving benefits and who does not have a vested right to an accrued benefit. Such individuals have no current or future right to any benefits under the plan, unless they are subsequently rehired. The elimination of this category from the definition of participant would simplify reporting obligations and payment of PBGC insurance premiums. The PBGC premium, of a minimum of $16 per "participant," should not be assessed on behalf of individuals who are in fact no longer participants.

This change would also clarify entitlements upon the termination of a plan. Under current law it is unclear whether non-vested terminated employees regain a right to the amounts they previously forfeited if the plan is terminated within a certain period of time (up to 5 years, according to some interpretations), after the employee's termination. The suggested change in the definition of participant would help clarify that non-vested terminated employees are not entitled to receive such amounts.

5. Eliminate Remnants of H.R. 10 Plans

Since 1982, when TEFRA was passed, Congress has attempted to create parity between the income tax treatment of self-employed individuals and common-law employees. A few changes are still necessary in the retirement plan rules in order to fully achieve this goal. The fact that a number of separate rules and limitations still exist is confusing, adds additional complexity, and impedes the professed objective of attaining parity. The most troublesome of these remaining rules are as follows:

(a) The employer aggregation rules of Code section 401(d) (1) and (2) differ from those in Code sections 414(c) d, (m), and (n), and impose more restrictions on owner-employees. The additional complexity is not justified by the minimal opportunity for abuse in this area.

(b) Code sections 401(c)(2) and 404(a)(8)(C) limit contributions on behalf of the self-employed to their "earned income." No such limit exists for corporate employees. Furthermore, contributions to retirement plans should be subtracted from earned income before determining the deduction limits or the section 415 limits, as such contributions are not included as compensation for corporate employees.

(c) Plan loans to self-employed participants are prohibited transactions, unless the plan obtains an administrative exemption under ERISA section 408(a). Qualified loans to other participants are not prohibited transactions.

(d) Lump sum treatment of distributions (Code section 402(e)) is not available to the self-employed upon separation from service, though common law employees may receive lump sum treatment upon separation from service. Conversely, self-employed individuals may be eligible for lump sum treatment upon becoming disabled, but common law employees are not.

These separate rules for self-employed employees should be eliminated.

6. Clarify Standards for Retroactive Revocation of a Plan

A plan which satisfies all the requirements of Code section 401(a) is considered a "qualified plan" and consequently receives a special status for tax purposes. In the event the plan fails to satisfy any requirement for a qualified plan in any year, the IRS may retroactively disqualify the plan.

Under Code sections 401(b) and 7805(b), the IRS may provide relief from retroactive disqualification. These Code sections should be clarified to make clear that (1) such relief is available when sponsors have made good faith efforts to comply with statutory requirements and (2) participants who had no control over plan design are exempted from adverse tax consequences of disqualification.

Attachments.

ASSOCIATED BENEFITS CORPORATION

April 4, 1990

Mr. Jim Klein
APPWP
1212 New York Avenue, N.W.
Suite 1250
Washington, D.C. 20005

Dear Jim:

You asked me to describe for you some of the experiences we have had lately that might be eased by simplification of our pension laws. Where to begin?

Let me start by saying that our staff of ten people averaged over eleven hours a week during 1989 reading CCH, Prentice Hall, IRS, DOL, PBGC and various consultant publications in an attempt to avert accidentally violating anything or anybody. We are a small Company but when you magnify this over the pension industry you can see that our Government has done a good job of providing employment opportunities for writers, printers, and mail handlers. Unfortunately, we do the bulk of our reading evenings and weekends, and nothing I've seen in the last decade has made any of our tasks simpler...quite to the contrary.

We ran across a particularly good example of the tail wagging the dog. One of our clients could not make a deductible contribution to their defined benefit plan using the IRS full funding assumptions...but owed a risk premium using the PBGC assumptions...and had phantom income for FAS 87. We know that the Financial Accounting Standards Board is not an official government agency, but the conflict with the IRS and the PBGC assumptions are a big enough problem with out FASB.

We have made presentations to no less than ten employers in the past three months who should really have defined benefit plans for their employees. We believe in full disclosure however, and when an employer gets advice that says this is best for your employees but here are the rules you must function under ("We think", or "as we understand them" and "subject to change, retroactively") they very quickly move in other directions. I don't blame them.

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Jim Klein
Page 2

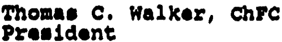
I don't pretend to have an accurate count on all the pending and proposed new legislative actions affecting pensions, but I can readily think of over a dozen. Put these on top of the legislation that is as much as six years old, for which we do not have regulations and must make a good faith effort at complying with, and complexity becomes a gross understatement.

We got some relief, however. We do not have to amend our plans for some of these laws, that are already in force, until the regulations are finalized. That saves us significant dollars in that we don't have to try to amend, and then amend again because our try didn't fully meet the regulations. Unfortunately, we have to treat our participants as if the plan was amended during the period we wait for the regs. This makes absolutely no sense. The Participant is confused, we are confused, and Washington says "such is life".

Now, to add insult to injury, proposed legislation is carrying dates that would make the laws, if passed, effective when the legislation is proposed (i.e. Sen. Metzenbaum's latest effort at eliminating reversions). That is simply not fair. We used to at least be able to count on having actions taken today that are legal today, not be deemed illegal six months or a year later because there was pending legislation. How can we function...how can we advise...how can the system live with uncertainty of that magnitude.

I wish I was old enough to retire.

Sincerely,



Thomas C. Walker, ChFC
President

TCW/hcs

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April 5, 1990

Mr. James A. Klein
Deputy Executive Director
Association of Private Pension
and Welfare Plans
1331 Pennsylvania Avenue, N.W.
Suite 719
Washington, D.C. 20004

Dear Jim:

It was good to talk with you by phone and I would like to elaborate on our company's decision to discontinue our pension plan.

In 1954 we adopted a qualified profit sharing plan and in 1955 we adopted a qualified pension plan, also.

Our company has provided additional employee benefits which we have felt give us an advantage in attracting better employees which obviously makes for a better company.

In recent years, Congress has seen fit to impose changes and additional requirements on companies that sponsor qualified profit sharing and pension plans. As you know, these changes cause a considerable administrative burden both in explanation to employees and being forced to hire rather expensive employee benefit experts to rewrite the plans. With the added costs imposed by the recent requirement, eliminating the Social Security offset and with the proposed changes that are being considered by the Congress; i.e., the anti-reversion proposal and the Visclosky amendment, we have elected to discontinue the pension plan and have filed all the necessary papers to accomplish this.

We are not at all pleased with being forced to make this decision, but we do not feel that we can afford to continue to spend the time and the money necessary to maintain a pension plan in a constantly changing environment. While the profit sharing plan has provided a much greater benefit for those persons who have retired, the pension plan provided a nice additional benefit.

We are continuing to sponsor the qualified profit sharing plan, but are very concerned that congressional tampering may detract from the possible future retirement benefits (such as the Kassebaum proposal which is nothing more than a foot in the door to tax earnings of profit sharing and pension trusts).

There are other companies in Birmingham who have chosen to discontinue pension plans and I am enclosing an article that appeared recently in the Atlanta paper indicating that a great many companies have already decided to discontinue pension plans. I am extremely concerned that whith what Congress has already done, there is, in fact, irreparable damage to the national retirement system. I don't think our people in Congress understand:

1. That most employers want to provide some type of private retirement benefit for

Mr. James A. Klein
Page Two
April 5, 1990

their employees.

2. Small businesses cannot afford to be and will not be "abused" by Congress's frequent and arbitrary changes in laws governing the operation of private retirement plans, both defined benefit and defined contribution.

REMEMBER SECTION 89 !

I want to thank you for your efforts on behalf of the private retirement plans and please let me know any time that I may be of help to you.

Best personal regards,

Frank L. Mason
Chairman of the Board

FLM:sbn

Enclosure: Newspaper article

John Spink/Staff

Ray DeLafosse, president of Custom Plastics, disliked "paying $1,500 to $2,000 a year to have the funds monitored and have reports filed."

Many small businesses scrapping pension plans

By Hank Ezell
Staff writer

Small businesses across America are retiring their pension plans on grounds that federal regulations are making the owners prematurely old.

The business owners complain that federal regulations are too complex, the cost for attorneys and other outside advisers is too high, and the rewards to their businesses are too small to make employee pensions worthwhile.

"They keep changing [the law]," said Rockey Tripodi, a partner in Consulting Services Inc. of Atlanta. "If they'd leave the things alone, maybe we could learn how to deal with them."

Among small businesses, the number of pension plan terminations skyrocketed during the late 1980s. "We probably did more terminations last year than we did new plans," said Atlanta lawyer Ken Russell, who specializes in pension law. "It's been that way for two or three years now."

In 1987, the most recent year with complete statistics, 73,443 companies with fewer than 100 employees terminated their pension plans, according to the Internal Revenue Service.

That was down from a 1985 peak of 86,130, but significantly up from 27,828 in 1980. Experts believe the relatively high, late-1980s level of terminations will continue.

The overall trend is also down: 46 percent of the full-time work force had employer-financed financed pensions or retirement plans in 1988, down from 50 percent in 1979, according to the Social Security Administration.

The squeeze on pensions

- 46 percent of private sector workers had company-financed pension plans in 1988, down from 50 percent in 1979.
- At least 73,000 pension plans covering 100 or fewer employees have been terminated each year from 1985 to 1987, the last year with full data. In 1980, the total was 27,828.
- The smaller the firm, the less likely it is to offer a company-paid pension. Only 22 percent of workers in companies employing 10 to 24 workers had pensions in 1988. For firms with 250 or more employees, the figure was 67 percent.

Source: Internal Revenue Service, Pension and Welfare Benefits Administration.

That suggests that in small businesses, as well as large, fewer Americans in the future will have the protection of a company-backed pension as their retirements approach.

Historically, small businesses have been pension-shy. According to a 1988 study by the IRS, only 11 percent of the work force in firms with fewer than 10 employees are covered by pensions, including both defined-benefit and defined-contribution plans.

In defined-benefit plans, workers are promised a specified benefit after retirement, usually paid for by the employer and

Please see PENSION, C6 ▶

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Pension: Many small businesses are dropping plans

▶ Continued from C1

usually calculated according to earnings and years of service.

They are different from defined-contribution plans, which include most profit-sharing and 401(k) plans. Such plans usually include amounts invested by both worker and employer, and the payout from them depends on the value of the investments when they are cashed in.

The small-firm numbers compare with pension coverage of 40 percent in firms of 50 to 99 employees and 67 percent in firms with 250 or more employees.

Business owners have a variety of complaints. Among them:

■ Complex regulations. "Congress passes this general law, then you end up with 100 pages of complicated regulations trying to explain the law," Mr. Russell said.

■ The cost of expert advice. "Every year when I would get the bill, I would just get livid," said Roy DeLafosse, president of Custom Plastics Inc. in Decatur. "My biggest problem was that we were paying $1,800 to $2,000 a year to have the funds monitored and have reports filed." The costs took a stinging bite out of the fund's investment income of about $4,000 or $5,000 a year, he said. The fund contained about $60,000 or $70,000 when Mr. DeLafosse terminated it last year.

■ Paper work goofs, even from the experts. "Every time I had to unsnarl something, I would get livid all over again," Mr. DeLafosse added.

On the other side of the equation, business operators argue, the pension plans offer no significant rewards. Mr. DeLafosse said his nine employees were not interested in retirement benefits. "They were interested in their spending power each week," he said. "We felt we were getting no benefit from an employee standpoint."

From Washington, D.C., the reaction to all these complaints is mixed.

"It isn't so much that the rule books are complicated as that Congress changes the rules so often," said Judith E. Bekelman, a spokeswoman for the Pension Benefit Guaranty Corp. That executive branch agency is studying the costs to business of running pension plans and the particular objections to various proposed changes. "Mostly what this administration is opposing is change for change's sake," she said.

On Capitol Hill, a Senate staff member who specializes in pension legislation said the most common complaint about small businesses is not that they cancel pensions, but that they never establish any.

But she added that Simplified Employee Pension plans, which can be established without expert help by any company with 25 or fewer employees, have not become popular.

The required federal form is "no more than 10 lines," she added. "I can't think of how much easier you can get. There is an easy option for small business, and they're not taking it."

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AMCRA AMERICAN MANAGED CARE AND REVIEW ASSOCIATION

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March 22, 1990

Mr. Jim Klein
Deputy Executive Director
Association of Private Pension
and Welfare Plans
1212 New York Avenue, N.W., Suite 1250
Washington, D. C. 20005

Dear Mr. Klein:

On behalf of American Managed Care and Review Association ("AMCRA"), I am writing to express our strong support for legislation that would simplify the rules governing private pension plans. Compliance with the existing rules under the Internal Revenue Code is extremely burdensome and discourages small employers like AMCRA and our member companies from establishing, or continuing to maintain, their qualified plans.

In general, while the administrative requirements apply equally to all employers, the complexity of those requirements make it very difficult, if not impossible, for small employers to comply on their own. The multitude of existing rules coupled with the need to keep abreast of the various changes in the governing laws and regulations necessitates that these employers seek the advice of pension specialists which further adds to the cost of maintaining their qualified plans.

Because administrative costs are relatively fixed, the administrative costs per employee are higher for small businesses. As a result, employers like AMCRA are finding that they are unable to offer benefits comparable to those offered by larger companies. In fact, because of the significant costs associated with continuing to maintain a pension plan, AMCRA is currently considering terminating its pension plan and one of our members has recently terminated its plan. The inability to offer comparable benefits significantly disadvantages small

Mr. Jim Klein
March 22, 1990
Page 2

companies in trying to compete with larger companies for well-trained, experienced employees.

Changes in the laws which would ease the administrative burden and keep down the costs associated with qualified plans would go a long way in assisting and encouraging small employers in the maintainence of pension plans for their employees. For example, the various government forms could be designed so that a person with little or no expertise in the area of employee benefits could complete the required forms.

Simplification of the complex pension rules would serve to send a strong message that Congress is committed to encouraging employers to provide retirement income to their workers. We strongly support that message.

Sincerely,

Ronald A. Hurst for SGP
Ronald A. Hurst
Executive Vice President

cc: The Honorable David H. Pryor
The Honorable Lloyd Bentsen
The Honorable John Heinz

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PREPARED STATEMENT OF JAMES P. HOLDEN

Good morning. My name is James Holden. I am Chair of the Section of Taxation of the American Bar Association. I am testifying today on behalf of the American Bar Association at the request of L. Stanley Chauvin, Jr., President of the Association. I am accompanied by Mark Dray, Chair of the Employee Benefits Committee of the Section of Taxation, and Stuart Lewis, Chair of that Committee's Subcommittee on Proposed Pension Legislation.

We are pleased to have been invited to testify on the need to simplify the laws governing private pension plans. The American Bar Association endorses the importance of simplifying these rules and is pleased to cooperate with Congress in helping to reduce this complexity. The Chairman and the members of this Subcommittee are to be commended for focusing the attention of Congress on the vital need for simplification.

We note that our comments today will address only the simplification of the rules applicable to qualified pension and profit sharing plans and will not deal with simplification of the rules regarding welfare plans and other employee benefit issues. We believe, however, that simplification of these other areas is also an important goal that should be pursued by Congress at the first opportunity.

THE IMPORTANCE OF SIMPLIFICATION

The goal of an appropriate pension policy should be to develop rules that contain only the minimum amount of complexity necessary to achieve the policy objectives established by Congress. Unfortunately, the rules governing private pension plans have achieved a degree of complexity that goes far beyond what is necessary. In fact, the complexity itself has become a significant deterrent to increasing pension coverage among American workers and therefore should be promptly eliminated as an important first step to improving the retirement security of Americans.

The adverse affects created by unnecessary complexity are numerous. Let me articulate a few that are particularly troublesome.

1. Increased Cost for Employers.—Complexity increases the costs of providing retirement benefits to employees. This cost initially arises in the designing and redesigning of retirement plans to comply with frequently changing and unnecessarily difficult qualification rules. Once designed, the various administrative tests required to ensure that plans continue to comply with all of the limitations, nondiscrimination and other rules applicable under ERISA and the Internal Revenue Code ensure continued high compliance costs. Further, compliance costs are also increased through the completion of annual reports, disclosure statements and tax returns, and the preparation of valuations and audit costs.

2. Increased Costs/Reduced Benefits for Employees.—This increased compliance cost most likely has the effect of reducing the retirement benefits available to employees. In general, employers will view the entire cost of the benefit programs in determining the level of the retirement benefits to provide and, therefore, will take into account these increased costs in establishing the level of benefits or deciding whether to increase (or reduce) benefits for employees in the future. Employees also experience increased costs by having to evaluate complicated alternative tax options pertaining to the distributions they receive because of the necessity of obtaining professional advice with respect to the complicated rules applicable to the taxation of such distributions.

3. Increased Cost for the Government.—Because the rules are also difficult for the government to administer, the complexity of the rules governing pension plans has a direct adverse affect upon the government. One immediate affect is that greater staff time (and budget authority) is required in order to develop rules and regulations that carry out these complex mandates. This not only means more time devoted to the development of regulations, but also decreased effectiveness of the rules since often regulations are substantially delayed because of the difficulty in developing and coordinating them among agencies with overlapping jurisdictions. In addition, there is an increased cost through diminished enforcement capability. When the rules and regulations become as complex as they currently are, the government has considerable difficulty training employees to understand the rules so that there can be adequate government enforcement. This creates increased pressure for guidance from the government and decreased effectiveness in ensuring compliance with the rules.

4. Complexity Leads to Noncompliance.—Overly complex rules regarding the private pension system significantly undermine Congressional policy objectives. Employers may not carry out the mandates inherent in statutory schemes simply because they fail to understand these complex rules fully. Worse, they may not comply

fully because the complexity creates doubts about adequate enforcement of the law. An employer or an employee may feel that the rules have become so complex that nobody understands them anymore and therefore there is no need to comply with all of the details. This breeds a disrespect for the laws that can undermine important policy objectives and that should not be allowed to continue.

5. *Effects of Decreased Retirement Security.*—Because increased complexity means that less money is delivered to employees at retirement, the important social goal of increasing the adequacy of retirement coverage will be seriously undermined. Further, the complexity of the rules may lead many employers, especially small employers, to redirect their efforts to provide direct compensation instead of retirement benefits. The consequence of that may lead to increased consumer consumption, lower personal savings rates, reduced provision for private retirement pensions and increased pressure on the social security system to be the principal provider of income.

The Need for Simplification is Urgent

Congress should immediately consider, as a top priority, the need for simplification of the rules applicable to pension and profit sharing plans. IRS statistics demonstrate a substantial increase in plan terminations and a substantial decline in the creation of new retirement plans. Unnecessary complexity and expense are major factors in this decline and should be addressed promptly in an effort to stem this unfortunate trend. Under current proposals it would cost a plan sponsor $700 to simply apply for a determination from the Internal Revenue Service on an individually-designed retirement plan. Unless action is taken by Congress, employers will continue to abandon benefit programs and either reduce the retirement benefits of their employees or substitute increased direct compensation in its place. Once this change has been made it will be difficult to induce employers to reestablish retirement plans once again. Therefore, unless prompt action is taken, the complexity burden imposed on the private pension system will have the effect of substantially diminishing the retirement security of many Americans.

AREAS FOR IMMEDIATE ATTENTION

We believe several areas of the law are deserving candidates for the Subcommittee's immediate consideration. These can be grouped into areas involving statutory simplification, regulatory simplification and paperwork simplification. All are equally important. Even though regulatory and paperwork simplification may not be directly the result of the statutory rules, Congress can and should also act to simplify these rules and should encourage Treasury and the Internal Revenue Service to simplify the regulations and paperwork requirements.

Statutory Simplification

A. Qualification Rules

The qualification rules applicable to pension and profit sharing plans under the Internal Revenue Code contain four general areas that are in substantial need of simplification.

1. *Definitional Terms.*—The Internal Revenue Code defines numerous terms that are used elsewhere in the plan qualification requirements. Many of these terms are unnecessarily complex and the analytical work required in order to apply the definitions is unnecessarily burdensome. Some of the definitions that are particularly in need of simplification concern the definition of highly-compensated employee under section 414(q) of the Code; the definition of compensation under section 414(s) of the Code; the controlled group and affiliated service group rules under sections 414(b), (c) and (m) of the Code, and the separate line of business rules under section 414(r) of the Code. Too much effort was and is being spent designing definitions to deal with every conceivable situation when the definitions should instead be directed at establishing a general standard that can be readily recognized and applied by employers.

2. *Discrimination Tests.*—Without question, the backbone of the rules applicable to qualified plans is the maintenance of viable nondiscrimination tests for ensuring that qualified plans do not unduly favor highly-compensated employees. At present, however, these tests have become so numerous and so complicated that they are extremely burdensome to apply. The coverage tests under section 410(b), the basic nondiscrimination tests under section 401(a)(4), the minimum participation requirements under section 401(a)(26) the top-heavy rules under section 416, the maximum disparity rules under section 401(l) and the special rules regarding Keogh plans under section 401(d) are all in need of reexamination, repeal and simplification. Sub-

stantial simplification in these rules is entirely feasible while maintaining the necessary nondiscrimination standards in the law.

3. Contribution and Benefit Limitations.—The Internal Revenue Code establishes numerous limitations on the contributions and benefits that may be provided to qualified plan participants. The purposes of these limits is to control the government's revenue expenditure and to ensure that excessive benefits are not provided to highly-compensated employees while maintaining adequate incentives for those employees so that employers will establish qualified retirement plans. In three areas, however, the rules create excessive complexity without commensurate benefit. One area concerns the overall contribution and benefit limitation of section 415(e). This provision not only adds substantial complexity but in practice has the effect of undermining retirement security by further encouraging employers to maintain defined contribution plans instead of defined benefit plans. More than likely, few, if any, plan sponsors understand or properly administer this limitation. In addition, the testing rules for cash or deferred arrangements under section 401(k) and the rules regarding employee contributions and matching employer contributions under section 401(m) require excessive annual testing that has proven to be an expensive administrative burden and one fraught with expensive traps for the unwary.

4. Distribution Requirements.—The Internal Revenue Code imposes not only complex minimum distribution requirements under section 401(a)(9), but also qualified joint and survivor annuity rules under section 401(a)(11) and section 417 that create more complexity than is necessary to carry out their basic purposes. Individual members of the Tax Section's Employee Benefits Committee are currently working with the staff of the Joint Committee on Taxation to develop simple alternatives to some of these requirements.

B. Taxation Rules

Another area in which statutory simplification is urgently needed concerns the taxation rules applicable to plan benefits and distributions. Much of this complexity falls directly on employees rather than employers since it is the employees who must pay these taxes. Five areas in particular deserve Congressional scrutiny: (1) the excess accumulations tax under section 4980A of the Code; (2) the basis recovery rules under section 72; (3) the rules regarding lump-sum distributions under section 402; (4) the rules regarding tax-free rollovers under section 402; and (5) the treatment of net unrealized appreciation in employer securities under section 402(a) and section 402(e). Each of these rules carries significant complexity and simplification could undoubtedly be achieved. Individual members of the Tax Section's Employee Benefits Committee are currently working with the staff of the Joint Committee on Taxation to develop simple alternatives to some of these rules.

C. Funding Rules

The third general area affecting qualified plans that needs statutory simplification are the complex rules of section 412 regarding the funding of qualified plans. Primarily for revenue reasons, the level of complexity that has been achieved here not only goes beyond the need to fund retirement plans adequately, but it in fact seriously impedes that goal by preventing, in many cases, the adequate and level funding of retirement plans. This is clearly evident in the recently-enacted limitations on full funding—which intentionally reduce funding below levels required to fund the ultimate retirement benefits adequately. The adequate funding of retirement plans was an original motivating purpose for the enactment of ERISA in 1974 and yet recent legislation has actually hindered the achievement of that goal.

Regulatory Simplification

A second area deserving Congressional attention is the need to simplify unnecessarily complex regulations that have been issued. Encouragement from Congress to the Internal Revenue Service in these areas will help ensure that that regulatory simplification is achieved. We recognize and applaud current efforts by Commissioner Goldberg and the IRS to simplify regulations currently being developed. We are also very pleased to note that the Assistant Secretary of Treasury for Tax Policy has recently established the Office of Benefits Tax Counsel, to be headed by Thomas Terry, a nationally recognized expert in this field. This new Treasury office can—and, we assume, will—focus exceedingly useful efforts on precisely the sorts of concerns we described here. We believe that Congressional encouragement of and support for these efforts will be very helpful.

Four areas that we would single out as being in need of prompt and immediate simplification concern the regulations dealing with leased employees under section 414(n); the regulations on affiliated service groups under section 414(m); the regula-

tions under section 414(o) of the Code; and the regulations dealing with hardship distributions from section 401(k) plans. In each case, these regulations create complexities that go far beyond the objectives that need to be achieved or that Congress mandated. A reexamination of these rules in their entirety is appropriate.

Paperwork Simplification

Clearly it is important to provide an adequate disclosure of information to employees so that they both know the amount and type of retirement benefits that they will receive and, in addition, will be aware of any problems that may be created so that they can take the initiative in ensuring their own retirement security. However, the reporting and disclosure requirements as they currently exist appear to be excessive and therefore wasteful. Some of the paperwork complexity arises from statutory requirements while the rest results from regulatory and other requirements. Congress should attempt to streamline these requirements in a way that will carry out the objective of providing adequate information to employees without being unduly expensive and burdensome.

We believe that there are five areas that particularly deserve reexamination and simplification. One of those includes the summary annual report requirement which we believe provides no meaningful information to employees and yet has become a significant cost in maintaining retirement plans.

A second is the income tax withholding requirements and notices applicable to employees. Experience has strongly shown almost all employees will elect not to have income tax withholding applicable to pension distributions. Yet employers are forced to provide complex notices depending on the type of benefits to be provided and are then forced to obtain elections from employees verifying that they do not wish to have income tax withholding applied to their benefits. This charade of paperwork serves no purpose other than to increase the cost of administering retirement plans.

A third area concerns the confusion and difficulties of reporting pension distributions to employees and to the IRS. Currently three forms are used, form 1099, form W-2P and form W-4P. The Internal Revenue Service should take immediate action to simplify and streamline these reporting requirements so that they are more easily understood by employers and can be handled with a single form rather than forcing the employer to determine which form is applicable.

A fourth requirement that has proven to be unnecessary is the notice to interested parties regarding an application to the Internal Revenue Service for a determination letter. This not only delays IRS applications, because of the various time constraints required under the IRS procedures (e.g., the IRS application must generally be held for two to three weeks under the prior notification rules) but its results are not effective. Almost without exception employees do not comment to the IRS on applications for determination letters. This requirement could be easily simplified in a way that would decrease the burden on employers and still provide employees with an adequate opportunity to make their views known.

Finally, the requirements of the summary plan description, which are vital for employee understanding of their pension benefits, have become misdirected. Courts have frequently held employers liable for mistakes in summary plan descriptions so that these documents, instead of being helpful to employees, have become overly complex legal defense documents to ensure that they do not create any inadvertent legal liability on the employer's part. As such, they have become far less useful as laymen's descriptions of pension plans. Efforts should be taken to establish guidelines in this area that would enable employers to more easily describe the benefit provisions of plans.

RECOMMENDATIONS

We recommend that Congress promptly take action to enact legislation simplifying very considerably the laws governing private pensions. In enacting this legislation we suggest that there are three important goals that should be kept in mind. First, the legislation should avoid excessive concern over hypothetical or very limited abuses. Too often these types of concerns distort and complicate legislation in a way that imposes a significant burden on employers and employees.

Second, simplification should be treated by Congress as a priority goal in the enactment of legislation. It should not be given low priority treatment as it has in the past but instead should be viewed as a goal that is vitally important and necessary to effective legislation. Although simplicity was a stated goal of the Tax Reform Act of 1986, the legislation adopted in the benefits area—as illustrated by the Congress' recent repeal of section 89 was far from it.

Third, although we recognize the budgetary problems and constraints facing Congress, we urge that Congress minimize short-term revenue considerations in enacting legislation regarding the private pension system. This may be difficult, especially in view of the potentially large revenues available from pension plans, but the important social policies that need to be protected require Congress to carefully weigh its options before taking steps that may prove detrimental in the long term. The health of this system demands that Congress apply long-term, not short-term, thinking because to do otherwise will severely undermine the retirement security that the private pension system needs to provide.

Fourth, we urge Congress to refrain from frequent modification of the law. We recognize that in our testimony we have urged that you enact pension legislation. We do this only regretfully. We believe, however, that the complexity in the system currently is such that "cleanup" legislation is necessary. Thereafter, we strongly urge that Congress make any effort to avoid changing the rules for a significant period. The frequency of change in and of itself creates very considerable complexity and uncertainty, which is detrimental to the system.

Fifth, we urge that Congress take steps to make the need for simplification known to the agencies that administer the rules governing ERISA so that they take steps on their own and in concert each with the other to reduce the paperwork and complexities created by inconsistent administration of the rules and that they treat as a priority goal in and of itself the need for simplification.

Finally, except where the changes simplify existing complicated rules, we recommend that any changes made in the statutory rules be made only on a prospective basis with a substantial lead time so that employers are not forced, as they currently are, to deal with the complexity of complying with rules on which there is little or no guidance. Further, we urge Congress to encourage Treasury and the Internal Revenue Service to exercise their discretion to make regulations in this field effective only prospectively after the date of their finalization. This encouragement is important. Such delayed effective dates would alleviate the burden placed on employers of being perpetually confronted with the problem of trying to comply with complex regulations that are only proposed and that may not be finalized for many years. Regulations should not be effective until a date after they have actually been finalized (perhaps the commencement of the second plan year following their adoption) so that employers will not be forced to choose between complying with regulations that may ultimately be changed or not complying with the regulations and facing sanctions. Few changes are important enough to require the chaos created under the current system.

The Tax Section looks forward to working with you and your staff to help with the legislative process wherever you or they think our participation might be useful. Our goals are to maintain the essential soundness of the present system, to work to improve and simplify it, and to educate you and our members about it. We look forward to working with the Subcommittee to those ends.

Prepared Statement of David J. Kautter

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

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

The rules governing the taxation of private retirement plans have become increasingly intricate and complex over the past 15 years and we believe that they now rival any other area of the tax law in their complexity. In our opinion, this complexity is now at a point where it is adversely affecting both the private pension system itself and the administration of the tax system, and we believe this is an unhealthy state of affairs.

Specifically, the current rules are having three adverse effects on the private pension system and the administration of the tax laws. First, they are discouraging the establishment of new plans and encouraging the termination of existing plans. Employers without qualified plans, primarily small employers, are discouraged from establishing new plans because of the cost of establishing and maintaining arrangements which they cannot understand. Employers with existing qualified plans have grown weary of continuously amending their plans with provisions that they cannot understand and which do not, to them, seem to enhance their employees' retirement

security. Second, the current rules divert more money toward plan administration and less toward actual benefits to plan participants than would a simpler system. Third, the current rules are resulting in increased noncompliance—both intentional and unintentional. We believe this last trend is a particularly dangerous one since it not only means that our voluntary compliance system is diminished, but it means that taxpayers who attempt to comply with the law are at a competitive disadvantage with those who do not.

There are a number of reasons why the current rules are overly complex:

- One reason can be characterized as "incremental overload," the relentless layering of one set of changes upon another without the integration of these sets of changes into a comprehensive statutory scheme. Part of the reason for the incremental overload is the budget deficit and the yearly pressure on Congress to raise revenues. There is no doubt that closing so-called "loopholes" in the qualified plan rules to raise revenues as part of this process has resulted in increased complexity.
- A second reason is the attempt by policy makers to write rules that are so comprehensive and so specific that it is impossible for a taxpayer, even in the most remote circumstance, to contravene statutory intent in the slightest. Not all of the complexity attributable to this second cause emanates from Congress. The Executive Branch in its efforts to "fine tune" statutory language and fully implement the intent of Congress has written exhaustive regulations which are virtually incapable of being fully understood either by practitioners or Internal Revenue Agents. For example, regulations implementing the rules of §401 (a)(26), dealing with minimum participation in qualified plans, are so broad in scope and intricate in detail that their full impact will take years of implementation to comprehend. Yet taxpayers and agents are expected to understand and implement the rules almost immediately after their issuance. The current approach can be likened to that of a fisherman who weaves his nets so tightly, to prevent even the smallest fish from slipping through the net, that the fisherman is pulled overboard when the net is tossed into the water.
- A third reason is the process by which qualified plan rules have been changed in recent years. Often there are no hearings held on the specific qualified plan proposals contained in budget reconciliation bills and continuing resolutions. These provisions become lost and buried in the volume of these bills as they are rushed to the floor with little time allowed for comment by the public, floor debate of many provisions, or any real opportunity to alter or amend their content.
- The final reason involves those of us in the private sector and it is the desire on the part of taxpayers and their advisors to retain as much flexibility as possible in designing retirement arrangements. It seems clear that some flexibility will have to be sacrificed if the rules are to be made simpler.

In the qualified plan area, as in other areas of tax policy, a balance must be struck between simplicity and equity. Equity usually comes in the form of nondiscrimination rules in the pension area. The size, shape, and scope of "undue" complexity are elusive and relative concepts, but it is clear that, in reducing the complexity implicit in some of the current pension rules, some equity of current law will be lost. In simplifying other areas of the pension rules, however, equity will be enhanced. We believe the goal is to find the right balance between inhibiting as much discrimination as possible while utilizing rules that can be broadly understood and implemented and which encourage employers to establish and maintain qualified pension plans. We also believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the policy objectives of current law.

We propose that, as Congress looks at this area in the upcoming months, it use the following test to guide it in determining which rules of existing law should be retained and which should be changed:

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

Although this test is easy to state, answering it in many cases will not be easy. In some cases, reduction of complexity will not involve a re-examination of the tax policy underlying the current rules. In others, tax policy re-examination will be required and may involve accepting, as a society, some incremental discrimination or enhanced equity beyond that which is currently allowed. It may also involve accepting less flexibility on the part of taxpayers in the design and operation of tax-favored pension arrangements. These may not be easy for some to accept.

In applying this test, we would urge you to consider the complete elimination of rules which do not meet the test instead of trying to patch them up in ways that

will only add more complexity. We also urge the use of design based rules whenever possible in order to avoid detailed testing rules which add to uncertainty and plan administration costs.

In summary, the process of reducing complexity in this area must involve two steps. First, the existing rules must be restructured into a comprehensive statute. This requires clarity of purpose and entails the elimination of a number of provisions which are largely or partially duplicative. Second, both the statutory and regulatory rules need to be amended to focus on the general rules instead of the exceptions. Taking this second step means modifying or eliminating those rules whose incremental contribution to equity is outweighed by their incremental contribution to complexity. Even at a time of significant budget deficits, implementing these two steps does not have to be difficult since some changes will raise revenue while some will reduce revenue. Unless the complexity of the retirement rules is reduced, the trend is likely to be increasing noncompliance—not intentional, but unintentional brought about by taxpayers' inability to understand what is expected of them under the law—and a weakened private pension system.

The balance of my testimony identifies specific areas of the law where we believe substantial simplification can be achieved while retaining substantially all of the underlying legislative policy behind current law.

GENERAL PROPOSALS

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

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

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

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

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

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

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

2. *Reduction of Complexity Achieved*—When dealing with qualified retirement plans, the following sections would no longer need to be considered: §§401(a)(28), 409, 404(a)(9), 404(k), 41 5(c)(6), 4975(e)(7), and 4975(d)(3). These sections would be collected in a separate subchapter of the Code.

C. Proposal: Eliminate, to the extent possible, the remaining statutory distinctions between self-employed individuals and common-law employees.

1. *Proposal and Rationale*—Those distinctions that remain after TEFRA can be divided into two groups: 1) those designed to treat certain self-employed individuals differently from other plan participants (the owner-employee rules), and 2) those necessary to make sure there is equivalent treatment between self-employed individuals and other participants. Eliminating the first set of distinctions would simplify the law without sacrificing any significant policy goals. It is proposed that the flush language in §4975(d) that prohibits loans from qualified plans to participants who are owner-employees be repealed. The special aggregation rules of §401(d) should also be repealed. These changes would eliminate an existing trap for the unwary as well as simplify the Code.

Retention of the second set of distinctions will ensure equivalent treatment between self-employed individuals and other participants.

2. *Reduction of Complexity Achieved*—The flush language in §4975(d) would be repealed. Also repealed would be §§401(c)(3), 401(c)(5), 401(d), and 401 (a)(10)(A). Section 416(i)(3) would be repealed as part of an overall repeal of the top-heavy rules discussed below.

D. Proposal: Simplify the definition of highly compensated employee under §414(q).

1. *Proposal and Rationale*—One of the key concepts that permeates the entire qualified plan area is the prevention of discrimination in favor of "highly compensated" employees. Under TRA 86, the Code for the first time specifically set forth rules for determining who is in this group. However, the definition is difficult to work with and a clear simple definition would reduce complexity. It is recommended that the Code define the highly compensated group as: (1) 5% owners with attribution (as defined in §318 of the Code), and (2) those earning compensation in excess of $75,000 (indexed for inflation). In addition, the "highly compensated" group would be determined on the basis of the preceding plan or employer year, not the current preceding years as under current law.

2. *Reduction of Complexity Achieved*—The proposal would simplify plan administration and testing because the highly compensated group would be easy to identify.

E. Proposal: Provide a uniform definition of compensation for purposes of the employee benefit rules.

1. *Proposal and Rationale*—A uniform definition of compensation should be established to simplify the task of plan sensors and administrators.

The uniform definition should be tied to taxable compensation with elective contributions under §§125, 401(k), 408(k), 403(b), 457, and 501(c)(18) added back at the employer's election on a uniform and nondiscriminatory basis. For example, a calendar year plan would simply use W-2 compensation including the specified elective contributions if the employer elects. A fiscal year plan could either determine taxable compensation on the fiscal year basis or use W-2 compensation for the calendar year which ends in the fiscal year. This definition should be used for all purposes of the employee benefit rules.

2. *Reduction of Complexity Achieved*—A uniform, simplified standard for compensation which would reduce complexity in plan design and administration, and eliminate the existing trap for the unwary.

PLAN QUALIFICATION PROPOSALS

A. Proposal: Repeal the top-heavy rules.

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

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

In view of the fact that virtually all plans must include these provisions, and that the incremental benefit of the top-heavy rules has been diminished by subsequent

changes in the Code, these provisions could be eliminated with little adverse impact on participants and reduce complexity in the law and plan documents.

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

B. Proposal: Reconsider §401(a)(26).

1. *Proposal and Rationale*—The §401(a)(26) minimum participation rules are aimed at preventing multiple plans covering few employees from discriminating against nonhighly compensated employees. Section 410(b) is also aimed at preventing discrimination against nonhighly compensated employees, but may be applied on a group plan basis if such plans are comparable in accordance with Rev. Rul. 81-202, 1981-2 CB 93.

In enacting §401 (a)(26), the legislative history indicates Congressional concern that although plans that are aggregated are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of the prohibited group. Differences in the rates at which benefits are accrued (e.g. presence or absence of past service credit) and the selective use of actuarial assumptions in valuing plan benefits may cause a plan that satisfies the requirement of comparability with respect to the amount of contributions or benefits to favor the highly paid. Similarly, in the case of plans that are comparable with respect to the amount of contributions or benefits, discrimination favoring the highly paid may occur because of disparate funding levels and benefit options that are not taken into account in such a comparability analysis.

Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in funding levels and benefit options, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans. Thus, Congressional intent may be summarized as desiring to obtain both nondiscrimination and simplicity.

The regulations issued under §401(a)(26) by all standards are anything but simple. The Service has stated that it will soon issue a new revenue ruling which will expand upon Rev. Rul. 81-202 and make it more difficult to discriminate using comparability of plans in order to satisfy §410(b).

Eliminating one-person plans or highly specialized plans that cover small numbers of employees is appealing in reducing the number of plans maintained by a controlled group and in easing the audit burden of the Internal Revenue Service. However, unless the regulations under §401(a)(26) can be re-drafted in a manner that reflects the straightforward manner of the statute, then §401(a)(26) should be repealed. If the regulations can be properly drafted, the repeal of §401(a)(26) may not be necessary.

If the regulations cannot be re-drafted and if §401(a)(26) is repealed, then any perceived problems with comparable plans should be dealt with directly by amending the rules of Rev. Rul. 81-202. Section 410 should adequately cover the objective of preventing plans from being discriminatory against the nonhighly compensated. If any gaps exist, the forthcoming revenue ruling, final §410(b) regulations, or additional pronouncements from the Service, could cover them. Alternatively, the percentage tests of §410(b) could be increased above 70% to minimize any abuses. This proposal is one which could result in some incremental discrimination above that allowed by current law, but the reduction in complexity achieved would be substantial.

2. *Reduction of Complexity Achieved*—The complexity resulting from §401(a)(26) and the regulations promulgated thereunder would be eliminated.

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

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

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

retiree health obligations, e.g., earnings on funds set aside for retiree health obligations should not be subject to unrelated business income tax.

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

D. Proposal: Eliminate §1.401-4(c)(2)(ii) concerning restriction of benefits which may be paid to the 25 highest paid employees.

1. *Proposal and Rationale*—Under §415, the benefits which may be paid to an employee are limited to no more than $90,000 (indexed) or 100% of compensation actuarially reduced for early retirement. In addition, §415 now sets forth the requirement that the maximum benefit payable may only be accrued ratably over 10 years of plan participation. This prevents a highly compensated employee from receiving a large benefit shortly after a plan has been established. This structure significantly diminishes the possibility of abuse at which §1.401-4(c) is aimed. In addition, this regulation was adopted before ERISA, which introduced the Pension Benefit Guaranty Corporation and minimum funding rules. Both innovations have also helped to prevent the type of abuse which this regulation was originally enacted to prevent. Finally, the new minimum funding rules under the Omnibus Reconciliation Act of 1987 (OBRA) also help to ensure that plan participants and beneficiaries are protected from the type of abuse at which this regulation is aimed.

Due to the diminished possibility of abuse, §1.401-4(c) of the regulations should be revoked. This is a situation where significant reduction in complexity could be achieved by eliminating a largely redundant provision.

2. *Reduction of Complexity Achieved*—Treasury regulation §1.401-4(c) would be eliminated and, therefore, plan design would be simplified.

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

1. *Proposal and Rationale*—The OPSA notice should be required to be provided only to individuals within a reasonable period after they become plan participants.

There is little logic in providing this notice only at the current age range, since most employees are sophisticated enough to understand the notice at any age. This provision has simply resulted in an increased compliance burden for plan sponsors without a commensurate return, either in understanding on the part of the participants, or in achieving effective disclosure.

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

BENEFIT ACCRUAL PROPOSALS

A. Proposal: Eliminate the actual deferral percentage test in cash or deferred arrangements.

1. *Proposal and Rationale*—The actual deferral percentage test of §401(k) was enacted at a time when highly compensated employees could elect to defer up to $30,000 annually under a §401(k) plan. It is aimed at preventing a 401(k) plan from discriminating against lower compensated employees, and operates to supplant §401(a)(4). The potential for discrimination in a 401(k) plan has been dramatically reduced by the lowering of the elective deferral limitation in TRA 86 to $7,000, (indexed for cost of living). The performance of the actual deferral percentage test is time consuming for a plan of any significant size and many plan sponsors have not accurately tested on a timely basis.

The §401(k) rules should be amended: (1) to require that all employees with a requisite age and year(s) of service and not in excluded categories under §410(b) be permitted to make deferrals under an employer's 401(k) plan, and (2) the actual deferral percentage test be repealed.

2. *Reduction of Complexity Achieved*—Code §401(k)(3), §4979 and the regulations and notices promulgated thereunder would be eliminated. Section 402(g)(1) would be modified to reflect a lower limit and the §402(g)(5) adjustment for cost-of-living would remain in effect.

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

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

In addition, there appears to be no compelling policy justification for requiring employees of tax-exempt organizations to participate in annuity contracts or custo-

dial accounts rather than in the investments available to employees of non-tax-exempt organizations. The repeal of §403(b) should be considered in an age where self-directed accounts are very commonly available through any of the large, national brokerage firms or other financial institutions, individual accounts are relatively easy to establish, not very costly, and much more convenient for employees of tax-exempt organizations than when §403(b) was enacted.

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

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

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

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

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

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

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

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

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

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

1. *Proposal and Rationale*—The concept of permitted disparity should either be altogether eliminated or substantially simplified. A complete repeal of permitted disparity rules would reduce the complexity of the qualified plan area and would generally provide greater benefits to employees in those plans currently using the permitted disparity rules. Repeal of the disparity rules could, however, lead to termination of existing plans. Therefore, if complete repeal is not desired, the rules

should be simplified. For example, the pre-TRA 86 rules could be reinstated with a minimum benefit required for all plan participants.

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

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

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

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

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

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

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

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

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

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

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

DEDUCTION PROPOSALS

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

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

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

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

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

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

DISTRIBUTION PROPOSALS

A. Proposal: Repeal five year averaging for distributions from qualified retirement plans.

1. *Proposal and Rationale*—The proposal is that five-year averaging be repealed. Lump Sum distributions would be included in income in the year received and taxed as ordinary income unless rolled over into an IRA.

Congress has become increasingly concerned that retirement plan balances are being used to fund expenditures unrelated to retirement, e.g. venture capital. Studies indicate that lump-sum distributions are often depleted by the time an employee reaches retirement age. Repeal of favorable tax treatment is intended to encourage

using retirement funds to pay for living expenses upon retirement. This would also simplify decision making for plan participants at retirement by eliminating one of the current taxation alternatives.

It is not recommended that lump-sum distributions from plans be prohibited because of the administrative convenience of paying an employee's balance, especially smaller sums, upon termination of employment. What would be eliminated would be preferential tax treatment if the distribution were not rolled over into another qualified plan or IRA.

2. *Reduction of Complexity Achieved*—Repeal of five-year averaging would eliminate the following Code sections: 402(e)(1), (2), (3), 402(e)(4)(B), (C), (D) (G), (H), (M), and (O).

B. Proposal: Allow the rollover of any distribution from a qualified plan, other than required minimum distributions.

1. *Proposal and Rationale*—Any distribution from a qualified plan should be eligible to be rolled over into an IRA except for distributions pursuant to §401(a)(9). This would simplify distribution planning and encourage retention of funds originally contributed to retirement plans for retirement. It would also eliminate the disparity between the amount required to be distributed to be eligible for a rollover and, at the option of the recipient, the lesser amount which is permitted to be rolled over.

2. *Reduction of Complexity Achieved*—Section 402(a)(5)(D) would be repealed and the definition of a qualified total distribution would no longer be necessary.

C. Proposal: Simplify the minimum distribution rules of §401(a)(9).

1. *Proposal and Rationale*—The minimum distribution rules are aimed at preventing plan participants from using qualified retirement plans as estate planning devices. With the repeal of the estate tax exclusion in DEFRA for qualified plan interests, a strong argument can be made for the repeal of §401(a)(9). However, even after DEFRA, participants could still receive a significant tax advantage by deferring the receipt of their benefits to a date in the distant future.

Two changes can be made to simplify §401(a)(9) without compromising the purpose of the provision. First, at death, distributions could be required to be paid over the life expectancy of the beneficiary beginning at the decedent's death. There would be no distinction between situations where an individual dies before or after his required beginning date. There would also be no distinction between types of beneficiaries as there is under current law. Second, the calculation of life expectancy should not be recalculated. The only method of determining life expectancy would be reducing the initial calculated life expectancy by one each year. Both of these suggestions are intended to streamline §401(a)(9) without altering the underlying concept. Finally, consideration should be given to reducing the number of participants to whom this rule applies by limiting its application to participants with accrued benefits in excess of a certain level.

2. *Reduction of Complexity Achieved*—Section 401(a)(9)(B) would be condensed from four rules for distributions upon death to one rule. The regulations would be simplified concerning the calculation of life expectancy.

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

1. *Proposal and Rationale*—The rules governing hardship distributions from qualified plans could be substantially simplified by specifying certain situations in the statute which would be considered a hardship for distribution purposes, e.g., purchase of a principal residence, education, or medical expense. In addition, no suspension from plan participation would be imposed on account of a hardship withdrawal. An alternative to simplification would be elimination of hardship withdrawals. Elimination of hardship withdrawals, however, might discourage nonhighly compensated employees from participating in §401(k) plans.

2. *Reduction of Complexity Achieved*—The complicated plan amendments required as a result of the prosed and final regulations on hardship withdrawals in 401(k) plans which were issued on August 8, 1988 would no longer be needed and the role of plan administrators in administering affected 401(k) plans both now and in future years would be simplified.

CONTROLLED GROUP PROPOSALS

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

1. *Proposal and Rationale*—The §414(m) affiliated service group definitions under the Code and the regulations are extremely complex. If Congress wishes to prevent the perceived abuse at which §414(m)(2) was aimed, it appears that much of the

complexity would have to remain. However, it would be helpful if some of the terms used in the Code were more clearly defined. The use of too many qualitative terms causes plan sponsors and their advisors to spend extra time and effort in attempting to interpret them.

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

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

Section 414(n) is a fairly straightforward Code provision aimed at abusive situations where employers do not employ their own employees, but rather lease employees from a third organization. This provision should be clarified so that it does not cover independent contractors where there is no third party leasing organization involved. Also, it would be helpful if the reference to § 144(a)(3) under § 414(n)(6) were eliminated as it makes analysis under this Code provision extremely difficult.

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

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

Prepared Statement of Senator David Pryor

PENSION COMPLEXITY AND COVERAGE

The purpose of this morning's hearing is to take a look at the changes in ERISA over the past 15 years and to see what effect they have had on plan coverage.

When Congress enacted ERISA in 1974, many thought the act was sufficiently comprehensive and flexible that further changes would be relatively few and far between. But like many other good intentions, things have not quite worked out that way: ERISA and the Internal Revenue Code have been amended an average of almost once a year since 1974.

Most of the changes that have been made in the law over the past 15 years are probably meritorious. They have attempted to enhance benefit security, address possible discrimination in plans, and permit plans to adapt to the needs of a growing and economically diverse workforce.

But the time has come to take a look at what we have wrought. ERISA clearly has become a boon for lawyers and consultants, but I remain firm in my conviction that that was not the original intent of Congress.

The goal of ERISA, of course, is to provide income to our nation's workers after retirement. And to achieve this goal, there must be security of assets and sufficient flexibility to allow employers and employees to establish pension plans that meet their needs.

I fear that maintaining a pension plan is no longer a routine administrative, simple administrative matter performed at a reasonable cost, but rather a legalistic and very expensive endeavor.

I hope that the witnesses this morning will help the subcommittee address two major questions that we will pose:

• First, is the complexity of ERISA discouraging the initiation and continuation of pension plans, particularly defined benefit plans?

• Second, how and in what areas might it be most fruitful to rationalize or simplify the law?

With the help of our witnesses this morning, we hope to find answers to these questions—answers that will help this subcommittee make an informed judgment. I am afraid that the complexity of ERISA has become so great that we risk stagnation or even decline in our private pension system at a time when we should be actively promoting it to support the nation's growing retiree population.

Attachment.

[JOINT COMMITTEE PRINT]

PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS

SCHEDULED FOR A HEARING

BEFORE THE

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

OF THE

SENATE COMMITTEE ON FINANCE

ON MARCH 23, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 22, 1990

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INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on March 23, 1990, to review the Internal Revenue Code rules relating to private pension plans and possible options for simplification of pension plan rules.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of issues relating to simplification of the Federal income tax rules relating to tax-qualified retirement plans. Part I of the pamphlet is a summary. This is followed by a description of the present-law Federal tax rules regarding tax-qualified plans (Part II), legislative background of the present-law rules (Part III), and a brief discussion of pension plan simplification issues (Part IV).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present-Law Tax Rules Relating to Qualified Pension Plans* (JCS-9-90), March 22, 1990.

I. SUMMARY

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

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

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

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

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

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. There are several sources for this complexity, including the interaction of retirement policy and tax policy, the volume and frequency of employee benefits legislation, the structure of the workplace, the need to provide

employers and employees flexibility in tailoring compensation packages, the desire for certainty in the law, and transition rules.

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

—

II. PRESENT-LAW RULES [2]

A. Overview of Qualified Plans

In general

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

The special tax benefits for qualified plans and qualified plan benefits represent a significant tax expenditure. For fiscal year 1991, the tax expenditure for the net exclusion for pension contributions and earnings is estimated to be $52.2 billion.[3]

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

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

Types of qualified plans

Defined benefit pension plans and defined contribution plans

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

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service

[2] This pamphlet is limited to a discussion of the Internal Revenue Code rules relating to tax-qualified retirement plans. In addition to the rules in the Internal Revenue Code, the labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain extensive rules regarding employee benefit pension plans. A discussion of the labor law provisions is beyond the scope of this pamphlet. This pamphlet also does not discuss other types of employer-sponsored tax-favored retirement programs such as tax-sheltered annuities (sec. 403(b)) or simplified employee pensions (sec. 408(k)).

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

completed by an employee. Benefits under a defined benefit pension plan also may be specified as a flat or step-rate percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.[4]

Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC) (a Federal corporation within the Department of Labor).

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs). The various different types of plans are in part historical and reflect the various different ways in which employers structure deferred compensation programs for their employees.

Money purchase pension plans and target benefit plans

Under a money purchase pension plan, the amount of employer contributions allocated to the account of an employee must be fixed or determinable from a formula set forth in the plan. Under a target benefit plan, contributions are determined on an actuarial basis in an attempt to provide the participant with a specified level of retirement benefit. Although money purchase pension plans and target benefit plans are defined contribution plans, many of the qualification rules applicable to defined benefit plans also apply to such plans. For example, benefits may be paid under a defined benefit pension plan or a money purchase pension plan only in the event of death, disability, separation from service, or attainment of normal retirement age.

Profit-sharing and stock bonus plans

Under a profit-sharing plan, employer contributions are generally provided out of current or accumulated profits of the employer. Profit-sharing plans are not required to specify a contribution rate or formula; the amount of contributions may be determined at the discretion of the employer. Stock bonus plans are similar to profit-sharing plans, except that they are generally designed to provide benefits in the form of employer stock. Under a profit-sharing or stock bonus plan, benefits can generally be distributed to an employee who has not separated from service provided the amounts distributed have been in the plan for at least 2 years.

A profit-sharing or stock bonus plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments (e.g., a portion of current salary) directly to the employee in cash or as contributions to a qualified plan on behalf of the employee. Qualified cash or deferred arrangements are subject to special rules. For 1990, elective deferrals under a qualified cash or deferred arrange-

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

ment are limited to $7,979 per individual. This limitation is increased annually for inflation.

Employee stock ownership plans

An ESOP is a qualified stock bonus plan or a combination of a stock bonus plan and money purchase pension plan that is designed to invest primarily in employer securities and that meets certain other requirements.

ESOPs have the unique ability to acquire employer securities by borrowing from the employer maintaining the plan or with a loan guaranteed by the employer. An ESOP that borrows to acquire employer securities is referred to as a leveraged ESOP. For example, in a typical ESOP leveraging transaction a corporation borrows from a bank or other financial institution and then relends the funds to an ESOP, which uses them to acquire employer securities. The employer makes contributions to the ESOP which are used to retire the debt. Because of this unique leveraging ability, ESOPs are often used as a device for capital formation as well as an employee benefit program.

ESOPs are subject to rules not applicable to other types of qualified plans. In addition, ESOPs receive special tax benefits not available to other types of qualified plans. For example, the deduction limits for leveraged ESOPs are higher than the deduction limits applicable to other types of defined contribution plans; a bank or other financial institution lending money to an ESOP can exclude from income 50 percent of the interest received on the loan if the ESOP owns more than 50 percent of the stock of the employer and certain other requirements are satisfied (sec. 133); in certain circumstances, an individual who sells employer securities to an ESOP can defer recognition of gain on the sale (sec. 1042); and an employer may deduct certain dividends paid on employer securities held by an ESOP (sec. 404(k)).

Sanction for failure to meet qualification rules

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

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

B. Plan Qualification Requirements

1. Minimum participation standards

In general

Under present law, a qualified plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation (sec. 410(a)). A qualified plan generally may not require an employee to complete more than one year of service or attain an age greater than 21 as a condition of plan participation. A plan may require 2 years of service prior to an employee becoming eligible to participate if an employee's accrued benefit becomes 100 percent vested immediately upon his or her admission to the plan.

Determining years of service [5]

For purposes of the participation requirements, the term "year of service" generally means a consecutive 12-month period during which an employee has worked at least 1,000 hours. Detailed rules for counting hours of service and alternative methods of measuring service are set forth in Treasury and Department of Labor regulations.

In general, all years of service with the employer maintaining a plan are taken into account for purposes of the minimum participation requirements. No credit need be provided however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to work for an employer after a break in service may lose credit for pre-break service, and therefore may be required to satisfy again the plan's participation requirement before being readmitted to the plan.

A plan may provide that a 1-year break in service occurs in a 12-month measuring period in which the employee does not complete more than 500 hours of service. A plan may provide that an employee who completes more than 500 hours of service but fewer than 1,000 hours of service has neither a 1-year break in service nor a year of service for participation purposes.

A plan may provide that years of service before a 1-year break in service are not taken into account until after the employee completes a post-break year of service. If the plan has a 2-year participation requirement and an employee has a 1-year break in service before satisfying such requirement, then service before the break may be disregarded.

In the case of a nonvested participant, years of service with the employer before any period of consecutive 1-year breaks in service are required to be taken into account after a break in service unless the number of consecutive 1-year breaks in service equals or exceeds the greater of (1) 5 years or (2) the aggregate number of years of service before the consecutive 1-year breaks in service. If any years of service are not required to be taken into account by reason of a period of breaks in service under this rule, then those

[5] Similar rules regarding counting years of service also apply under the vesting rules (discussed at 3.a., below).

years of service are not required to be taken into account if there is a subsequent break in service.

For purposes of determining whether a break in service has occurred an individual is deemed to have completed hours of service during certain periods of absence from work for maternity or paternity reasons. This rule applies to an individual who is absent from work (1) by reason of the pregnancy of the individual, (2) by reason of the birth of a child of the individual, (3) by reason of the placement of a child in connection with the adoption of the child by the individual, or (4) for purposes of caring for the child during the period immediately following the birth or placement for adoption. During an absence for maternity or paternity reasons, the individual is treated as having completed (1) the number of hours that normally would have been credited but for the absence, or (2) if the normal work hours are not known, 8 hours of service for each normal workday during the leave (whether or not approved). The total number of hours of service required to be treated as completed is 501 hours.

2. Coverage and nondiscrimination requirements

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

a. Minimum coverage rules

In general

A plan is not qualified unless the plan satisfies at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all an employer's nonhighly compensated employees (the "percentage test");

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan (the "ratio test"); or

(3) the plan meets the average benefits test.

A plan maintained by an employer that has no nonhighly compensated employees is deemed to satisfy the coverage requirements. A plan that benefits only nonhighly compensated employees will also automatically satisfy the minimum coverage requirements.

The coverage rules may be applied separately to each separate line of business of the employer. (The definition of a line of business is discussed below.) Present law contains a special rule for application of the coverage rules in the event of dispositions or acquisitions and other corporate transactions. These rules are designed to provide a transition period during which the transaction will not result in a failure to satisfy the rules.

Average benefits test

A plan meets the average benefits test if (1) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of highly compensated employees ("classification test"); and (2) the average benefit percentage for nonhighly compensated employees of the employer is at least 70 percent of the average benefit percentage for highly compensated employees of the employer.

The term "average benefit percentage" means, with respect to any group of employees, the average of the benefit percentages calculated separately with respect to each employee in such group. The term "benefit percentage" means the employer-provided contributions (including forfeitures) or benefits of an employee under all qualified plans of the employer, expressed as a percentage of such employee's compensation.

For purposes of determining benefit percentages, all pre-tax contributions or benefits provided under a qualified plan are considered employer-provided and are to be taken into account, including, for example, elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)). In no case may an employer disregard any qualified plan in determining benefit percentages, even if such qualified plan satisfies the percentage test or ratio test standing alone. Contributions or benefits under other types of tax-favored retirement plans other than qualified plans (such as simplified employee pension plans (sec. 408(k)) or tax-sheltered annuity programs (sec. 403(b)) are not taken into account.

After the benefit percentage of each employee is determined in the manner described above, the average for the 2 groups (highly compensated employees and nonhighly compensated employees) is then determined by averaging the individual benefit percentages of each employee (including employees not covered by any qualified plan).

Employees benefiting under the plan

For purposes of the coverage rules, an employee generally will be treated as benefiting under the plan only if the employee is a participant with respect to whom the plan benefit accrues or, in the case of a defined contribution plan, is contributed. However, in the case of a qualified cash or deferred arrangement or the portion of a defined contribution plan to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive (as applicable) contributions under the plan.

However, for purposes of the average benefit percentage component of the average benefits test, it is actual benefits and contributions, not eligibility, that is taken into account with respect to all types of plans.

Aggregation of plans and comparability

For purposes of applying the percentage test or the ratio test, an employer may designate more than 1 plan as a single plan and test the plans as a unit if the plans provide comparable benefits or con-

tributions. Also, for purposes of satisfying the average benefits test, 2 or more comparable plans may be aggregated for purposes of determining whether the plans together satisfy the classification test. The determination of whether a group of plans is comparable is made in accordance with Treasury regulations, and is based on the relevant facts and circumstances.[6]

Excluded employees

For purposes of determining whether a plan satisfies the coverage rules, the employer generally is to exclude from consideration the following classes of employees: (1) employees who have not met the plan's minimum age or service requirements; (2) for purposes of applying the minimum coverage rules to qualified plan coverage of employees who are not included in a unit of employees covered by a collective bargaining agreement, employees not covered by the agreement; and (3) nonresident aliens with no United States source earned income.

Sanction

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

b. Minimum participation rule

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

The minimum participation rule was enacted because the Congress determined that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for cov-

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[6] As part of the Tax Reform Act of 1986, Congress directed the Secretary to issue new guidance relating to comparability. Under prior law, Rev. Rul. 81-202, 1981-2 C.B. 93, provided guidance for determining whether the amount of employer-derived benefits or contributions provided under several plans discriminated in favor of highly compensated employees. That ruling provided (1) methods for adjusting all types of benefits to a standard form; (2) methods for converting benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits.

erage purposes are required to be comparable, plans could be considered comparable and still be discriminatory because the comparability rules do not look at all plan features. Moreover, the Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in plan benefits, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination rules by small aggregated plans.

The Secretary of the Treasury is authorized to provide that any separate benefit structure, any separate trust, or any separate arrangement with respect to a plan may be treated as a separate plan for purposes of applying the minimum participation rule. Thus, for example, a plan that provides 2 different formulas for calculating participants' benefits or contributions may be treated as at least 2 plans.

For purposes of applying the minimum participation rules, the same categories of employees may be disregarded as are disregarded for purposes of applying the minimum coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such unit may be disregarded for purposes of satisfying the minimum participation rule. This exception does not apply to any collectively bargained plan that covers any professional (e.g., a doctor, lawyer, or investment banker).

The minimum participation rule generally does not apply to a multiemployer plan. However, this exemption does not apply to a multiemployer plan that covers any professional (e.g., a doctor, lawyer, or investment banker). Special rules also apply to plans for police and firefighters and in the case of dispositions and acquisitions and similar corporate transactions.

The special sanction that applies for failure to satisfy the minimum coverage rules (described above) also applies to failures to satisfy the minimum participation rule.

c. Nondiscrimination in contributions or benefits

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

Whether or not a plan meets the general nondiscrimination test is a factual determination, based on the relevant facts and circumstances. A plan does not fail to meet the general nondiscrimination test merely because contributions or benefits bear a uniform relationship to compensation.

d. Application of nondiscrimination rules to integrated plans

In general

Under present law, a qualified plan may be "integrated" with social security. That is, a plan may adjust benefits under the plan to take into account social security benefits. A plan that does so will generally provide greater benefits for highly compensated employees than nonhighly compensated employees, because social security does not provide complete wage replacement for more highly compensated employees. Present law provides that such a plan is not discriminatory under the general nondiscrimination rule merely because the contributions and benefits under the plan favor highly compensated employees, if the disparity between contributions or benefits for highly and nonhighly compensated employees meets certain requirements (sec. 401(l)). In addition, an integrated plan is required to provide that benefits may be distributed only upon retirement, death, disability, or other separation from service.

Permitted disparity in defined contribution plans

A defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage (i.e., the contribution by the employer with respect to compensation over the integration level, expressed as a percentage of compensation) does not exceed the base contribution percentage (i.e., the contribution by the employer with respect to compensation up to the integration level, expressed as a percentage of such compensation) by more than the lesser of (1) the base contribution percentage, or (2) the greater of 5.7 percentage points or the percentage equal to the portion of the rate of tax in effect attributable to old-age insurance as of the beginning of the plan year (sec. 3111(a)).

A plan is required to specify the applicable integration level for a year. The maximum integration level permitted for a year, however, is the OASDI contribution and benefit base under social security (taxable wage base) in effect at the beginning of the year ($51,300 for 1990).

Permitted disparity in defined benefit pension plans

There are two basic approaches to integrating defined benefit pension plans: the excess approach and the offset approach.

Excess plans.—An excess plan is a plan under which benefits are provided at one or more specified rates below the plan's integration level and at other higher rates above that level. The excess benefit percentage (i.e., benefits provided by the employer with respect to compensation in excess of the applicable integration level, expressed as a percentage of compensation) under a defined benefit excess plan may not exceed the base benefit percentage (i.e., benefits provided by the employer with respect to compensation not in excess of such integration level, expressed as a percentage of such compensation) by more than the maximum excess allowance.

In the case of an excess plan, the maximum excess allowance with respect to benefits attributable to any year of service taken into account under the plan is the lesser of (1) the base benefit percentage, or (2) 3/4 of a percentage point. The maximum excess allowance for such a plan with respect to total benefits is the lesser

of (1) the base benefit percentage, or (2) 3/4 of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan.

Offset plans.—The term "offset plan" means any defined benefit pension plan under which the employer-provided benefit for each participant is reduced by an amount specified in the plan. In the case of a defined benefit offset plan, a participant's accrued benefit may not be reduced by reason of the offset by more than the maximum offset allowance for such participant. The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of (1) 50 percent of the benefit that would have accrued without regard to the offset reduction, or (2) 3/4 percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan. For purposes of this allowance, a participant's final average compensation is calculated by disregarding compensation in any year over the social security taxable wage base for such year.

The Secretary is to reduce the 3/4 percent factor in the maximum excess and maximum offset allowances for certain plans providing for unreduced benefits (other than for disability, as defined under the Social Security Act) commencing before the social security retirement age.

e. Nondiscrimination rules relating to qualified cash or deferred arrangements

In general

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. Several special rules apply to cash or deferred arrangements.

As discussed above, a qualified plan generally cannot provide greater benefits to highly compensated employees. The integration rules provide one exception to this rule. Another exception is provided in the case of qualified cash or deferred arrangements. Under a special nondiscrimination test, the benefits provided to highly compensated employees under a cash or deferred arrangement can be a multiple of the benefits provided to nonhighly compensated employees.

The nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. The actual deferral percentage for a group of employees is the av-

erage of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

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

Under Treasury regulations, employer matching contributions that meet the vesting and withdrawal restrictions applicable to elective deferrals (discussed below) under a qualified cash or deferred arrangement, and qualified nonelective contributions may be taken into account in determining actual deferral percentages. Qualified nonelective contributions are defined to mean employer contributions (other than matching contributions) with respect to which (1) the employee may not elect to have the contributions paid to the employee in cash or other benefits in lieu of being contributed to the plan and (2) the vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement are satisfied. Employer matching contributions and qualified nonelective contributions do not meet the applicable withdrawal restrictions if such contributions (or earnings thereon) may be distributed on account of hardship.

Excess contributions

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

The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)), the 15-percent tax on excess distributions (sec. 4980A), or the 10-percent tax on nondeductible contributions (sec. 4972) (see below).

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination test.

Excise tax on excess contributions

An excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions (but not earnings on those contributions) under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions no later than 2-½ months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed or recharacterized within the applicable 2-½-month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash. For purposes of determining the employee's taxable year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a plan year. Of course, distributions of excess contributions (plus income) within the applicable 2-½-month period are not taxed a second time in the year of distribution.

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

In general

A special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans (sec. 401(m)).[7] This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement. Employer matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions, unless the employer elects otherwise.

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in

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

the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test are made, then all such contributions made on behalf of the highly compensated employee are aggregated for purposes of the special nondiscrimination test.

Permissive aggregation

Under Treasury regulations, an employer may elect to take into account elective deferrals, matching contributions treated as elective deferrals, and/or qualified nonelective contributions under the plan or under any other plan of the employer.

Elective deferrals, matching contributions treated as elective deferrals, or qualified nonelective contributions may only be taken into account for purposes of the special nondiscrimination rules if the deferrals or contributions taken into account satisfy the applicable nondiscrimination rules and other contributions would not fail to satisfy applicable nondiscrimination rules if the deferrals or contributions taken into account were disregarded.

Treatment of excess aggregate contributions

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

Distribution of excess aggregate contributions may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)) or the 15-percent tax on excess distributions (sec. 4980A). Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions.

A plan may designate whether excess contributions or excess aggregate contributions are attributable to elective deferrals, qualified nonelective contributions, employee contributions, or employer matching contributions, as long as the ordering designated by the plan is used consistently. A plan may not designate an order of distributions that results in the plan violating the general nondiscrimination requirements (sec. 401(a)(4)).

Excise tax on excess aggregate contributions

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

However, the tax does not apply to any excess aggregate contributions that, together with income allocable to the excess aggregate contributions, are distributed (or, if nonvested, forfeited) no later than 2-½ months after the close of the plan year in which the excess aggregate contributions arose.

Excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income) and income on excess employee contributions distributed within the applicable 2-½ month period are to be treated as received and earned by the employee in the employee's taxable year to which such excess aggregate contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess aggregate contributions.

g. Limit on includible compensation

A limit is provided with respect to the amount of a participant's compensation that can be taken into account under a qualified plan (sec. 401(a)(17)). This limit on includible compensation is $209,200 for 1990, and is adjusted annually for inflation. The limit applies for most rules relating to qualified plans, including the general nondiscrimination rules and the special rules for qualified cash or deferred arrangements, matching contributions, and employee contributions.

3. Vesting and accrual rules

a. Vesting requirements

In general

A plan is not a qualified plan (except in the case of a multiemployer plan) unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative minimum vesting schedules (sec. 411(a)). Vesting occurs when a participant acquires a nonforfeitable right to a benefit.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service,

60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service. Separate rules apply to top-heavy plans (discussed below).

Multiemployer plans

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100 percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Minimum period of service

As discussed above, a plan may require, as a condition of participation, that an employee complete a period of service with the employer of no more than 2 years. However, a plan that requires that an employee complete more than 1 year of service as a condition of participation is also required to provide that each participant in the plan has a nonforfeitable right to 100 percent of the participant's accrued benefit under the plan as the benefit is accrued.

Cash or deferred arrangements; employee contributions

Elective deferrals under a qualified cash or deferred arrangement and after-tax employee contributions are required to be nonforfeitable when made.

Changes in vesting schedule

If a plan's vesting schedule is modified by a plan amendment, the plan will not be qualified unless each participant with at least 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the plan amendment.

Years of service

In general, the same rules regarding years of service, breaks in service, and absences due to maternity and paternity that apply for purposes of the minimum participation requirements also apply for vesting purposes. In addition, the following periods of service are not required to be taken into account for vesting purposes: (1) years of service before age 18, (2) years of service during which the employee failed to make required contributions to the plan, and (3) years of service during which the employer did not maintain the plan (or a predecessor plan). A special break in service rule applies for vesting purposes to defined contribution plans. Under this rule, if a participant in such a plan has 5 consecutive 1-year breaks in service, years of service after such break are not required to be taken into account in calculating, the vested portion of benefits accrued before such 5-year period.

b. Rate of accrual requirements

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue (i.e., earn) benefits at a rate that meets one of 3 alternative schedules (sec. 411(b)). The pur-

pose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under the first alternative, known as the "3-percent rule," a plan participant must accrue a benefit during each year of participation (up to 33-⅓ years) of not less than 3 percent of a specified benefit amount. The specified benefit amount is the benefit to which an employee who entered the plan at the earliest entry age and participated until the earlier of normal retirement age or age 65 would otherwise be entitled.

Under the second alternative, known as the "133-⅓-percent rule," a plan will satisfy the accrued benefit requirements if the accrued benefit of a plan participant, as of his or her normal retirement age, is equal to the normal retirement benefit under the plan and the annual rate at which any plan participant accruing the retirement benefits in any year, is never more than 133-⅓ percent of the annual accrual rate for any prior year.

Under the third alternative, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the plan's benefit formula if the participant continued to earn the same rate of compensation annually until normal retirement age. The fractional portion is determined by dividing the plan participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

4. Limitations on contributions and benefits

In general

Under present law, overall limits are provided on contributions and benefits under qualified plans (sec. 415). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer.

Defined contribution plans

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

Defined benefit pension plans

In general

Under present law, the limit on the annual benefit payable by a defined benefit pension plan is generally the lesser of (1) 100 per-

cent of average compensation, or (2) $102,582, for 1990 (sec. 415(b)).[8] The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan.

The dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age so that the limit is actuarially equivalent to a benefit beginning at the social security retirement age. The actuarial reduction is computed using an assumed interest rate that is not less than the greater of 5 percent or the rate specified in the plan.

If retirement benefits provided by a defined benefit pension plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of the dollar limit applicable to a benefit beginning at the social security retirement age. The increase is to be computed using an interest rate assumption not higher than the lesser of 5 percent or the rate specified in the plan.

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

Special rules for plans of State and local governments

Special rules apply to State and local governmental plan. For those plans, the rules in effect prior to the Tax Reform Act of 1986 apply with respect to the limits on annual benefits.[9] Accordingly, the actuarial reduction of the dollar limit on annual benefits for early retirement does not reduce the limit (1) for benefits commencing on or after the participant has attained age 62 (rather than the social security retirement age), (2) below $75,000 for benefits commencing on or after the participant has attained age 55, or (3) below the actuarial equivalent of $75,000 payable at age 55, for benefits commencing before age 55.

Present law also contains a special rule that permits a plan maintained by a State or local government to provide benefits to qualified participants equal to the accrued benefit of the participant (without regard to any benefit increases pursuant to a plan amendment adopted after October 14, 1987) even though such benefit exceeds the otherwise applicable limits on benefits. A qualified participant is a participant who first became a participant in the plan before January 1, 1990.

The special rule does not apply unless the employer elects, by the close of the first plan year beginning after December 31, 1989, to

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

[9] These rules also apply to plans maintained by nongovernmental tax exempt organizations and qualified merchant marine plans. Certain other special rules apply to church plans, airline pilots, and police and firefighters.

have the normal limits on contributions and benefits apply to all plan participants other than qualified participants.

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

Combined plan limitation

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

Under the combined limit, the sum of the defined benefit plan fraction and the defined contribution plan fraction cannot exceed 1.0. Although the sum of these 2 fractions may not exceed 1.0, the plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied to the percentage limits).

The numerator of the defined benefit plan fraction is the projected annual benefit for the participant under the plan determined at the close of the year. The denominator is the lesser of (1) 1.25 multiplied by the dollar limit in effect for the year or (2) 1.4 multiplied by the amount of the 100 percent of compensation limit for the participant for the year.

The numerator of the defined contribution plan fraction is the total amount of annual additions to the participant's account through the close of the year for which the fraction is being determined. The denominator is the sum of the lesser of the following amounts, computed separately for such year and each prior year of service with the employer: (1) 1.25 multiplied by the dollar amount for such year or (2) 1.4, multiplied by the amount of the 25 percent of compensation limit for the participant.

5. Special rules for top-heavy plans

In general

Additional qualification requirements are provided for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) require more rapid vesting, (2) require a minimum nonintegrated benefit for plan participants who are non-key employees, and (3) reduce the overall limit on contributions and benefits for certain key employees.

Except as permitted in Treasury regulations, a plan (whether or not top-heavy in fact) will constitute a qualified plan only if the plan includes provisions that will automatically take effect if the

plan becomes a top-heavy plan and that meet the additional qualification requirements for top-heavy plans.

Definition of top-heavy plan

A defined benefit pension plan is a top-heavy plan for a plan year if (1) the present value of the accumulated accrued benefits for participants who are key employees for the plan year exceeds 60 percent of the present value of the accumulated accrued benefits for all employees under the plan, or (2) the plan is part of a top-heavy group. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, (1) the sum of the account balances of participants who are key employees for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan, or (2) the plan is a part of a top-heavy group.

Top-heavy groups

Any plan that covers a key employee, and any plan upon which a plan covering a key employee depends for qualification under the coverage or nondiscrimination rules (secs. 401(a)(4) and 410(b)) must be aggregated for purposes of determining whether the plans are top heavy. In addition, in testing for top-heaviness, an employer may elect to expand the aggregation group to take into account any other plan maintained by the employer, if such expanded aggregation group continues to satisfy the coverage and nondiscrimination rules.

An aggregation group is a top-heavy group if the sum of (1) the present values of the accumulated accrued benefits for key employees under any defined benefit pension plans included in the group, and (2) the sum of the account balances of key employees under any defined contribution plans included in the group exceeds 60 percent of the same amount determined for all participants under all plans included in the group. If an aggregation group is a top-heavy group, each plan required to be included in the group is a top-heavy plan. No plan included in the aggregation group at the election of the employer is subject to the top-heavy plan rules on account of such election.

Key employees

Key employees generally include employees who (during the plan year or any of the 4 preceding plan years): (1) are officers with compensation greater than 150 percent of the dollar limit for defined benefit pension plans (for 1990, 150 percent of such limit is $153,873), (2) are one of the 10 employees owning the largest interests in the employer and having compensation in excess of the limitation on annual additions to a defined contribution plan (i.e., $30,000), (3) own more than a 5-percent interest in the employer, or (4) own more than a 1-percent interest in the employer and have annual compensation from the employer in excess of $150,000. No more than 50 employees or, if lesser, the greater of 3 employees or 10 percent of all employees need be taken into account as officers.

Additional qualification rules relating to top-heavy plans

Vesting

For any plan year for which a plan is a top-heavy plan, an employee's right to the accrued benefit derived from employer contributions must become nonforfeitable under a vesting schedule that satisfies 1 of 2 alternative schedules. These vesting schedules apply to all accrued benefits, whether or not the accrued benefits are required by the top-heavy plan rules.

A plan will satisfy the first alternative vesting schedule if an employee who has at least 3 years of service with the employer maintaining the plan has a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions. A plan will satisfy the second alternative vesting schedule if an employee has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service with the employer, and 100 percent at the end of 6 years of service with the employer.

Minimum nonintegrated benefit under a defined benefit pension plan for non-key employees

In addition, a qualified plan that is a top-heavy plan must provide a minimum benefit or contribution for each non-key employee who is a participant in the plan. For a plan year for which a defined benefit pension plan is a top-heavy plan, each plan participant who is not a key employee for the year generally must accrue a benefit that, when expressed as an annual retirement benefit, is not less than 2 percent of the employee's average annual compensation multiplied by the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. All years of an employee's service otherwise required to be taken into account under the plan generally are required to be taken into account under the minimum benefit rules, except a year of service (1) ending before the date of enactment of the top-heavy rules, or (2) within which ends a plan year for which the plan is not a top-heavy plan. The required minimum benefit cannot be reduced on account of social security benefits (i.e., the minimum benefit is a nonintegrated benefit).

Minimum nonintegrated contribution under a defined contribution plan for non-key employees

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee an amount not less than 3 percent of the participant's compensation. However, if the employer's contribution rate for each participant who is a key employee for the plan year is less than 3 percent, the required minimum contribution rate for each non-key employee generally is limited to not more than the highest contribution rate for any key employee.

The required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to taxes paid by the employer under social security (i.e., the minimum contribution is a "nonintegrated" contribution). If a non-key employee participates in both a defined benefit plan and a defined contribution plan maintained by an employer, the employer is not required by this section to provide the non-key employee with both the minimum benefit and the minimum contribution.

Aggregate limit on contributions and benefits for key employees

The aggregate limit on benefits and contributions (sec. 415(e)) for a key employee who participates in both a defined benefit pension plan and a defined contribution plan that are included in a top-heavy group are reduced, unless (1) an extra minimum benefit (in the case of the defined benefit plan) or an extra minimum contribution (in the case of the defined contribution plan) is provided for non-key employees participating in the plans, and (2) the plan is not super top-heavy. The extra contribution or benefit is in addition to the minimum contribution or benefit required for all top-heavy plans.

The aggregate limits on contributions and benefits is reduced in all cases for super top-heavy plans. A plan is super top-heavy if it would be determined to be top-heavy if "90 percent" were substituted for "60 percent" in the definition of a top-heavy plan.

6. Definitions

a. Highly compensated employee

In general

For purposes of the qualification rules, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined under the top-heavy rules); (2) received more than $85,485 in annual compensation from the employer; (3) received more than $65,990 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as generally defined under the top-heavy rules) (sec. 414(q)). The $85,485 and $65,990 thresholds are applicable for 1990; these dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).[10] The identity of highly compensated employees is to be determined on an employer-wide basis, not on the basis of, for example, a line of business or operating unit.

Officers

An officer will not be treated as a highly compensated employee unless such officer receives compensation greater than 150 percent

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

of the defined contribution plan dollar limit in effect for the year ($30,000 for 1990). No more than 50 employees (or if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. If, for any year, no officer has compensation in excess of 150 percent of the defined contribution plan dollar limit, then the highest paid officer of the employer for such year is treated as a highly compensated employee. As under the rules applicable for determining top-heavy status (sec. 416), a partnership is considered to have officers.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees may be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17-1/2 hours per week; (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no U.S. source earned income.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described below.

The determination of the top-paid group is made solely with respect to individuals who perform services as an employee at any time during the year. Thus, individuals who separated from service in a prior year are not taken into account in determining the top 20 percent of employees by compensation.

Special rule for determining highly compensated employees for current year

An employee will not be treated as in the top-paid group, as an officer, or as receiving more than $85,485 or $65,990 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to the 1-year lookback or to the application of this special rule) remains highly compensated for the current year.

Thus, the 100-employee rule is intended as a rule of convenience to employers with respect to new employees hired during the current year, with respect to increases in compensation, and with respect to certain other similar factors. If any employee is not a 5-percent owner or within the top-100 employees by compensation for the current year (and was not a highly compensated employee in the preceding year (without regard to this special rule)), then that

employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $65,990 in annual compensation from the employer as highly compensated employees in lieu of applying the $85,485 thresholds and without regard to whether such employees are in the top-paid 20 percent. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

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

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

Former employees

A former employee is treated as highly compensated if the employee was highly compensated when (1) such employee separated from service or (2) at any time after the employee attained age 55.

Scope of highly compensated employee definition

The definition of highly compensated employee generally applies for all purposes under the qualified plan rules, but also applies under other Code provisions. Thus, for example, the same definition applies under nondiscrimination rules applicable to tuition reduction programs (sec. 117) and miscellaneous fringe benefits (sec. 132).

b. Compensation

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

For purposes of the limits on contributions and benefits, compensation generally includes all compensation includible in gross

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

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

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

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

For deduction purposes (sec. 404), compensation generally includes compensation paid or accrued during the year, except for compensation for which a deduction was allowed under the rules relating to employee benefit plans.

c. Employer

In general

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

tional aggregation rules as are necessary to prevent the avoidance of the qualification rules through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Controlled group of corporations

Employees of related corporations must be considered together for purposes of plan qualification requirements. A controlled group of corporations for this purpose generally is defined as under section 1563(a).

In general, a controlled group of corporations may be either a parent-subsidiary group or a brother-sister group of corporations. A parent-subsidiary group includes one or more chains of corporations connected through stock ownership with a common parent by reason of (a) 80 percent of the voting power or 80 percent of the value of the shares of all classes of outstanding stock (excluding the parent), being owned by one or more of the other corporations, and (b) the parent corporation owning 80 percent of the voting power or 80 percent of the value of the shares of all classes of outstanding stock (excluding stock held by subsidiaries) of at least one of the other corporations.

A brother-sister controlled group is a group of corporations in which 5 or fewer persons who are individuals, estates, or trusts own stock possessing (1) at least 80 percent of the voting power or 80 percent of the total value of all outstanding shares of each corporation; and (2) more than 50 percent of the voting power of all classes of voting stock or more than 50 percent of the value of all shares of each corporation, taking into account the stock ownership of each person only to the extent the ownership is identical with respect to each corporation.

If a corporation is a member of more than one controlled group of corporations, the corporation is treated as a member of each group.

Trades or businesses under common control

Employees must be considered employed by one entity to the extent they are employed by trades or businesses under common control. Like controlled groups of corporations, trades or businesses will be considered under common control if they are classified as a parent-subsidiary or brother-sister group of organizations. The term organization includes for this purpose a sole proprietorship, a partnership, a trust, an estate, or a corporation.

Trades or businesses will be considered under common control if they form a parent-subsidiary group of trades or businesses. This definition is met with respect to the group of organizations connected through ownership of a controlling interest with a common parent if (1) a controlling interest in each of the organizations (except the parent) is owned by one or more of the other organizations; and (2) the common parent owns a controlling interest in at least one other organization. In determining whether the second requirement is met, ownership of the controlled organization held by organizations other than the parent is disregarded.

For purposes of determining whether an organization holds a controlling interest in another organization, the following rules apply. If the controlled organization is a corporation, ownership of

80 percent of the voting power or value of the corporation constitutes a controlling interest. If the controlled organization is a trust or estate, a controlling interest constitutes ownership of 80 percent of the actuarial interest of the trust or estate. If the controlled organization is a partnership, a controlling interest constitutes ownership of 80 percent of the profits interest or capital interest. In the case of a sole proprietorship, ownership of the sole proprietorship is required in order to hold a controlling interest.

A group of trades or businesses will constitute a brother-sister group if (1) the same 5 or fewer persons who are individuals, estates or trusts own a controlling interest in each corporation; and (2) these persons are in effective control of each organization. In determining whether the second requirement is met, effective control constitutes more than 50-percent ownership of an organization. With respect to a sole proprietorship, effective control exists if one of the persons owns the sole proprietorship.

Affiliated service groups

An affiliated service group (sec. 401(m)) consists of a service organization (called the first service organization or FSO) and (1) any service organization which is a shareholder or partner in the FSO and that regularly performs services for the FSO or is regularly associated with the FSO in providing services to the general public, or (2) any other organization if a significant portion of that organization's business (e.g., greater than 5 percent of gross receipts) is performing services for the FSO or for organizations described in (1) above, of a type historically performed in the recipient's service held by employees. In addition, 10 percent or more of the interests in that organization must be held by highly compensated employees of the FSO or another member of the affiliated service group.

If an organization's principal business is performing, on a regular and continuing basis, management functions for another organization, the person performing the functions and the recipient for whom the functions are performed are treated as a single employer.

An organization includes a corporation, partnership, or any other organization. A service organization is an organization where capital is not a material income producing factor. A service organization means an organization the principal purpose of which is the performance of services.

Leased employees

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

For purposes of determining whether a plan maintained by the recipient satisfies the applicable tax-law requirements, the leased

employee is treated as the recipient's employee for periods after the close of the 12-month period. However, the leased employee's years of service for the recipient are determined by taking into account the entire period for which the leased employee performed services for the recipient. Contributions or benefits for the leased employee which are provided by the leasing organization under a qualified plan are treated as if provided by the recipient to the extent such contributions or benefits are attributable to services performed by the leased employee for the recipient.

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

To be a safe-harbor plan, a plan is required to cover all employees of the leasing organization (beginning with the date they become employees of the leasing organization) other than (1) employees whom the leasing organization demonstrates to the satisfaction of the Secretary performed substantially all of their services for the leasing organization (and not for recipients), and (2) employees whose total compensation from the leasing organization is less than $1,000 during the plan year and during each of the 3 prior plan years.

An employee covered under a safe-harbor plan is to receive the required allocation regardless of the number of hours of service credited to the employee for the year, regardless of whether the employee is employed by the leasing organization on any specified date during the year, and regardless of the employee's age.

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

Under Treasury regulations, a special recordkeeping requirement is provided in the case of an employer that has no top-heavy plans (sec. 416), and that uses the services of nonemployees only for an insignificant percentage of the employer's total workforce (i.e., 5 percent).

d. Lines of business or operating unit rules

In general

If an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the nondiscrimination rules separately to each separate line of business or operating unit for that year (sec. 414(r)). This rule does not apply,

however, to any plan that does not satisfy the classification test on an employer-wide basis.

Definitions of line of business and operating unit

The Secretary is to prescribe by regulation what constitutes a separate line of business or operating unit. In general, a line of business or operating unit includes all employees necessary for the preparation of property for sale to customers or for the provision of services to customers. Thus, a headquarters or home office is not to be treated as a separate line of business or operating unit.

In addition, whether claimed lines of business or operating units are separate and bona fide is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by such claimed lines of business or operating units are important considerations. Also, the manner in which the employer organizes itself is relevant. Thus, if an employer fails to treat itself as comprised of separate lines of business or operating units and treats employees from different claimed lines or units in an equivalent fashion for certain purposes, it may not be appropriate to allow such activities to be treated as separate lines of business or operating units.

Notwithstanding the general rules described above, the line of business or operating unit concept is not to be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not considered to be separate lines of business or operating units. Also, for example, secretaries and other support service personnel are not a line of business or operating unit separate from the lawyers, other professionals, or other employees for whom such personnel perform services, and nurses and laboratory personnel are not to be treated as in a line of business or operating unit separate from the medical doctors for whom they perform services. In addition, the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

Also, an operating unit will not be recognized for purposes of these rules unless, for a bona fide business reason, it is separately operated in a geographic area significantly separate from another operating unit in the same line of business.

Separate maintenance

A line of business or operating unit will generally be recognized as separate if it is separately maintained for bona fide business reasons under the rules described above. However, notwithstanding those rules, a line of business or operating unit will not be treated as separate unless it also satisfies the following 3 requirements:

(1) such line of business or operating unit has at least 50 employees;

(2) the employer notifies the Secretary that such line of business or operating unit is being treated as separate; and

(3) the line of business or operating unit satisfies guidelines prescribed by the Secretary or the employer obtains a determination from the Secretary that the line of business or operating unit may be treated as separate.

Safe harbor

A safe-harbor rule exists under which a separate line of business or operating unit is treated as meeting the third requirement listed above. A line of business or operating unit satisfies this safe-harbor rule if the "highly compensated employee percentage" of the line of business or operating unit is (1) not less than one-half ("50-percent rule"), and (2) not more than twice ("200-percent rule") the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the 50-percent rule will be deemed satisfied if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit. The term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees.

Excludable employees

For purposes of determining (1) the number of employees in a line of business or operating unit; (2) the highly compensated employee percentage of a line of business or operating unit; and (3) the percentage of all employees of the employer who are highly compensated, an employer is to disregard the categories of employees that are disregarded for purposes of determining which employees are highly compensated employees.

Allocation of employees

Headquarters and other employees are to be allocated to 1 line of business or operating unit under rules prescribed by the Secretary. Generally, this allocation is to be made in accordance with their performance of services.

If an employer is using the separate line of business or operating unit rule with respect to any plan, all employees must be allocated to a line of business or operating unit. Thus, it would not be permissible to maintain that an employer has, in addition to 1 line of business with 50 employees, 10 other employees who are not part of any line of business or operating unit and who would be tested separately.

Attribution of benefits

Benefits attributable to service for a line of business or operating unit are to be considered as provided by that line of business or operating unit. For purposes of these rules, an employee who performs services for more than one line of business or operating unit, but is allocated to one line of business or operating unit under the rules described above, is to be considered to perform services solely for that line of business or operating unit.

Plan years before issuance of guidance

In the case of any plan year beginning on or before the date the Secretary of the Treasury issues guidelines and begins issuing determination letters under the line of business rules, an employer is treated as operating separate lines of business or operating units if

the employer reasonably determines that it meets the requirements of the line of business rules.

C. Treatment of Distributions

1. Uniform minimum distribution rules

Minimum distribution requirements

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and individual retirement arrangements (IRAs). A uniform rule was adopted because it reduces disparities in opportunities for tax deferral among individuals covered by different types of plans and eases administrative burdens. The minimum distribution rules are designed to ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present law may be satisfied if the participant's entire interest is distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and a designated beneficiary.

The required beginning date for qualified plans is generally the April 1 of the calendar year following the calendar year in which the participant or owner attains age 70-½. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Additional rules apply in the event an employee dies before his or her entire interest in the plan is distributed. In such a case, the minimum distribution requirements depend on whether distributions have begun before the employee's death. If distributions have begun before the employee's death, then the remaining portion of the employee's interest in the plan is required to be distributed at least as rapidly as under the method distributions were being made as of the date of death.

If distributions have not begun before the employee's death, then the employee's interest is required to be distributed within 5 years after the death of the employee. As an alternative to the 5-year rule, the minimum distribution requirements are satisfied in the case of distributions beginning after the employee's death if (1) any portion of the employee's interest is payable to the employee's designated beneficiary, (2) such portion will be distributed over the life of such beneficiary or over a period not extending beyond the life expectancy of the beneficiary, and (3) the distributions begin no

later than one year after the date of the employee's death, or such later date as prescribed in regulations.

If the designated beneficiary is the employee's surviving spouse, then distributions under this alternative rule may be further delayed. In particular, in such a case, distributions do not have to begin before the date the employee would have attained age 70-½. If the surviving spouse dies before the distribution to the spouse begins, the alterative rule is applied as if the surviving spouse were the employee. In certain circumstances, payments to the children of a deceased employee may be treated as if they had been made to the surviving spouse.

For purposes of these rules, the life expectancies of the employee and the employee's spouse (other than in the case of a life annuity) may be redetermined not more frequently than annually. The effect of recalculating life expectancies is generally to lengthen the permissible payout period.

Distributions from qualified plans are also required to satisfy an incidental benefits rule. The incidental benefits rule requires that death and other nonretirement benefits (e.g., life, accident, or health benefits) payable under a qualified plan be incidental to the primary purpose of the plan, which is to provide retirement benefits. Under this rule, the relationship of an employee's total benefits under the plan to the retirement benefits or deferred compensation payable to the employee must be such that the primary purpose of the plan is to provide retirement benefits. The incidental benefits rule may in some cases require distributions in addition to those required under the minimum distribution rules. The distributions required under this rule are described in revenue rulings and Treasury regulations.

Excise tax on failure to make a minimum required distribution

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

The Secretary of the Treasury is authorized to waive the tax for a given taxable year if the taxpayer to whom the tax would otherwise apply establishes that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.

The sanction for failure to satisfy the minimum distribution rules is an excise tax rather than plan disqualification because Congress believed that the sanction of disqualification was too onerous for a plan's failure in operation to satisfy technical distribution requirements with respect to any one participant. Disqualifica-

tion might result in adverse tax consequences to all plan participants or all highly compensated plan participants, even though the plan administrator was responsible for the failure to make a required distribution, and the failure may have occurred with respect to only a single participant. Although Congress believed that a plan should, by its terms, prohibit the violation of the minimum distribution rules, Congress also believed an operational error should not cause plan disqualification.

2. Withdrawal rules

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

The least restrictive rules apply to profit-sharing and stock bonus plans. Amounts may generally be withdrawn from such plans after they have been in the plan for 2 years. Distributions before the expiration of such 2-year period may also be made in the event of retirement, death, disability, other separation from service, or hardship.

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

Special rules apply to qualified cash or deferred arrangements (sec. 401(k)). Elective deferrals under a qualified cash or deferred arrangement (and earnings thereon) may only be distributed on account of separation from service, death, or disability, or attainment of age 59-½. Elective deferrals (but not earnings thereon) may also be distributed on account of a hardship of the employee.

3. Cashout and survivor benefit rules

Present law contains a number of rules designed to preserve qualified plan benefits for retirement and to provide for income to the surviving spouse of a deceased employee.

Under present law, if the present value of the vested benefit of a plan participant exceeds $3,500, then that benefit may not be distributed prior to retirement age without the consent of the employee (sec. 411(a)(11)). This rule provides plan participants who separate from service before retirement age with the option of leaving their plan benefits in the plan until they retire.

Under the spousal protection rules, present law requires defined benefit pension plans and money purchase pension plans to provide that retirement benefits are payable in the form of a qualified joint and survivor annuity or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity.

The survivor benefit rules do not apply to other types of defined contribution plans if (1) the plan provides that, upon the death of the particpant, the participant's accrued benefit is payable to the participant's surviving spouse, (2) the participant does not elect payment of benefits in the form of an annuity, and (3) the plan is

not a transferee plan of a plan subject to the joint and survivor rules.

Benefits may be paid in a form other than a joint and survivor annuity or a preretirement survivor annuity with the consent of the particpant's spouse. Similarly, under a defined contribution plan, the spouse can consent to have benefits paid to another beneficiary. The Code provides detailed rules regarding the consent requirements.

4. Taxation of distributions [11]

In general

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

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

Basis recovery rules

In general

A participant in a qualified plan may have basis in the plan, e.g., because the participant has made after-tax contributions to the plan. In such cases, present law provides rules for determining what portion of each distribution is taxable and what portion is a nontaxable return of employee contributions. These rules depend in part on whether the distribution is an annuity or nonannuity distribution and when the distribution is made.

In all cases, under the basis recovery rules, the total amount that an employee may exclude from income cannot exceed the total amount of the employee's basis. In addition, if benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction for the last taxable year distributions are received by the annuitant. If an employee dies and benefit payments continue to be made to the employee's beneficiary, the beneficiary recovers the remaining basis with respect to the employee under the general rules.

Annuity distributions

In the case of amounts received as an annuity on or after the annuity starting date, each payment received by an employee generally is treated, in part, as a return of the employee's basis and, in

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

part, as taxable income. The portion of each payment treated as a return of the employee's basis is that amount which bears the same ratio to each payment as the employee's total basis bears to the total expected payments over the period of the annuity. For example, if an employee's contributions to a plan are 10 percent of the total expected payments, then 10 percent of each annuity distribution is a nontaxable return of basis, and 90 percent is includible in income.

If the expected return depends in whole or in part on an individual's life expectancy (e.g., a life annuity) the expected return is computed in accordance with actuarial tables prescribed by the Secretary of the Treasury. The IRS has issued a safe harbor method for calculating the tax-free portion of an annuity by authorizing the use of a simplified method of determining the expected number of payments (IRS Notice 88-118).

Nonannuity distributions

In the case of distributions not received in the form of an annuity and that are paid before the annuity starting date, basis is generally recovered on a pro-rata basis. That is, a distribution is generally treated as a return of basis in the proportion that the employee's basis bears to the account balance.

With respect to distributions that are not received in the form of an annuity and that are paid on or after the annuity starting date, the amount received is deemed to be attributable first to income on the contract and is therefore includible in income.

The annuity starting date is the first day of the first period for which an amount is received as an annuity.

Separate accounting for employee contributions

Under present law, employee contributions to a defined contribution plan or a separate account of a defined benefit pension plan may be treated as a separate contract for purposes of the basis recovery rules. Thus, if an employee withdraws amounts from such a separate contract either before or after the employee's annuity starting date, then for tax purposes, the distribution will be considered to be part nontaxable, i.e., a return of employee contributions, and part taxable, i.e., a distribution of earnings on those contributions. The distribution will not, however, be considered to be attributable to employer contributions. If an employee withdraws all amounts attributable to employee contributions and such amount is less than the total employee contributions, the employee may recognize a loss.

A plan may designate the contract from which a distribution is made either expressly through a plan provision or in practice by crediting a particular contract when a distribution is made under the plan. Alternatively, a participant can be permitted to designate the contract from which a distribution is made.

Rollovers

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

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

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

Lump-sum distributions

Under present-law, lump-sum distributions are eligible for special 5-year forward income averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee which becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-½, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution to an employee is treated as a lump sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59-½ may be made with respect to any employee.

Net unrealized appreciation

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

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

Additional income tax on early distributions

Under present law, an additional income tax is imposed on certain early distributions from any "qualified retirement plan" (sec. 72(t)). The tax applies to amounts distributed from qualified plans, tax-sheltered annuities and custodial accounts, and IRAs. The rate of the tax is 10 percent for all early distributions includible in gross income. A plan is not required to withhold the amount of the additional income tax on an early withdrawal.

The purpose of the early distribution tax is to prevent diversion of retirement savings for nonretirement purposes. The tax is designed to discourage preretirement withdrawals and to recapture a measure of the tax benefits that have been provided under the plan.

The additional income tax on early distributions does not apply to the following distributions: (1) a distribution made after the employee (or owner) attains age 59-½, (2) a distribution that is part of a scheduled series of substantially equal periodic payments for the life or life expectancy of the participant (or the joint lives or life expectancies of the participant and the participant's beneficiary); (3) a distribution to an employee who has attained age 55 and subsequently separated from service; (4) a distribution made to an employee to the extent such distribution does not exceed the amount of deductible health expenses for the year (sec. 213) (determined without regard to whether the taxpayer itemizes deductions); and (5) distributions after the death of the employee (or owner).

In addition, the early withdrawal tax does not apply to the following distributions: (1) payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)); (2) certain distributions of excess contributions, excess deferrals, or excess aggregate contributions; and (3) dividend distributions for which the employer is allowed a deduction (section 404(k)).

The 10-percent additional tax applies only to amounts includible in gross income. Thus, it does not apply to amounts representing the return of after-tax employee contributions or amounts rolled over into an IRA or another qualified plan.

In the case of distributions from IRAs (including simplified employee pensions (SEPs)), the age 55 and medical expense exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders. The exception for substantially equal payments applies to distributions from plans qualified under section 401(a) or 403(a) and tax-sheltered annuities and custodial accounts only if the distribution is made after separation from service.

Tax on excess distributions

In general

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs (sec. 4980A). The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

Distributions subject to the tax

In determining whether the distributions received by an individual are subject to the tax, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, IRAs, and tax-sheltered annuities generally are taken into account.

Certain amounts, however, are excluded in determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an individual's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the individual's investment in the contract; (2) amounts excluded from the recipient's income because they are rolled over to another plan or an IRA; and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income.

Distributions made with respect to a participant after the death of the participant are disregarded in applying this annual limit and are subject instead to an additional estate tax, described below.

Definition of excess distributions

Excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $150,000 or (2) $128,228 for 1990. The dollar limit in (2) is indexed annually for inflation.

A special higher ceiling applies for purposes of calculating the excess distribution for any calendar year in which an individual receives a lump-sum distribution that is taxed under the 5-year income averaging rules.[12] The higher ceiling is 5 times the otherwise applicable ceiling for such calendar year.

If an individual receives other retirement distributions during a taxable year in addition to a lump-sum distribution eligible for the special higher ceiling, the other retirement distributions are separately subject to the general rules relating to excess distributions and, thus, are subject to the 15-percent excise tax only to the extent that the aggregate of such other retirement distributions during the taxable year exceeds the generally applicable annual limit.

Post-death distributions

Present law provides special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions. In lieu of subjecting post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, present law imposes an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying this tax. Thus, beneficiaries who are receiving distributions with respect to an individual after the individual's death (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their own behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retire-

[12] The special rule is also available if the individual elects capital gains treatment or 10-year averaging under the grandfather rules included in the Tax Reform Act of 1986.

ment plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual ceiling ($150,000 or the applicable dollar limit in effect on the date of death), over a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries. However, the amount of excess retirement accumulations does not include the value of any death benefits payable immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death. Also, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are also disregarded in determining the excess retirement accumulation.

5. Treatment of loans

In general

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use a portion of his or her accrued benefit as security for the loan) provided the loan is made in accordance with specific provisions contained in the plan, bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of highly compensated employees (sec. 4975).[13]

A loan to a plan participant is treated as a taxable distribution of plan benefits unless the loan meets certain requirements relating to the amount of the loan and the repayment period for the loan (sec. 72(p)). Present law also includes limits on the deductibility of interest on participant loans in addition to the general rules restricting the deductibility of personal interest.

The rules governing the tax treatment of loans from certain tax-favored plans are intended to limit the extent to which an employee may currently use assets held by a plan for nonretirement purposes and to ensure that loans are actually repaid within a reasonable period. The loan restrictions also reflect Congressional belief that the favorable tax treatment of amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and that any exceptions to this general policy should be narrowly limited.

Amount of loan

In order not to be treated as a distribution under present law, a loan, when added to the outstanding balance of all other loans from all plans of the employer, cannot exceed the lesser of (1)

[13] A self-employed individual may not borrow from a qualified plan unless an administrative exemption from the prohibited transaction rules is granted by the Secretary of Labor. The prohibited transaction rules are discussed below.

$50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the 1-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made, or (2) the greater of (a) $10,000 or (b) one-half of the participant's vested accrued benefit under the plan.

For example, under the $50,000 rule, assume a participant with a vested benefit of $200,000 borrows $30,000 from a plan on January 1. On November 1, the participant wants to borrow an additional amount without triggering a taxable distribution. At that time, the outstanding balance on the first loan is $20,000. The maximum amount that the participant can borrow is $20,000, i.e., $50,000 - [$20,000 + ($30,000 - $20,000)].

Repayment period

Under present law, a loan is treated as a taxable distribution unless the loan is required, by its terms, to be repaid within 5 years, unless the loan is used to purchase or improve the principal residence of the participant.

Present law requires that plan loan repayments (principal and interest) be amortized in level payments, made not less frequently than quarterly, over the term of the loan. This requirement does not preclude repayment or acceleration of the loan prior to the end of the commitment period or the use of a variable interest rate.

Deductibility of interest

Present law provides for the disallowance of the deduction for interest paid by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account. These restrictions are in addition to the otherwise applicable restrictions on the deductibility of personal interest. No basis is created in a participant's account with respect to any nondeductible interest paid on a loan from a qualified plan or tax-sheltered annuity or custodial account.

D. Funding and Deduction Rules

1. Minimum funding requirements

In general

Under the Code, certain pension plans, including money purchase pension plans, are required to meet a minimum funding standard for each plan year (sec. 412). The present-law funding rules do not apply to (1) profit-sharing or stock bonus plans, (2) certain plans funded by insurance contracts, (3) governmental plans, (4) church plans, (5) plans that have not provided for employer contributions after September 2, 1974, and (6) certain plans maintained by a fraternal beneficiary societies (sec. 501(c)(8) or voluntary employees' beneficiary associations (sec. 501(c)(9)).

In the case of a money purchase pension plan, the contribution required by the minimum funding standard is generally the contri-

bution rate specified by the plan. Defined benefit pension plans are funded on an actuarial basis, and the minimum funding rules for such plans are more complex. A discussion of those rules follows.

As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Calculation of contribution

Actuarial cost methods

In general.—A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the balance in its funding standard account for a year. Generally, an actuarial cost method divides the cost of benefits under the plan into annual charges consisting of 2 elements for each plan year. These elements are referred to as (1) normal cost, and (2) past service liability.

Normal cost.—The normal cost of a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

Past service liability.—The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (1) on the date the plan is first effective, or (2) the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

Acceptable methods.—Normal cost and past service liability are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by the Code. The Code enumerates 6 acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once every plan year.

Charges and credits to the funding standard account

In general.—Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular

year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

Normal cost.—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability.—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years.

Gains and losses from changes in assumptions.—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years (30 plan years in the case of a multiemployer plan).

Experience gains and losses.—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period (15 plan years in the case of a multiemployer plan).

Waived funding deficiencies.—Under the funding standard, the amount of a waived funding deficiency is amortized over a period

of 5 plan years, beginning with the year in which the waiver is granted. Each year the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

Switchback liability.—The Code provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. The Code prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

Reasonableness of actuarial assumptions.—All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

Special rules for underfunded plans

In general

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted due to Congressional concerns regarding the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

Calculation of deficit reduction contribution

With respect to plans subject to the special rule, the minimum required contribution is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the sum of (i) normal cost, (ii) the amount necessary to amortize experience gains and losses over 5 years and gains and losses resulting from changes in actuarial assumptions over 10 years, and (iii) the deficit reduction contribution. In addition, a special funding rule applies with respect to benefits that are contingent on unpredictable events. In

no event is the amount of the contribution to exceed the amount necessary to increase the funded ratio of the plan to 100 percent.

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based on the plan's current liability.

Current liability

The term "current liability" generally means all liabilities to employees and their beneficiaries under the plan (sec. 401(a)(2)) determined as if the plan terminated. However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs.

The interest rate used in determining the current liability of a plan, as well as the contribution required under the special rule, is required to be within a specified range. The permissible range is defined as a rate of interest that is not more than 10 percent above or below the average mid-term applicable Federal rate (AFR) for the 4-year period ending on the last day before the beginning of the plan year for which the interest rate is being used (or, if shorter, the period that the AFR has been computed). The Secretary may, where appropriate, allow a lower rate of interest except that such rate may not be less than 80 percent of the average rate discussed above.

Within the permissible range, the interest rate is required to be reasonable. The determination of whether an interest rate is reasonable depends on the cost of purchasing an annuity sufficient to satisfy current liability. The interest rate is to be a reasonable estimate of the interest rate used to determine the cost of such annuity, assuming that the cost only reflected the present value of the payments under the annuity (i.e., and did not reflect the seller's profit, administrative expenses, etc.).

Unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

Unfunded old liability amount

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years (beginning with the first plan year beginning after December 31, 1988). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to certain collective bargaining agreements).

Unfunded new liability amount

The unfunded new liability amount for a plan year is the applicable percentage of the plan's "unfunded new liability." Unfunded new liability means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability (and the unamortized portion of certain unfunded liability from certain benefit increases) and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent.

Unpredictable contingent event benefits

The value of any unpredictable contingent event benefit is not considered in determining current liability until the event has occurred. If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event has occurred), then an additional funding contribution (over and above the minimum funding contribution otherwise due) is required.

Unpredictable contingent event benefits include benefits that depend on contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably predictable. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

The amount of the additional contribution is generally equal to the greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

The rule relating to unpredictable contingent event benefits is phased in for plan years beginning in 1989 through 2001.

Small plan rule

In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100.

Full funding limitation

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

The Secretary may, under regulations, adjust the 150-percent figure contained in the full funding limitation to take into account the average age (and length of service, if appropriate) of the participants in the plan (weighted by the value of their benefits under the plan). In addition, the Secretary is authorized to prescribe regulations that apply, in lieu of the 150 percent of current liability limitation, a different full funding limitation based on factors other than current liability. The Secretary may exercise this authority only in a manner so that in the aggregate, the effect on Federal budget receipts is substantially identical to the effect of the 150-percent full funding limitation.

Time for making contributions

Under present law, the required contribution for a plan year must be made within 8-½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year. In the case of single-employer defined benefit pension plans, 4 installments of estimated contributions are required during the plan year with the total contribution due within 8-1/2 months after the end of the plan year (sec. 412(m)). The amount of each required installment is one-fourth of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year. The requirement for quarterly contributions is phased-in so that it is fully effective for plan years beginning in 1992 and thereafter.

In the event that an employer fails to make a required installment, interest is charged to the funding standard account. The interest rate on missed contributions is the greater of (1) 175 percent of the mid-term applicable Federal interest rate (AFR) or (2) the rate of interest taken into account in determining costs under the plan. Interest continues at the specified rate until the missed contributions are actually paid to the plan.

In the case of a plan with a funded ratio of less than 100 percent, a statutory tax lien arises on all controlled group property in favor of the plan 60 days after the due date of an unpaid contribution (whether or not a waiver application is pending). This lien only arises when the unpaid balance due to the plan exceeds $1,000,000. The amount of the lien generally is the cumulative missed contributions in excess of $1 million.

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than 3 waivers may be granted within any period of 15 consecutive plan years. The IRS may require an employer to provide security as a condition of granting a waiver.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Controlled group liability

The funding requirements applicable to a plan are imposed on all employers that are members of the same controlled group of corporations as the employer who is responsible for making the contributions.

Sanction for failure to meet minimum funding standard

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan (and the controlled group of which the employer is a part) with an accumulated funding deficiency is subject to a 10-percent nondeductible excise tax (5 percent in the case of a multiemployer plan) on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan (and the controlled group of which the employer is a part) is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 10-percent tax, or (2) the date on which the 10-percent tax is assessed by the IRS.

2. Deduction rules

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. However, no deduction is allowed with respect to contributions or

benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Profit-sharing and stock bonus plans [14]

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid (sec. 404(a)(3)). If employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years (within limits).

Defined benefit pension plans

As discussed above, employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) the amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year;

(2) the level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan (adjusted, if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any 3 individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least 5 taxable years;

(3) an amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years (sec. 404(a)(1)).

In determining the amount deductible under these rules, the funding method and actuarial assumptions and by the plan for purposes of the minimum funding rules are used. No deduction is allowed for contributions in excess of the full funding limitation.

A special deduction rule applies to underfunded defined benefit pension plans. In the case of a single-employer defined benefit pension plan which has more than 100 participants, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible to the extent required by the minimum funding standard. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

[14] Special deduction rules apply in the case of leveraged ESOPs.

Combination of pension and other plans

If an employer maintains a defined benefit pension plan and a defined contribution plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year.

Compensation taken into account

Under present law, for 1990 no more than $209,200 of any employee's compensation for a year may be taken into account in computing deductions for plan contributions. The limit is adjusted annually for cost-of-living increases at the time and in the manner provided for the adjustment of the overall limits on annual benefits under a qualified defined benefit pension plan. Increases in the compensation limit may not be taken into account before they occur in determining the deduction limit for plan contributions.

Excise tax on nondeductible contributions to qualified plans

Under present law, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan. The purpose of the excise tax is to discourage employers from making excessive contributions to a plan in order to obtain the benefit of tax-free growth on the contributions.

The contributions to a plan that are subject to the excise tax on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus (2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year.

For example, assume that an employer made a nondeductible contribution of $100,000 for its 1988 taxable year. Assume further that, for its 1989 taxable year, the employer's contribution was $75,000 and the deductible limit was $150,000. Assume that no amount is returned to the employer and that the employer's contribution for 1990 is equal to the deductible limit for that year. Under present law, the excise tax would apply to the nondeductible contributions of $100,000 for the 1988 taxable year and to the nondeductible contributions of $25,000 for the 1989 and 1990 taxable years.

E. Terminations and Reversions

In general

Present law defines the rights of plan participants and beneficiaries, as well as employers, in the event of a termination of a qualified plan. The rules relating to plan terminations depend in part on whether the plan is a defined contribution plan or a defined benefit pension plan. One of the main differences in the rules

arises from the fact that it is possible under a defined benefit plan to accumulate excess assets. In the case of a defined contribution plan, plan contributions generally are required to be allocated to accounts of plan participants so that there is no accumulation of excess assets. As described above, defined benefit pension plans are funded on an actuarial basis, so that it is possible that assets in excess of those required to provide for plan benefits exist at the time of the plan termination.

Permanency requirement

An employer may reserve the right to change or terminate a qualified plan or to discontinue benefits thereunder. However, in order to be a qualified plan, the plan is required to be a permanent program rather than a temporary program. The termination of the plan for any reason other than business necessity within a few years after it has taken effect is evidence that the plan was not a bona fide program for the exclusive benefit of employees in general. Whether or not a plan that has terminated meets the permanency requirement depends on all the facts and circumstances. For example, in the case of a profit-sharing plan, it is not necessary that the employer contribute every year or that it contribute the same amount every year. On the other hand, a circumstance which may involve a violation of the permanency rule is termination of a defined benefit pension plan soon after pensions have been fully funded for highly compensated employees.

Payment of benefits upon early termination

The Code and regulations contain specific rules designed to prevent discrimination in favor of highly compensated employees upon early termination of a qualified plan. A qualified pension plan is required to include provisions that restrict the use of employer contributions to fund the benefit of the 25 top-paid employees of the employer in the event of early termination of the plan (Treas. reg. sec. 1.401-4(c)). The restrictions apply to employees who are among the 25 top-paid employees at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500. The events that trigger the restrictions are termination of the plan within 10 years after its establishment or the benefits of such an employee becoming payable within 10 years after the establishment of the plan.

The restrictions do not generally affect the payment of retirement benefits to such an employee while the plan is in operation. However, a lump sum distribution may be paid to such an employee during the period the restriction is in effect only if the employee agrees to repay the actuarial value of the restricted portion of the benefits upon early termination and such agreement is adequately secured.

Vesting

A plan is not a qualified plan unless the plan provides that the interests of plan participants in the plan become fully vested upon plan termination. For this purpose, a plan termination includes a full or partial termination of the plan, or, in the case of a profit-sharing, stock bonus, or other plan not subject to the minimum

funding requirements, the complete discontinuance of contributions under the plan.

A defined benefit pension plan is generally considered terminated when it is voluntarily terminated by the employer or involuntarily terminated by the PBGC. A defined contribution plan is considered terminated when it is voluntarily terminated by the employer. Whether a complete discontinuance of contributions (as compared to a temporary suspension of contributions) has occurred is determined based on all the facts and circumstances. Factors relevant in determining whether a complete discontinuance has occurred include whether the employer is calling an actual discontinuance of contributions a suspension in order to avoid full vesting or for any other reason, whether employer contributions are recurring and substantial, and whether there is any reasonable probability that the lack of contributions will continue indefinitely.

Whether a partial termination has occurred is also determined on a facts and circumstances basis. Factors relevant to this determination include the exclusion, by reason of plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan and plan amendments which adversely affect the rights of employees to vest in benefits under the plan. If a defined benefit pension plan ceases or decreases future benefit accruals under the plan, a partial termination is deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer is created or increased.

Special rules for defined benefit pension plans; employer reversions

Under the Code, a trust forming part of a pension plan is not qualified unless under the trust instrument it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (sec. 401(a)(2)). However, upon termination of the defined benefit pension plan and after satisfaction of all fixed and contingent liabilities of the participants and beneficiaries (termination liability), the employer may recover any excess assets remaining in the trust that are due to erroneous actuarial computations (Treas. reg. sec. 1.401-2(b)(1)).[15]

Similarly, under ERISA [16] the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan. However, as under the Code, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and

[15] A reversion is also possible in limited circumstances in the case of a defined contribution plan. Under present law, a suspense account may be maintained to hold amounts that cannot currently be allocated to plan participants because of the limitations on benefits and contributions (sec. 415). In certain cases, amounts remaining in the suspense account on termination of the plan may revert to the employer.

[16] Both ERISA and the Code also permit the return of contributions to the employer in certain limited situations prior to the termination of the plan, for example, contributions made by mistake of fact, contributions conditioned on the initial qualification of the plan, and contributions conditioned on the deductibility of the contribution. ERISA sec. 403(c)(2), Code sec. 401(a)(2), Rev. Rul. 77-200, 1977-1 C.B. 98.

their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution.

Under present law, upon the termination of the plan all accrued benefits must become 100 percent vested and nonforfeitable. In addition, the accrued benefits must be distributed or annuitized, that is, annuities providing for the payment of accrued benefits must be purchased and distributed to participants.

Under present law, whether the employer has the right to the excess assets or must share excess assets with plan participants is generally determined under the plan document. Thus, if the plan document provides that the employer is entitled to the reversion of excess assets, the employer is not required to share the reversion with participants.[17]

Although an employer technically is not permitted to recover excess assets except upon termination of a plan, present law permits certain transactions that in effect permit the withdrawal of assets from an ongoing plan. Typical examples of such transactions are termination-reestablishment and spinoff-termination transactions.

In a termination-reestablishment transaction, the employer terminates a defined benefit pension plan, recovers the excess assets, and then establishes a "new" plan that covers the same employees and provides the same or substantially similar benefits as the old plan. In a typical spinoff-termination transaction, a single plan is split into two plans, one plan covering retirees and one covering active employees. The excess assets are allocated to the plan covering retirees. That plan is then terminated, allowing the employer to recover the excess assets.[18]

In response to concern that reversions can reduce the security of participants' benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans" or the "Implementation Guidelines," were issued by Treasury, the Department of Labor, and the PBGC as a news release on May 24, 1984.

The Implementation Guidelines set forth administrative procedures for processing certain terminations of qualified defined benefit pension plans involving reversions of excess assets to the plan sponsor. The guidelines generally provide that a bona fide termination of a defined benefit pension plan will be recognized as having occurred under either a spinoff-termination or a termination-reestablishment transaction only if certain conditions are met.

A spinoff-termination is considered bona fide under the guidelines only if (1) the benefits of all employees are vested as of the date of the termination, (2) all benefits accrued by all employees as of the date of the termination are provided for by the purchase of annuity contracts, (3) the continuing plan adopts a special funding

[17] Under ERISA, except in the case of a new plan, a plan provision providing that excess assets revert to the employer generally is not effective until for 5 years after the provision is adopted.

[18] In some circumstances, present law may restrict the amount of assets that may be allocated to a plan upon a plan spin-off (sec. 414(l)).

method (with the approval of the IRS), and (4) appropriate notice is provided to employees.

Under the Implementation Guidelines, termination-reestablishment transactions are generally recognized as bona fide. If the new plan provides credit for service before that plan was adopted, however, the guidelines do not treat the transaction as bona fide unless a special funding method is adopted (with the approval of the IRS).

The guidelines note that spinoff-terminations or termination-reestablishments may affect the qualified status of plans under the tax law because the Code requires that qualified plans be permanent. The guidelines generally provide that the permanency requirement prohibits an employer that has engaged in a spinoff-termination or termination-reestablishment transaction from engaging in another such transaction for at least 15 years.

Asset reversions are includible in the gross income of the employer receiving the reversion. In addition, employer reversions are subject to an excise tax equal to 15 percent of the reversion (sec. 4980). The excise tax was enacted in order to recapture the tax benefit received by the employer from the tax-free growth of plan contributions.

F. Prohibited Transaction Rules

In order to prevent persons with a close relationship to a plan from using that relationship to the detriment of plan participants and beneficiaries, the Code prohibits certain transactions between a plan and a disqualified person (sec. 4975). A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, and certain persons related to such disqualified persons.

Transactions prohibited include (1) the sale or exchange, or leasing of property between the plan and a disqualified person, (2) the lending of money or other extension of credit between the plan and a disqualified person, (3) the furnishing of goods, services, or facilities between the plan and a disqualified person, or (4) the transfer to, or use by or for the benefit of, a disqualified person, of any assets of the plan.

The Code contains a number of statutory exemptions to the prohibited transaction rules. These rules also permit the Secretary of the Treasury and the Secretary of Labor, respectively, to grant exemptions from the prohibited transaction rules on a case-by-case basis. The prohibited transaction exemption program under both the Code and ERISA generally is administered by the Secretary of Labor.

The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. In any case in which the initial tax is imposed and the prohibited transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed. Each disqualified person engaging in the prohibited transaction (other than a fiduciary acting as such) is jointly and severally liable for the excise taxes. The Secretary of the Treasury has authority to waive the second-level tax.

For purposes of determining the amount of the excise tax, the amount involved means the greater of the amount of money and the fair market value of other property received. For example, if a disqualified person obtains a one-year loan from a plan at an interest rate of 6 percent, and the fair market value of the use of the funds is 10 percent, the amount involved is 10 percent times the amount of the loan.

To correct a prohibited transaction means to undo the transaction to the extent possible. In any event, the plan must be placed in a financial position not worse than that in which it would be in if the disqualified person acted under the highest fiduciary standards.

III. LEGISLATIVE BACKGROUND

In general

Prior to 1921, no special tax treatment applied to employee retirement trusts. Retirement payments to employees and contributions to pension trusts were deductible by the employer as an ordinary and necessary business expense. Employees were taxed on amounts actually received as well as on employer contributions to a trust if there was a reasonable expectation of benefits accruing from the trust.

Since 1921, in order to stimulate the adoption of retirement plans by employers, the Internal Revenue Code has specifically provided that certain employee trusts are exempt from Federal income tax. The 1921 Code provided an exemption for a trust forming part of a qualified profit-sharing or stock bonus plan. The 1926 Code provided a similar exemption for qualified pension trusts and established deduction limits to limit the extent to which tax-favored treatment would be available under qualified plans. A number of changes to the qualification rules and deduction limits were made prior to the enactment of the 1954 code.

The special tax treatment afforded employee trusts was retained in the 1954 Code. Section 401(a) (and sections referred to therein) contains the basic qualification standards which a trust must satisfy in order to be exempt from tax under section 501(a); section 404 limits the amount of contributions that can be deducted; and section 402 and 72 govern the taxation of benefits distributed to employees.

The standards applicable to qualified plans have been revised over time to reflect Congressional concerns related to the expansion of pension, profit-sharing, and stock bonus plans and the prevention of tax abuses. The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 ("ERISA"), which added minimum participation, coverage, vesting, benefit accrual, and funding requirements, and overall limits on contributions and benefits. The next comprehensive revision of the rules was made by the Tax Reform Act of 1986. Further revisions of the rules were made by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, the Retirement Equity Act of 1984, the Consolidated Omnibus Budget Reconciliation Act of 1986, the Omnibus Budget Reconciliation Act of 1987 (including the Pension Protection Act), the Technical and Miscellaneous Revenue Act of 1988, and the Revenue Reconciliation Act of 1989 (included in the Omnibus Budget Reconciliation Act of 1989). The major legislative revisions are discussed below.

Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 ("ERISA"), enacted on September 2, 1974, forms the basis for the modern private pension system. ERISA established a comprehensive legislative program addressing almost all major aspects of employer-provided pensions and reflects Congressional concern that certain minimum standards for private pension plans are necessary to provide adequate retirement security for plan participants.

ERISA's requirements included minimum participation rules which limit the age and service requirements an employer can impose as a condition of participation in the plan; general and numerical coverage and nondiscrimination rules designed to ensure that pension plans benefit a substantial portion of an employer's rank and file employees as well as highly compensated employees; benefit accrual and vesting rules which limit the period of service an employer can impose before an employee earns or is entitled to receive a pension benefit; and minimum funding standards designed to ensure the solvency of defined benefit and money purchase pension plans.

ERISA also contained limitations on the tax benefits for employer-maintained plans. Thus, ERISA provided that contributions to such plans are deductible, within limits, and included limitations on the benefits that can be accumulated by a plan participant and the contributions that can be made on behalf of a plan participant.

ERISA also added prohibited transaction rules which are designed to prevent misuse of plan assets by plan fiduciaries and others closely associated with the plan.[19]

Tax Reduction Act of 1975

The Tax Reduction Act of 1975 provided that employers could qualify for a credit against income tax by making contributions to an ESOP that meets certain requirements. The amount of the credit was based on the employer's qualified investments.

Tax Equity and Fiscal Responsibility Act of 1982

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. For example, such plans were subject to lower limits on contributions and benefits than other types of qualified plans. TEFRA eliminated most of this disparity and, for the most part, applied the same rules to all

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[19] ERISA established a dual system regulating private pension plans. In addition to modifying Internal Revenue Code provisions, ERISA added significant labor law provisions regulating employer-sponsored pension plans. The labor law provisions included minimum participation, vesting, accrual, funding, and prohibited transaction rules substantially similar to those of the Code. The labor law provisions also include standards regulating the conduct of plan fiduciaries, rules regarding the rights of plan participants and disclosures of plan provisions to plan participants, and a termination insurance program administered by the Pension Benefit Guaranty Corporation. A detailed discussion of the labor law provisions relating to pension plans is beyond the scope of this pamphlet.

types of qualified plans without regard to whether or not the employer was incorporated.

For taxable years beginning after 1983, TEFRA added special qualification requirements for plans which primarily benefit an employer's key employees (referred to as "top-heavy plans"). The additional requirements included faster vesting rules and minimum benefit requirements.

TEFRA added the basic employee leasing rules, under which an individual who performs services for another person is treated as the recipient's employee where the services are performed pursuant to an agreement between the recipient and a leasing organization. These rules were designed to prevent avoidance of the qualification requirements through innovative employment structures that do not represent the true employment relationship. TEFRA also expanded the class of employees who, under the affiliated service group rules, are to be treated as employed by a single employer for purposes of the qualification rules.

TEFRA also reduced the maximu limits on contributions and benefits under qualified plans. In addition, TEFRA repealed the investment-based ESOP tax credit and replaced it with a credit for ESOP contributions based on the compensation of plan participants.

Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 ("DEFRA") expanded the special tax benefits for ESOPs. In particular, DEFRA provided for deferral of recognition of gain on certain sales of stock to an ESOP, an employer deduction for dividends paid on certain stock held by an ESOP, the exclusion of 50 percent of the interest paid on certain loans to an ESOP, and the assumption of estate tax liability by an ESOP.

DEFRA also made miscellaneous changes to the employee leasing rules, distribution rules, nondiscrimination rules for cash or deferred arrangements, and certain other qualification requirements.

Retirement Equity Act of 1984

The Retirement Equity Act of 1984 ("REA") reflected Congressional concern that the previous qualification rules did not adequately reflect changing work patterns of workers and their spouses and did not provide adequate protection for the surviving spouse of the worker. REA demonstrated Congressional concern that workers, and particularly women, often enter the work force at an earleir age and leave and re-enter the work place at various times during their careers with the result that they often did not earn a pension benefit under prior law.

REA lowered the minimum age employers may require individuals to attain before they participate in a pension plan, and modified the rules relating to the service that must be taken into account for purposes of vesting and benefit accural (including special rules for maternity and paternity leave), spousal survivor benefits, the distribution of qualified plan benefits upon divorce, and the protection of accrued benefits.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (the "1986 Act"), contains the most comprehensive revision to the qualified plan rules since ERISA. The 1986 Act made changes to the limitations on tax deferral under qualified plans, nondiscrimination rules, tax treatment of distributions, and special rules for ESOPs.

With respect to the tax deferral provided to qualified plans, the 1986 Act lowered the maximum limits on benefits and contributions, imposed a cap on elective deferrals under qualified cash or deferred arrangements, and added a tax on aggregate excess distributions from all tax-favored retirement plans of an individual.

The 1986 Act also imposed a tax on nondeductible employer contributions to qualified employer plans, and added a 10-percent excise tax on employer reversions. The tax on reversions was intended to recapture the tax benefits of deferral on income earned on plan contributions.

The 1986 Act made a number of changes to the coverage and nondiscrimination rules. The Act added a uniform definition of highly compensated employee, the minimum participation rule, reduced the permitted disparity between contributions for highly and nonhighly compensated employees under qualified cash or deferred arrangements, and added nondiscrimination rules for employee contributions and employer matching contributions similar to the rules applicable to cash or deferred arrangements.

The 1986 Act also modified the minimum coverage rules, generally reducing the disparity between benefits of highly and nonhighly compensated employees. Prior to the 1986 Act, the rules relating to integration of qualified plans permitted an employer to eliminate all qualified plan benefits for lower-paid employees. The 1986 Act modified the integration rules by generally reducing the amount by which benefits for lower-paid employees could be reduced due to social security and ensuring that all employees covered by the plan receive some benefit under the plan.

The 1986 Act reflects further Congressional concern for workers who change jobs frequently, particularly women and minorities. Thus, the Act provides for more rapid vesting than permissible under prior law.

In the area of plan distributions, the 1986 Act provided for more uniform distribution rules for IRAs, qualified plans, and other tax-favored retirement vehicles. The 1986 Act also provided for a more uniform 10-percent tax on early withdrawals from tax-favored retirement vehicles. This tax had previously applied only to IRAs and certain distributions from top-heavy plans.

The 1986 Act revised the rules relating to income taxation of qualified plans. In general, the 1986 Act modified the basis recovery rules to provide for pro rata basis recovery, provided for 5-year averaging of lump sum distributions (as compared with 10-year averaging under prior law), and eliminated capital gains treatment for qualified plan distributions.

The 1986 Act modified the rules relating to ESOPs by requiring that ESOP stock be valued by an independent appraiser and that an ESOP provide employees close to retirement age the opportunity to diversify plan investments. The 1986 Act also eliminated the

tax credit for contributions to ESOPs, expanded certain other special tax benefits for ESOPs, and added an estate tax deduction for sales for securities by an executor to an ESOP.

Omnibus Budget Reconciliation Act of 1987

The Omnibus Budget Reconciliation Act of 1987 (including the Pension Protection Act) modified the minimum funding requirements applicable to single-employer defined benefit pension plans and the maximum amount that may be deducted for contributions to such plans. These changes were designed to eliminate excessive overfunding and underfunding of defined benefit pension plans.

The Pension Protection Act (PPA) was prompted by Congressional concern over the solvency of the single-employer defined benefit pension plan system. The PPA recognized that the prior-law funding rules were not in all cases sufficient to ensure that defined benefit pension plans are adequately funded in the event of plan termination. Thus, PPA required more rapid funding for underfunded plans, accelerated the time for making plan contributions, and made other changes relating to funding.

In passing the Omnibus Budget Reconciliation Act of 1987, Congress was also concerned that prior law permitted employers desiring to do so to excessively overfund pension plans and obtain tax deductions for liabilities that have not yet been accrued by the plan. Thus, the Act added the 150-percent of current liability full funding limitation.

Revenue Reconciliation Act of 1989

The Revenue Reconciliation Act of 1989 (included in the Omnibus Budget Reconciliation Act of 1989) modified the special tax benefits for ESOPs. The Act restricted the availability of the partial interest exclusion for ESOP loans to cases in which the ESOP owns more than 50 percent of the stock of the employer, modified the tax-free rollover provisions, and repealed the estate tax deduction for sales of stock to an ESOP and other miscellaneous ESOP provisions.

The Act also made numerous technical corrections to the PPA.

IV. ISSUES RELATING TO THE SIMPLIFICATION OF EMPLOYEE PENSION BENEFITS TAX LAWS [20]

Overview

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

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

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

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

A brief discussion follows of the reasons for complexity in the pension area and of possible issues to be considered in the development of legislative proposals to reduce this complexity.

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[20] This discussion is phrased in terms of pension benefits because the focus of this pamphlet is complexity in pension laws. However, the discussion is also applicable to other types of employee benefits (e.g., health benefits), as well as the tax generally.

Reasons for complexity in employee pension benefits laws

Retirement policy vs. tax policy

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

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

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

Jurisdiction of pension legislation

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

Although many of the pension laws enacted in ERISA had mirror provisions in the labor laws and in the Internal Revenue Code, subsequent legislation has not always followed the same

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

In addition, the enforcement of rules relating to employer-provided pension plans is shared by the IRS and the Department of Labor. Thus, there is no single agency of the Federal Government that is charged with the development and implementation of regulations and with the operational enforcement of the rules relating to pension plans.

Although the authority of each applicable agency has been clarified, complexity can occur because of the manner in which the agencies interact. An employer must determine the agency with which it must consult on an issue and may find that the goals of each agency are different. For example, the Pension Benefit Guaranty Corporation (PBGC) views the funding of a defined benefit pension plan from its goal of assuring solvency of the plan when benefit payments are due. On the other hand, the IRS is also concerned that employers should not be permitted to overfund defined benefit pension plans as a mechanism by which the employer can shelter income from taxation. Without careful coordination of the goals of these 2 Federal agencies, employers may receive inconsistent directives.

Volume and frequency of employee benefits legislation

Many employers and practitioners in the pension area have argued that the volume of legislation affecting pension plans enacted since 1974 has contributed to complexity. In many cases, a particular substantive area of pension law may be dealt with legislatively every year. For example, the rules relating to the form and taxation of distributions from qualified pension plans were significantly changed by TEFRA, DEFRA, and the Tax Reform Act of 1986. In many cases, changes in the rules are lobbied for by employers and practitioners.

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

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

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

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

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

The structure of the workplace

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

Large employers tend to have complex structures. These complex structures may include the division of employees among various subsidiaries that are engaged in different types of businesses. Rules are required to deal with the issues that arise because a business is operated in many tiers. For example, questions arise as to which employees are required to be taken into account in determining whether an employer is providing pension benefits on a nondiscriminatory basis. To what extent are employees of various subsidiaries that are engaged in completely different activities required to aggregated? If these employees must be aggregated for testing purposes, what kind of recordkeeping burdens are imposed on the employer? How are headquarters employees treated and how does the treatment of such employees differ from the treatment of subsidiary employees? If an employer retains temporary workers, to what extent are such workers required to be taken into account? Should employees covered by collective bargaining agreements be treated differently than other employees? Employers face these issues every day because of the way in which their businesses are operated, rather than simply because the laws governing pension benefits are complex.

Flexibility and complexity

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

plans, different ways of funding such plans, and different ways of providing benefits under such plans.

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

Certainty created by complexity

Although employers and practitioners often complain about the complexity of the rules relating to employer-provided pension plans, some of that complexity is, in fact, attributable to the desire of employers or the Congress to have certainty in the rules. For example, the general nondiscrimination rule relating to qualified pension plans merely requires that a plan not discriminate in either contributions or benefits in favor of highly compensated employees. This rule is easy to articulate; however, determining whether or not the rule is satisfied is not a simple task. The most obvious problem is determining what the word "discriminate" means. If it means that there can be no difference in contributions or benefits between those provided to highly compensated employees and those provided to rank-and-file employees, then the rule is fairly straightforward. However, because the rules permit employers some flexibility to provide more contributions or benefits for highly compensated employees, then it is necessary to determine how much of a difference in the contributions or benefits is permitted. On the other hand, rules that provide greater certainty for employers tend, on their face, to appear to be more complex. A case in point are the nondiscrimination rules for employee benefits added in the Tax Reform Act of 1986 (sec. 89).[21] Employers complained vigorously about the calculations and recordkeeping requirements imposed by section 89. However, these rules developed during the legislative consideration of the 1986 Act in large measure in response to employer's complaints about the uncertainty of a general rule prohibiting nondiscrimination in favor of highly compensated employees.

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

Transition rules

When the Congress enacts tax legislation altering the tax treatment of qualified pension plans or distributions from such plans, transition relief is often provided to specific employers or individual taxpayers or to a class of employers or taxpayers. Transition

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

relief generally delays temporarily or permanently the application of the enacted rule to the applicable taxpayer. Sometimes, transition relief will apply a modified rule that is a compromise between present law and the enacted rule.

The adoption of transition rules for a taxpayer or a class of taxpayers contributes to the actual and perceived complexity of employee benefits laws.

Possible considerations in developing proposals to reduce complexity of the employee benefits laws

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

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PENSION RIGHTS CENTER

918 16th Street, N.W. Suite 704 Washington, D.C. 20006 (202) 296-3776

March 22, 1990

The Honorable David Pryor, Chairman
Subcommittee on Private Retirement Plans
and Oversight of the Internal Revenue Service
205 Dirksen Building
U.S. Senate
Washington, D.C. 20510

Dear Senator Pryor:

We read with interest your announcement of the hearing on "Internal Revenue Code rules governing private pension plans and options for simplification" to be held by the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service on March 23, 1990.

We share your concern that complex pension rules result in administrative costs that discourage some employers from setting up plans and cause others to spend less for benefit increases.

For this reason, we hope that you will consider using the Subcommittee hearing as an opportunity to alert employers, particularly small business owners, to the fact that many of the most complex pension rules **apply only to those companies that have made a cost-benefit decision to use their plans to reward certain workers at the expense of others.** These companies have made a business judgment that it is less costly to take advantage of these complicated rules than to provide benefits fairly to all workers.

For example, among the most complicated of all pension rules are "coverage" and "participation" rules that permit companies to leave their less favored workers out of plans, and "integration" rules that permit companies to provide contributions and benefits based on a smaller percentage of pay for lower-paid workers than for the higher-paid. If a company wants to take advantage of these rules, it -- or its consultants -- must master nearly 60 pages of federal regulations. But none of these regulations is applicable if an employer is willing to include all employees in a plan and to provide benefits or contributions fairly to workers at all income levels.

Pension coverage could be significantly expanded if more employers were made aware that current rules allow them to set up simple plans. There are many businesses that would happily trade off the complexity of "flexible" plans for straightforward,

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understandable rules. The reality is that few company owners start out with an intention to hurt their most vulnerable employees -- who most often are women. "Coverage exclusions" and "permitted disparities" are concepts that are sold to employers by pension consultants.

* * *

In addition to educating employers about the existence of simple and fair pension plans, we urge the Subcommittee to consider legislation that could be adopted immediately and that would open the door to greater simplicity and equity in the private pension system.

A first step in this direction would be adoption of a provision similar to Section 3 of the Pension Reform Act of 1989 (H.R. 3306), introduced into the House of Representatives by Congresswoman Barbara Kennelly. This provision would require employers with pension plans to cover all employees in a single line of business. This would eliminate countless pages of regulations for virtually all small businesses and other nondiversified companies.

A second, even more modest, simplification measure would be the adoption of Section 2(b) of the Pension Reform Act. Section 2(b) would end the integration of Simplified Employee Pensions with social security. SEPs are potentially the simplest and the fairest of all pension plans. As noted in the attached booklet, they can be easily administered by employers and easily understood by employees. However, current rules permitting integration of SEPs add needless complexity to these otherwise simple plans.

There is much more that can -- and must -- be done, but these are meaningful first steps toward expanding coverage by reducing administrative costs.

Sincerely yours,

Anne Moss, Director
Women's Pension Project

Cindy Hounsell, Fellow
Women's Pension Project

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the pension plan *almost* nobody knows about

Simplified Employee Pensions

Does your company have a pension plan?

If not, you should know about SEPs.

SEPs are "Simplified Employee Pensions," the easiest way for companies to provide pensions for their employees.

Many companies do not have pension plans. In some cases this is because they cannot afford to provide pensions. In others, it is because the companies think their employees are not concerned about retirement income. Often, however, companies do not provide pension benefits because they think pension plans are costly to set up and administer.

SEPs make it possible for your company to provide you with a pension without paying the start-up and operating costs of conventional pension plans.

You need a pension

With social security benefits averaging only $6,444 a year for retired workers, you will have to have other sources of income to live comfortably when you are no longer able to work. Unless you are one of the fortunate few with income from savings and investments, a pension can make all the difference in how you live during your retirement years.

If you do not have a pension plan where you work, you should consider talking to your employer about a SEP. Many employers are very responsive when employees express concern about retirement income.

You may find that no one has ever asked your employer about a pension plan. He or she may never have thought about your income needs at retirement or may have assumed that your social security payments would be enough for you to live on.

Why your company might want to set up a SEP

■ The company president can contribute up to 15 percent of pay to his or her own SEP account each year—or $30,000 if this is less.

■ The company is not locked into making any future contributions. It can decide each year whether to pay into the SEP and how much to contribute.

■ Once the company puts money into employees' SEP accounts it has no further responsibility for the amounts contributed.

■ The company's contributions to a SEP are tax deductible and the company pays no taxes on SEP investment earnings.*

■ The company does not have to pay any consulting fees, commissions or administrative expenses to establish and operate a SEP. It does not have to file any documents with the government.

SEPs can be set up by self-employed people, unincorporated businesses, partnerships and corporations, including nonprofit and S corporations.

*SEP contributions for a particular calendar year can be made up until the date a company's tax return for that year is due, including any extensions. No social security or federal unemployment compensation taxes are payable on SEP contributions.

You and your

If your company sets up a SEP . . .

- The money that the company pays into your SEP account belongs to you—even if you leave the company.
- All of the investment earnings on the amounts contributed to your SEP account are yours.
- Most SEPs give you the right to choose where your SEP money is invested.
- You can change where your SEP money is invested.
- You can start withdrawing your SEP money when you are age [illegible] or earlier, if you become disabled.
- When you die, your SEP money will go to someone you have chosen.

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- You pay no taxes on the amounts in your SEP account until you start withdrawing your money at retirement age (or if you become disabled).
- You can contribute up to $2,000 (or 100% of pay if this is less) to an Individual Retirement Account in addition to the amount your company puts into your SEP account.*

Note: If you withdraw your SEP money before age 59½ and are not disabled, you will ordinarily have to pay the government a substantial penalty tax, as well as income tax. There is an exception if you arrange to take your SEP money out in lifetime monthly payments.

You should also be aware that although your employer can continue making SEP contributions as long as you are employed by the company, you must start withdrawing your SEP money when you reach age 70½.

*You may not be able to take a tax deduction for your IRA contribution if your income exceeds a specific level. See IRS Publication 590.

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Setting up a SEP

Your employer can set up a SEP in a matter of minutes by using the Internal Revenue Service's "Model SEP" agreement.

(1) The employer decides the percentage of payroll he or she can afford to contribute to the SEP.

(2) The employer fills out Internal Revenue Service Form 5305-SEP, a quarter-page form with five blank spaces.

(3) The employer asks you, and the other employees, to set up an Individual Retirement Account at a financial institution of your choice.

(4) The employer mails SEP contributions, equal to the same percentage of each employee's pay, to the financial institutions you and the other employees have chosen.

(5) The employer gives you, and the other employees, a completed copy of the Form 5305-SEP and the questions and answers attached to that form, as well as a statement of the amount contributed to your SEP account.

No other reporting or disclosure is required by the employer, and he or she does not file the Form 5305-SEP with the IRS.

as easy as 1-2-5

Note: If you choose not to set up an Individual Retirement Account, your employer can set up an IRA on your behalf and make a SEP contribution for you. Also, if the employer prefers to write a single check, he or she can choose one financial institution to receive all of the SEP contributions. You and the other employees can then decide if you want to transfer your SEP accounts to other financial institutions.

You will receive a statement from the financial institution investing your SEP money both at the time your employer makes your first SEP contribution and once a year after that. The financial institution must give you a plain-English explanation of any fees and commissions it charges and any penalties it imposes if you withdraw your SEP money before the expiration of a specified period of time.

Who Must Be Included in a SEP?

Companies are allowed to include all employees in a SEP but do not have to do so. Your company is generally required to include you in the SEP if you have worked for the company for at least 3 out of the last 5 years, are over age 21 and are paid more than $327 in the year for which contributions are made. You can be left out of a SEP if you are a union employee and retirement benefits were the subject of good faith bargaining with a union representative. You can also be excluded if you are a non-resident alien.

Non-Model SEPs

Although using the IRS form 5305-SEP is the easiest way of setting up a SEP, your employer does not have to use the IRS model agreement.* Many financial institutions have their own SEP arrangements that have been approved by the Internal Revenue Service. In addition, employers may design their own SEP subject to IRS approval.

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*Employers *cannot* use the IRS "Model SEP" if they

- now have another pension plan or other type of qualified retirement plan;
- formerly had a pension plan that promised to pay specific benefits at retirement—a "defined benefit" plan;
- take social security into account in figuring SEP contributions;
- have any leased employees;
- have any eligible employees for whom SEP accounts have not been established; or
- are members of an "affiliated" or "controlled" group of employers that has eligible employees who are not included in a SEP.

There is an important difference between an IRS Model SEP agreement and a non-model SEP agreement. Companies using the Model SEP must contribute the same percentage of pay for each employee included in the SEP. Companies using a non-model SEP agreement are permitted (but not required) to take social security payments into account in figuring SEP contributions. Companies can subtract part of the social security taxes they pay for an employee in calculating the SEP contributions for that employee.

Because social security contributions for lower paid employees are a much higher percentage of their pay than the contributions for higher paid employees, the result of this practice is that the SEP contributions for lower paid employees can be very small.*

*There are two limitations to this practice.

First, the percentage of pay contributed to SEP accounts on earnings below the social security wage base ($48,000) must be at least half the percentage of pay contributed to SEP accounts on earnings above the social security wage base.

Second, if the result of taking social security contributions into account would be that more than 60% of the SEP contributions would go to company officers and owners, the company may be required to make SEP contributions for lower paid workers of up to 3% of their pay.

Savings SEPs for small companies

If you work for a small for-profit company, your employer may be able to set up a "Salary Reduction SEP."

Unlike other SEPs, Salary Reduction SEPs are savings plans, not pension plans. The money in these plans is put in by workers rather than by their companies.

Your company can set up a Salary Reduction SEP if it has 25 or fewer employees who would be eligible for a company-paid SEP, *and* if half of those employees choose to put money into the plan.

If your company has a Salary Reduction SEP and you choose to contribute to the plan, your taxable income will be reduced by the amount you put in, up to a maximum of $7,627 a year or 15% of your pay, whichever is less.* (Both you and your employer are required to pay social security taxes on the amounts you contribute.)

A company can have both a company-paid SEP and a Salary Reduction SEP as long as the total amount contributed for any employee each year is not more than 15% of pay or $30,000.

The simplest way for your employer to set up a Salary Reduction SEP is by using the Internal Revenue Service's model agreement, Form 5305A-SEP. Employers using this model agreement may be required to make contributions for lower paid employees who choose not to put money into the Salary Reduction SEP or who contribute only small amounts. The required employer contributions can be made to the Salary Reduction SEP or to a separate company-paid SEP.**

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*Company owners, officers and certain highly paid employees cannot contribute more than 125% of the average percentage of pay put into the salary reduction SEP by all other eligible employees. The employer must notify employees by March 15 if the employees' contributions for the preceding year exceed these limits.

**The IRS Model Salary Reduction SEP generally cannot be used by companies not eligible to set up company-paid Model SEPs or by [illegible]anies consisting of only owners, officers, and highly-p[illegible]mployees.

Investments

Financial institutions authorized to hold and invest SEP contributions include banks, savings and loan associations, investment companies, credit unions, brokerage firms and insurance companies.

Your SEP money can be put into stocks, bonds, mutual funds, money market funds, certificates of deposit, and other similar types of investments.

For More Information About

You can call the nearest office of the Internal Revenue Service and ask for IRS Publication 590. You may also want to request the IRS Model SEP, Form 5305-SEP, and the IRS Model Salary Reduction SEP, Form 5305A-SEP. Both forms have questions and answers to help you understand how these SEP agreements work.

If you have technical questions about SEPs, you can call the Internal Revenue Service Employee Plans Division Taxpayer Assistance line at (202) 566-6783 weekdays between 1:30 and 4:00 p.m. Eastern Time. This is not a toll free number.

Also, you or your employer may want to request a copy of **SEPs: What Small Businesses Need to Know,** a booklet written by the Pension Rights Center for the U.S. Small Business Administration and the U.S. Department of Labor. Write to the U.S. Small Business Administration, Office of Advocacy, 1441 L Street, N.W., Washington, D.C. 20416 or the U.S. Department of Labor, Pension and Welfare Benefits Administration, Room N-5666, 200 Constitution Avenue, N.W., Washington, D.C. 20210.

Form **5305-SEP**
(Rev. June 1988)
Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under Section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499
Expires 7-31-91

Do NOT File with Internal Revenue Service

______________________________ makes the following agreement under the terms of section 408(k) of
(Business name—employer)
the Internal Revenue Code and the instructions to this form.

The employer agrees to provide for discretionary contributions in each calendar year to the Individual Retirement Accounts or Individual Retirement Annuities (IRA's) of all eligible employees who are at least ________ years old (not over 21 years old) (see instruction "Who May Participate") and worked in at least ________ years (enter 1, 2, or 3 years) of the immediately preceding 5 years (see instruction "Who May Participate"). This ☐ includes ☐ does not include employees covered under a collective bargaining agreement and ☐ includes ☐ does not include employees whose total compensation during the year is less than $300.

The employer agrees that contributions made on behalf of each eligible employee will:

- Be made only on the first $200,000 of compensation (as adjusted per Code section 408(k)(8)).
- Be made in an amount that is the same percentage of total compensation for every employee.
- Be limited to the smaller of $30,000 (or if greater, ¼ of the dollar limitation in effect under section 415(b)(1)(A)) or 15% of compensation
- Be paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

____
Signature of employer

____
Date

____
By

214

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The Pension Rights Center is publishing **The Pension Plan Almost Nobody Knows About** as part of a nationwide Coverage Campaign. The Campaign is committed to increasing workers' access to company and union pension plans. Currently, only half of all private sector employees have pension plans where they work.

The Pension Rights Center is the nation's leading pension educator and advocate. Started in 1976, the Center is the only organization in the country that works full-time to protect and promote the pension interests of workers, retirees and their families. The Center's activities are supported by foundation and government grants, and donations from organizations and individuals. Contributions to the Center are tax deductible.

United States General Accounting Office

GAO

Briefing Report to the Subcommittee on Labor-Management Relations, Committee on Education and Labor, House of Representatives

October 1989

PRIVATE PENSIONS

Impact of Vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans

GAO/HRD-90-4BR

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-229263

October 23, 1989

The Honorable William L. Clay
Chairman, Subcommittee on Labor-Management Relations
Committee on Education and Labor
House of Representatives

The Honorable Marge Roukema
Ranking Minority Member
Subcommittee on Labor-Management Relations
Committee on Education and Labor
House of Representatives

On May 3, 1989, you requested information on how certain rules for top-heavy pension plans affected participants' pension benefits. Top-heavy pension plans are those in which more than 60 percent of the benefits or contributions go to company owners or other key employees. Your request in part reflected your ongoing interest in whether the top-heavy rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) are necessary in light of changes made to the rules governing pension plans included in the Tax Reform Act of 1986 (TRA). In response we agreed to provide information comparing the proportion of participants in top-heavy plans with no legal right to receive earned benefits (i.e., those who were not "vested") under the top-heavy and TRA vesting rules. You also asked for information on the effect of TEFRA's top-heavy minimum benefit and contribution rules. We agreed to identify top-heavy plans and participants that were not affected by TEFRA's rules. This briefing report summarizes information presented in our May 11, 1989, briefing to the Subcommittee.[1]

Background

Top-heavy rules were enacted to curb perceived inequities in small business pension plans where key employees were the primary beneficiaries.[2] Among other things, the top-heavy rules reduced the time a worker can be made to wait to gain a legal right to receive earned benefits or "vest," and stipulated minimum benefits or contributions that participants who are not owners, officers, or other key employees must receive.

[1] The vesting status information updates preliminary data presented in Pension Plans: Vesting Status of Participants in Selected Small Plans (GAO/HRD-88-31, Oct. 30, 1987)

[2] Generally, the smaller the plan, the more likely it is to be top-heavy

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The continued need for accelerated vesting for top-heavy plans has been a topic of debate since the passage of TRA, which significantly lessened the vesting period for plans that are not top-heavy. As originally enacted in 1974, the Employee Retirement Income Security Act (ERISA), provided that the longest a plan could require a participant to wait before fully vesting was 10 to 15 years. In 1982, TEFRA lowered this requirement to 3 to 6 years, but only for top-heavy plans. In 1986, TRA amended ERISA and changed the maximum period to 5 to 7 years for plans other than top-heavy ones. Some argue that the accelerated vesting periods for top-heavy plans and those that are not top-heavy are similar enough to make the special rules for top-heavy plans unnecessary. However, groups concerned with protecting workers' and retirees' pensions have argued that retaining the top-heavy rules is necessary. They note that small businesses generally have highly mobile workforces that would be less likely to vest in any pension benefits under the less stringent vesting requirements of TRA.

Approach and Methodology

Our data were drawn from GAO's pension database, which we created to respond to the mandate in the Retirement Equity Act of 1984 (P.L. 98-397, Sec. 304) that GAO study the effect of federal pension rules on women. The database contains information on a nationwide sample of plans in operation in 1984 and 1985 sponsored by small employers (fewer than 100 employees). The sample was selected from a universe of the four most prevalent types of pension plans in the five industry groups with most of these types of plans.[3] (See app. I.) This universe included 67 percent of small employers' plans otherwise eligible for our study.

About three-fourths of the small employers' plans represented in our database were top-heavy and were included in our analysis of participants' vesting status under TEFRA and TRA.[4] This represented about 55,000 top-heavy plans with about 346,000 participants. Because of time and data constraints, our analysis of the minimum benefits and contributions included only non-key participants in those cases where the employer sponsored one top-heavy plan. This represented about 26,000 top-heavy plans with about 142,000 participants.

[3]The universe also only included plans that (1) were sponsored by a single employer, (2) contained more than one participant, and (3) were not Keogh plans for self-employed people.

[4]The database also contains information on a nationally representative sample of plans sponsored by large employers (100 or more employees) None of these plans were top-heavy

We compared participants' vesting status under TEFRA and TRA using two different scenarios. In Scenario 1, which some pension experts think is the most likely scenario, we assumed that plans using top-heavy vesting schedules used TRA's 5-year cliff schedule instead.[5] In Scenario 2, thought to be a less likely alternative, we assumed each plan retained its type of vesting (graded or cliff) using the longer TRA time limits. For both scenarios, we assumed employers sponsoring plans that allowed full vesting sooner than TEFRA's top-heavy rules continued to give participants vested benefits sooner under TRA rules.

To identify top-heavy plans and non-key participants that were not affected by the top-heavy minimum benefit or contribution requirements ("minimums"), we compared each non-key participant's total accrued benefit or annual employer contribution with the applicable minimum, as defined under law (see app. II). In some cases, the participant's accrued benefit or contribution was equal to the minimum. Because of time and data constraints, we could not determine whether this was due to the plan formula or the minimum rules. Therefore, we categorized these cases as "may be affected." The top-heavy minimum rules differed for defined benefit and defined contribution plans, so we performed separate analyses for these two types of plans.[6]

Principal Findings

Many more participants, men and women alike, would have had smaller or no vested benefits if TEFRA's top-heavy vesting rules had been repealed and replaced with TRA's vesting rules in the 55,000 top-heavy plans in our study population. However, the effect of this change in vesting status on participants' retirement income would likely have been small and would only have occurred if these participants left their jobs before becoming fully vested. This is because these participants probably would have been vested in a relatively small pension benefit at that point in their careers.

Over one-half of the 26,000 plans and over two-thirds of the 142,000 participants represented in our analysis were not affected by the top-heavy minimums. However, short-service participants (fewer than 3

[5] Under a cliff schedule, participants move from nonvested to fully vested status after a specified length of service. Under a graded vesting schedule, vesting begins after a specified length of service and increases by a fixed percentage each year until full vesting is achieved. (See pp. 8-9.)

[6] In a defined contribution plan, each participant has an individual account and the retirement benefit will depend on the amount of contributions and the investment experience of the account. In a defined benefit plan, the retirement benefit is determined through a formula based on a worker's years of service, earnings, or both.

years' service) appeared to be more likely than those with longer service to be affected by the defined benefit minimums after just 2 years under the top-heavy rules. Only about one-third of short-service non-key participants—compared with over two-thirds of longer service participants—had accrued benefits greater than the minimum benefit and so were not affected.

More Participants Would Not Have Been Vested Under TRA

Our analysis showed that, had top-heavy rules been repealed and replaced with TRA rules, many more participants in top-heavy plans would not have had vested benefits under either TRA scenario. In Scenario 1, where we applied TRA's 5-year cliff vesting schedule to most participants, the proportion of participants not vested in their pension benefits would have about tripled—increasing from 13 percent to 40 percent. In Scenario 2, where we assumed plans retained their form of vesting but used the TRA time limits, the proportion of participants not vested would have increased from 13 to about 23 percent. (See app. III.)

Men would have been disproportionately affected if top-heavy rules had been replaced by TRA's rules under either scenario. Under top-heavy rules about 18 percent of women and 8 percent of men were not vested. In Scenario 1, 4.4 times as many men would not have been vested compared with 2.4 times as many women. In Scenario 2, 2.4 times as many men would not have been vested compared with 1.5 times as many women.

Many Plans and Participants Not Affected by Top-Heavy Minimums

Many top-heavy pension plans and non-key participants were not affected by the top-heavy minimums. However, participants with short service appeared more likely than those with longer service to have total accrued benefits equal to the defined benefit minimums, and, therefore, may have been affected.

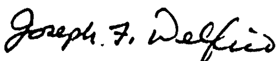
Among defined benefit plans, we estimated that 58 percent of the plans used benefit formulas that gave every non-key participant accrued benefits greater than the minimum. In other plans, some non-key participants may have been affected but others were not. In total, about 70 percent of all non-key participants in our study population had benefits greater than the minimum 2 years after the rules had been in effect. Only about 33 percent of non-key participants with fewer than 3 years of service had accrued benefits greater than the minimum, compared with about 66 percent of those with 3 or 4 years of service and about 91 percent of those with 5 or more years of service.

Some long-service workers may not be affected by the minimum benefit rule because any benefit accruals, whether or not attributable to years for which the plan was top-heavy, may be used to satisfy the defined benefit minimums. For example, a worker who entered the plan in 1985 must accrue benefits at least equal to the minimum for that year. However, a worker who joined in 1982 may accrue less than the minimum for 1985 if his or her total accrued benefit (for 1982 through 1985) is at least equal to the minimum required for 1985.

We estimated that in 61 percent of defined contribution plans employer sponsors made contributions greater than required by the minimum contribution rules. About 85 percent of all non-key participants in defined contribution plans where contributions were made received contributions above the minimum.

We did not obtain written comments on this briefing report because we were not reviewing specific agency functions or programs. However, we discussed our methodology with the Chief, Pension Actuarial Branch, of the Internal Revenue Service, and he agreed that it was appropriate. We are sending copies of this briefing report to other interested congressional committees. Copies will also be made available to others upon request.

If you have questions about information contained in this briefing report, please call me on 275-6193. Other major contributors to this briefing report are listed in appendix IV.



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Abbreviations

ERISA	Employee Retirement Income Security Act of 1974
GAO	General Accounting Office
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TRA	Tax Reform Act of 1986

Private Pensions: Impact of Vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans

Objectives

On May 3, 1989, the Subcommittee on Labor-Management Relations, House Committee on Education and Labor, requested information about the impact of vesting and minimum benefit rules in top-heavy pension plans. We agreed to provide information (1) comparing participants' vesting status under the top-heavy rules and vesting rules included in the Tax Reform Act of 1986 (TRA) and (2) identifying plans and participants not affected by the top-heavy minimum benefit and contribution rules.[1]

Background

A plan is top-heavy when more than 60 percent of the benefits or contributions go to company owners, officers, or other key employees.[2] Top-heavy plans must comply with different rules than other pension plans, such as shorter vesting schedules and minimum benefit and contribution rules in any year in which the plan is top-heavy.

Explanation of Vesting Rules

Vesting standards for private pension plans were first established by the Employee Retirement Income Security Act of 1974 (ERISA). These standards governed how long an employer could make a plan participant wait before the participant had earned a right to receive pension benefits.

Cliff vesting and graded vesting are two common types of vesting. Under a cliff schedule, participants move from nonvested to fully vested status after a specified length of service. Using a graded vesting schedule, vesting begins after a specified length of service and increases by a fixed percentage each year until full vesting is achieved. The longest vesting schedules first allowed under ERISA included 10-year cliff and 5- to 15-year graded vesting.

The Congress added special rules for top-heavy plans as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Among other things, TEFRA reduced the maximum time top-heavy plans could require for vesting, increasing the likelihood of shorter-tenured workers receiving pension benefits. As described below, top-heavy rules prescribe either 2- to 6-year graded vesting or 3-year cliff vesting.

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[1] The vesting status information updates preliminary data presented in Pension Plans: Vesting Status of Participants in Selected Small Plans (GAO/HRD-88-31, Oct. 30, 1987)

[2] A key employee is an officer, an employee owning more than a 5-percent interest in the firm, an employee owning more than a 1-percent interest in the firm and earning over $150,000, or one of the 10 employees owning the largest interest in the firm.

Under the 2- to 6-year graded vesting schedule, a participant is 20-percent vested after 2 years of service. The vesting percentage of the participant increases by 20 percent each year until the participant is 100-percent vested (fully vested) after 6 years. Under the 3-year cliff schedule, participants are fully vested after 3 years of service but not vested at all before that time.

TRA amended ERISA to reduce the vesting schedules allowed for plans that are not top-heavy. The vesting schedules provided as a result of TRA are: 3- to 7-year graded vesting or 5-year cliff vesting.[3] TEFRA's rules, which still apply to top-heavy plans, provide shorter vesting periods than TRA's rules.

Explanation of Top-Heavy Minimums

TEFRA established minimum benefit and contribution rules ("minimums") for all non-key participants in top-heavy plans, but not for other plans. The rules apply to all years in which the plan is top-heavy, beginning in 1984. Before TEFRA, some plans provided participants a minimum benefit independent of the normal benefit formula. But other plans, by coordinating their benefits with social security, provided some participants with little or no pension benefits.[4]

For defined benefit plans,[5] TEFRA requires that each non-key participant receive a total accrued benefit of at least 2 percent of average annual compensation for each year in which the plan is top-heavy.[6] After a non-key participant's accrued benefit reaches 20 percent (2 percent times 10 top-heavy years), the minimum no longer applies. For example, if the plan had been top-heavy in both 1984 and 1985, each non-key participant would have to have a total accrued benefit at the end of 1985 of at least 4 percent of average annual compensation (2 percent times 2 top-

[3] Multiemployer plans satisfy TRA's vesting requirements if benefits are fully vested after 10 years of service.

[4] The Tax Reform Act of 1986 eliminated methods of coordination that resulted in some lower paid workers receiving no pension benefits. For more information about pension plan coordination with social security, see Pension Integration: How Large Defined Benefit Plans Coordinate Benefits With Social Security (GAO/HRD-86-118BR, July 21, 1986) and Private Pensions: Plan Provisions Differ Between Large and Small Employers (GAO/HRD-89-105BR, Sept. 26, 1989).

[5] In a defined contribution plan, each participant has an individual account and the retirement benefit will depend on the amount of contributions and the investment experience of the account. In a defined benefit plan, the retirement benefit is determined through a formula based on a worker's years of service, earnings, or both.

[6] Average annual compensation is calculated over a period of consecutive years, not exceeding 5, when the participant had the highest aggregate compensation.

heavy years) to meet the minimum. If the plan had been top-heavy only 1 year, the applicable minimum would be 2 percent of annual average compensation (2 percent times 1 top-heavy year).

In determining whether a participant's benefit is above the minimum, any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used. Thus, longer-service participants may not be affected by the minimums if their plans have been top-heavy for a relatively short period. For example, a participant with 20 years of service and a total accrued benefit of 5 percent of average annual compensation would exceed the top-heavy minimum as long as the plan had been top-heavy for no more than 2 years.

In top-heavy defined contribution plans that make contributions in a given year,[7] non-key participants must receive a contribution for the year at least equal to 3 percent of their annual compensation when key employees receive 3 percent or more. However, if no key participant receives a contribution of 3 percent or more of annual compensation, the top-heavy rules stipulate that all non-key participants must receive a contribution equal to the highest percentage contribution for any key employee in the plan.

Scope and Methodology of GAO's Vesting Analysis

Our data were drawn from GAO's nationwide sample of pension plans sponsored by small employers (fewer than 100 employees) in operation in 1984 and 1985. This sample was selected from the universe of the four most prevalent types of pension plans in the five industry groups with most of these types of plans.[8] (See app. I.) This universe included about 67 percent of small employers' plans otherwise eligible for our study.

Our analysis of vesting status used data from the plans in our survey that were top-heavy. This represented about 346,000 participants in about 55,000 top-heavy plans.[9]

[7] In a defined contribution profit sharing plan, the employer's contribution is a function of profits. The employer may not make a contribution each year.

[8] The universe also included only plans that (1) were sponsored by a single employer, (2) contained more than one participant, and (3) were not Keogh plans for self-employed people.

[9] We excluded about 4 percent of the top-heavy plans who reported vesting schedules that were not in compliance with the top-heavy rules.

We performed the comparison of vesting status under the two acts for all participants and separately for men and women. Specifically, we compared (1) the percentages of participants not vested and (2) the average vesting percentages. The vesting percentage is the fraction of total accrued benefits that are vested. The average vesting percentage equals the sum of the participants' vesting percentages—0, 20, 40, 60, 80, or 100 percent—divided by the number of participants.

We used two scenarios to evaluate the possible effects on participants' vesting status of using TRA's vesting rules instead of the top-heavy rules. Some pension experts think that the first scenario described below is the most likely scenario of how top-heavy plans would change their vesting schedules should the top-heavy rules be repealed. The second scenario is thought to be a less likely alternative. These scenarios assumed different TRA vesting schedules depending on what type of top-heavy vesting schedule the plan used. About 73 percent of the participants in our study population were in top-heavy plans that used 2- to 6-year graded vesting schedules. About 3 percent of the participants were in top-heavy plans that used 3-year cliff schedules. About 24 percent were in top-heavy plans with other, faster schedules.

TRA Scenario 1

Under Scenario 1, for participants in plans using TEFRA's 2-to 6-year graded vesting schedule or 3-year cliff vesting schedule, we estimated the number of participants that would not have been vested had the plans used TRA's 5-year cliff vesting schedule instead. Participants who were not vested under the top-heavy rules would not have been vested in this scenario. Similarly, participants with fewer than 5 years of service who may have been partially or fully vested would not have been vested. However, participants with 5 or more years of service who were partially vested under the top-heavy rules would have been fully vested under this scenario.

We assumed no change for plans using schedules with full vesting sooner than the top-heavy schedules; for example, immediate vesting, 1- to 5-year graded vesting, or 2-year cliff vesting. We assumed employers sponsoring these plans would continue to give participants vested benefits at a rate faster than required.

TRA Scenario 2

In Scenario 2, we assumed each top-heavy plan's type of vesting (graded or cliff) remained the same, but the TRA time limits were used. For participants in plans using 2- to 6-year graded vesting, we assumed TRA's

3- to 7-year graded vesting. Among these participants, those who had been partially vested and some who had been fully vested would have had 1 year less of vesting credit. Those who were not vested would have remained not vested. Those who were fully vested and had 7 or more years of service would have remained fully vested.

For participants in plans using the 3-year cliff schedule, we assumed TRA's 5-year cliff schedule. Among these participants, those with fewer than 5 years of service who had been fully vested under the top-heavy rules would not have been vested in this scenario. Those who had not been vested would have remained not vested. Those who had been fully vested and had 5 or more years of service would have remained fully vested. As with Scenario 1, we assumed faster schedules did not change.

More Participants Would Not Have Been Vested Under TRA

Many more participants would not have had vested benefits if TEFRA's top-heavy rules had been repealed and top-heavy plans had adopted the changes assumed in either TRA Scenario. In Scenario 1 (where we assumed most participants were under TRA's 5-year cliff schedule), the estimated percentage of participants not vested in their pension benefits would have about tripled (from 13 percent to 40 percent), as shown in figure 1. If top-heavy plans kept the same type of schedules (graded or cliff) and used TRA's time limits (Scenario 2), the percentage of participants not vested would have increased from 13 percent to about 23 percent, according to our analysis. (See app. III.)

Under top-heavy rules participants were vested in about 66 percent of accrued benefits on average. Without top-heavy rules, this average vesting percentage would have been about 57 percent.

For a participant who would have lost vesting status had top-heavy rules been replaced by TRA's rules, the effect on retirement income would likely be small, and would occur only if she or he left the job before fully vesting.[10] Consider the 27 percent of participants in Scenario 1 who had at least partially vested benefits under the top-heavy rules and would have had no vested benefits under TRA's 5-year cliff schedule. If these participants left their jobs before fully vesting (in this case, with fewer than 5 years of service), they would have had no vested benefits for retirement using TRA rules. But this would compare

[10]For more information on how job mobility can adversely affect workers' pension incomes in retirement, see Private Pensions: Portability and Preservation of Vested Benefits (GAO/HRD-89-15BR, Feb. 3, 1989).

Figure 1: More Participants Would Not Have Been Vested Under TRA

Note Total 346,000 participants

with a relatively small vested benefit under the top-heavy rules. Even with the top-heavy rules on minimum benefits and contributions,[11] pension benefits for shorter-tenured participants in the early years of participation are likely to be relatively small. This is because these participants have few years of service and tend to have lower salaries than they would at retirement.

[11] The top-heavy rules that specify minimum benefits and contributions for non-key participants are discussed on pp 9-10 and 16-22

Rate of Increase in Proportion Not Vested Greater for Men Than Women Under TRA

Men would have been disproportionately affected if top-heavy rules had been replaced by TRA's rules under either scenario. Although the absolute percentage point increase in the proportion not vested was similar for men and women, the proportion of men who would not have been vested increased at a greater rate than the proportion of women. Consequently, although a greater proportion of women than men were not vested under both the top-heavy rules and the TRA scenarios, the differences between women and men were less under TRA.

Comparing top-heavy and TRA rules under Scenario 1, 4.4 times as many men would not be vested (35 percent versus 8 percent) compared with 2.4 times as many women (43 percent versus 18 percent). (See fig 2.) Likewise, under Scenario 2, 2.4 times as many men would not be vested (19 percent versus 8 percent) compared with 1.5 times as many women (27 percent versus 18 percent).

The average vesting percentages for both men and women would have been less if TRA's vesting rules had been applied to top-heavy plans under either scenario. Men were vested in about 72 percent of accrued benefits under top-heavy rules and would have been vested in about 63 percent using TRA's vesting rules. For women, this average vesting percentage would have dropped from about 62 percent under top-heavy rules to about 53 percent.

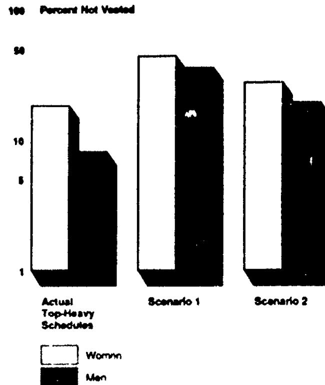
Scope and Methodology of GAO's Analysis of Top-Heavy Minimums

Top-heavy minimum rules differed for defined benefit and defined contribution plans, so we performed separate analyses for these two types of plans. Our analysis of the defined benefit minimums represented about 9,000 plans with about 42,000 non-key participants.[12] Our analysis of the defined contribution minimum represented about 17,000 plans with about 100,000 non-key participants.

We focused our analysis on non-key participants in these top-heavy plans because it is these participants that top-heavy rules were designed to help. Because our data did not distinguish between key and non-key

[12] Our analysis of the top-heavy minimums focused on those cases where the employer sponsored only one top-heavy plan. Because of time and data constraints, we did not include cases where top-heavy minimums were more complicated—namely, those where the employer sponsored more than one top-heavy plan.

Figure 2: Rate of Increase Greater for Men Than Women Under TRA



Notes: 182,000 women and 164,000 men. A logarithmic scale was used to illustrate relative rather than absolute changes in the proportions of men and women not vested.

participants using the criteria established under law, we classified participants with reported annual compensation less than $50,000 as non-key participants.[13]

To identify plans and non-key participants that were not affected by the top-heavy minimums, we compared each non-key participant's accrued benefit or employer contribution with applicable TEFRA minimums. (See app. II.) In some cases the participant's accrued benefit or contribution did not exceed the minimum. Because of time and data constraints, we could not determine whether this was due to the plan formula or the minimum rules. Therefore, we categorized these cases as "may be affected."

[13] TRA created a new classification of employees (for purposes unrelated to determining top-heavy status). TRA's "highly-compensated employees" include two categories of TEFRA's key employees—5 percent owners and officers. However, the highly-compensated group also includes employees who earn more than $50,000 but have no ownership interest and so are not considered key employees.

Over One-Half the Defined Benefit Plans Not Affected

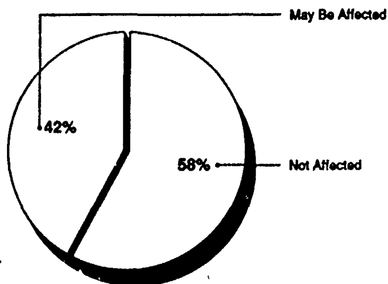
We estimated that 58 percent of the defined benefit plans in our study population were not affected by the minimum benefit rule (see fig. 3). Every non-key participant in each of these plans had a total accrued benefit exceeding the minimum.

Unaffected plans contained about 28 percent of all the non-key participants. On average, they had fewer non-key participants than the other defined benefit plans in our study.

Many Participants in Defined Benefit Plans Not Affected

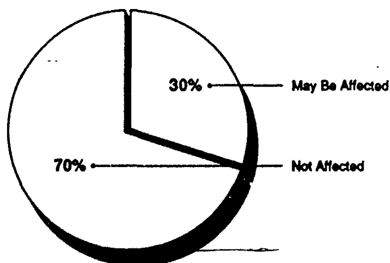
In addition to the 28 percent of participants in plans not affected, many participants in plans that "may be affected" also had benefits above the minimum. In total, we estimated that 70 percent of the 42,000 non-key participants represented in our analysis had total accrued benefits greater than the minimum and so were not affected. (See fig. 4.)

Figure 3: Over One-Half the Defined Benefit Plans Not Affected



Note Based on 9,000 defined benefit plans for which we had complete information

Figure 4: Many Participants in Defined Benefit Plans Not Affected



Note Based on 42,000 non-key participants for which we had complete information

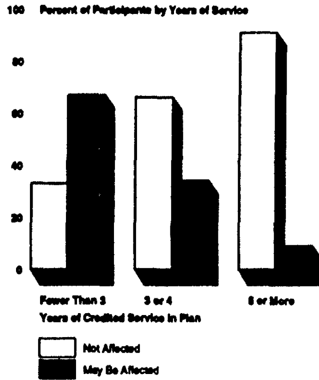
More Short-Service Participants May Be Affected in Short Term

After 2 years of operation, the top-heavy defined benefit minimum appeared mainly to affect short-service plan participants (fewer than 3 years of service) in our analysis. Long-service participants were more likely to have total accrued benefits greater than the top-heavy minimum in the short term. As shown in figure 5,

- about 91 percent of non-key participants with 5 or more years of service were not affected,
- about 66 percent of non-key participants with 3 or 4 years of service were not affected, and
- about 33 percent of non-key participants with fewer than 3 years of service were not affected.

Some long-service workers in our analysis may have accrued benefits greater than the minimum because any benefit accruals, whether or not attributable to years for which the plan was top-heavy, may be used to satisfy the defined benefit minimum. As the top-heavy minimum benefit increases with additional top-heavy years, more long-service workers may be affected.

Figure 5: More Short-Service Participants May Be Affected in Short Term

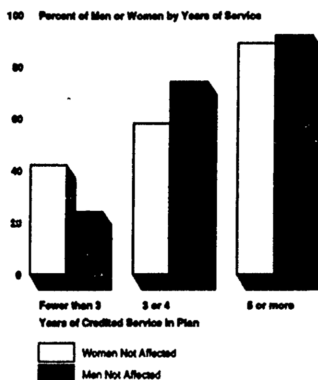


Note Basec on 42,000 non-key participants for which we had complete information

More Short-Service Men Than Women May Be Affected

The minimum benefit rule appeared to affect more short- service men than women after 2 years of operation. Fewer short-service men than women accrued benefits in excess of the defined benefit minimums and so were not affected by the minimums (24 percent versus 42 percent). (See fig. 6.) Among participants with longer service, the differences in the proportion of men and women who were not affected by the minimum benefit rule were not statistically significant at the 95-percent confidence level.

Figure 8: More Short-Service Women Than Men Not Affected



Note. Based on 20,000 women and 22,000 men in defined benefit plans for which we had complete information.

Most Defined Contribution Plans Not Affected

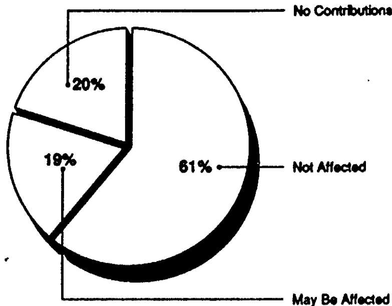
We estimated that in 61 percent of the defined contribution plans in our study employer sponsors made contributions greater than required by the minimum contribution rules. (See fig. 7.) All non-key participants in these plans received contributions greater than 3 percent of annual compensation. About 49 percent of all non-key participants in defined contribution plans in our analysis were in these plans.

Most Participants in Defined Contribution Plans Not Affected

In addition to plans in which every non-key participant received a contribution greater than the minimum, other plans contained some participants that received contributions in excess of the minimum and some that did not. (See fig. 8.) In total, we estimated that 85 percent of participants in plans where contributions were made received contributions greater than the minimum required and so were not affected by the minimum.[14]

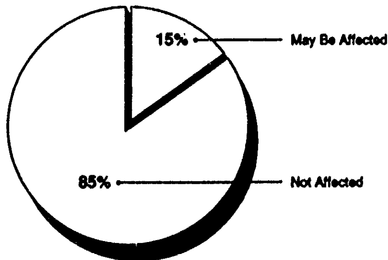
[14]As noted earlier, in a defined contribution profit-sharing plan, the employer's contribution is a function of profits. The employer may not make contributions each year. Employer sponsors made no contributions for about 20 percent of the defined contribution plans containing about 25 percent of the participants.

Figure 7: Most Defined Contribution Plans Not Affected



Note Total 17,000 plans

Figure 8: Most Defined Contribution Plan Participants Not Affected



Note Total 72,000 participants in 13,000 plans with contributions.

GAO's Sample of Plans Sponsored by Small Employers

From Employee Retirement Income Security Act (ERISA) reports for employee benefit plans filed for the plan year beginning during 1984,[1] we drew a sample of private pension plans operating in both 1984 and 1985 sponsored by employers with fewer than 100 employees (small employers). The reports maintained by the Internal Revenue Service were the most up-to-date information available to us on pension plans operating in 1984 and 1985, but did not include plans that began operating in 1985. Consequently, our sample includes only plans that started before 1985.

We estimated from the ERISA reports that 202,299 plans sponsored by small employers met our sampling criteria. That is, the plans were:

1. ongoing plans of the four most prevalent types—fixed-benefit and unit-benefit defined benefit plans, and profit-sharing and money-purchase defined contribution plans;[2]

2. in one of the five industry groups with the most of these types of plans: wholesale trade; retail trade; finance, insurance, and real estate; legal, medical, and health services; and other serviees;[3]

3. sponsored by a single employer with fewer than 100 employees;

4. plans with more than one participant, and,

5. not Keogh plans for self-employed individuals.

Table I.1 shows the distribution of the universe and sample among the selected plan types and industry groups.

[1] The Form 5500-C for plans with fewer than 100 participants.

[2] A fixed-benefit plan provides a retirement benefit that is not related to the years of service of the plan participant; e.g., a specified percentage of compensation, such as 50 percent of the participant's final pay. A unit-benefit plan uses a formula that provides an explicit unit of benefit for each recognized year of service with the employer; e g., 1 percent of compensation per year of service In contrast, rather than fixing benefits by a formula, profit-sharing and money-purchase plans fix the amount of the employer's contribution to each participant's account. In a profit-sharing plan, the total employer contribution to all participants is a function of profits, and the amount contributed to each participant is generally in proportion to the participant's share of total compensation paid to all participants. In a money-purchase plan, the employer is committed to periodic contributions according to a specific formula, usually a percentage of salary

[3] Omitted industry groups included agriculture, mining and construction, transportation, communications, and utilities, durable and nondurable manufacturing, tax-exempt organizations, and other industries.

Table I.1: The Universe and Sample of Plans Sponsored by Small Employers

Fixed Benefit Plans	Original universe	Original sample	Eligible[a] sample	Adjusted universe	Response rate	Population estimate
Wholesale trade	3,855	31	20	2,487	85	2,114
Retail trade	3,356	17	10	1,974	80	1,579
Finance, insurance, and real estate	4,416	25	10	1,766	60	1,060
Legal, medical, and health services	17,646	119	78	11,566	59	6,821
Other services	11,054	71	39	6,072	54	3,270
Unit Benefit Plans						
Wholesale trade	478	34	27	380	78	296
Retail trade	430	28	24	369	71	261
Finance, insurance, and real estate	984	53	39	724	72	520
Legal, medical, and health services	1,659	82	51	1,032	61	627
Other services	936	56	34	568	65	368
Profit Sharing Plans						
Wholesale trade	10,942	33	23	7,626	61	4,642
Retail trade	11,254	20	15	8,441	80	6,753
Finance, insurance, and real estate	9,902	21	9	4,244	78	3,301
Legal, medical, and health services	44,633	94	61	28,964	70	20,417
Other services	25,605	81	37	11,696	41	4,742
Money Purchase Plans						
Wholesale trade	3,431	16	11	2,359	64	1,501
Retail trade	3,254	15	10	2,169	100	2,169
Finance, insurance, and real estate	4,881	24	12	2,441	67	1,627
Legal, medical, and health services	31,698	153	98	20,303	65	13,112
Other services	11,885	50	22	5,229	55	2,852
Total	**202,299**	**1,023**	**630**	**120,410**	**65[b]**	**78,031[c]**

[a]Originally sampled plans were ineligible if they were (1) Keogh plans for self-employed persons, (2) plans with only one participant, (3) sponsored by employers with 100 or more employees, or (4) terminated during the 1984 plan year

[b]The total response rate is weighted to represent industry and plan types in proportion to their representation in the universe

[c]Population estimate has total precision of ± 5,471 plans (± 7 percent)

Our original stratified sample included a total of 1,023 plans selected from each of the four plan types. Within each plan type, we sampled from the five selected industry groups, generally in proportion to each group's representation in the universe. We determined the final sample size of 630 and adjusted our universe estimates after we identified 393 cases in the original sample that did not meet our sampling criteria. The adjusted universe included an estimated 120,410 plans (± 7,373).

Among these 630 sampled plans, 65 percent (407) responded across all sampled plan types and industries. We compared respondents and nonrespondents on several characteristics—plan size, top-heavy status, integration with social security, vesting method, industry, and plan type—and found some significant differences. For example, defined contribution plans that did not respond tended to be smaller than those that did. Because of these differences, our estimates apply only to that proportion of the adjusted universe that responded to our survey As indicated in the final column of table I.1, our respondents represent an estimated 78,031 plans (± 5,471). These plans contained an estimated 700,000 participants (± 100,000).

Additional Information on GAO Methodology for Analysis of Top-Heavy Minimums

This appendix contains additional information on the assumptions used in our analysis of top-heavy minimum benefit and contribution rules to determine which top-heavy plans and non-key participants were not affected by top-heavy minimums.

Analyzing the Impact of Minimum Benefit Rules

To identify defined benefit plans and non-key participants that were not affected by top-heavy minimum benefit rules, we first had to estimate each participant's accrued benefit as a percentage of the participant's average annual compensation and determine the applicable top-heavy minimum. In making these estimates, we

- included participants' accruals before 1984,
- estimated total average annual compensation,
- omitted participants with no reported accrued benefit, and
- assumed plans were top-heavy in 1984.

In determining whether a plan or participant was affected by minimum benefit rules, our analysis included participants' accruals credited to the years before 1984. Under TEFRA, any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used to satisfy the defined benefit minimums.

We modeled wage growth for the 5-year period from 1981 to 1985 (or the participant's tenure with the company, whichever was less), to estimate each participant's average compensation for our analysis. The top-heavy rules required a test of the total accrued benefit as a percentage of average annual compensation, and our data contained compensation for only 1 year. We used three different rates of annual wage growth—0, 4-, and 10-percent—to test the sensitivity of the results to changes in average annual compensation. The results in this briefing report were based on 4-percent wage growth. (See table II.1 for the results of the sensitivity analysis.)

Table II.1: Results of Sensitivity Analysis for Impact of Defined Benefit Minimums

Figures are percentages

	Wage growth assumption		
Estimate of	**0**	**4**	**10**
Plans not affected	58	58	60
Participants not affected	66	70	73

We did not include 4 percent of the participants in our survey because they received no accrued benefit, according to survey responses. We assumed these were family members included in the plan who received no accrued benefits. Under top-heavy rules, family members may be considered key employees, and key employees are not required to receive minimum benefits.

For analysis purposes, we assumed that plans that were top-heavy in 1985 were also top-heavy in 1984. Therefore, some participants and plans that we identified as "may be affected" actually may not be affected. This will occur in the case of a defined benefit plan that was top-heavy in 1985, but not in 1984. In this case, the 4-percent threshold we used (2 percent times 2 top-heavy years) would be higher than the applicable threshold of 2 percent. However, given the relatively small size of plans in our analysis, and the general rule that the smaller the plan the more likely it is to be top-heavy, the effect of this assumption is likely to be small, in our opinion, because most plans were probably top-heavy in both years.

Criteria for Application of Rules

We used the following criteria for identifying plans and non-key participants that were not affected and that may be affected by the minimum benefit and contribution rules for top-heavy plans.

Applying Defined Benefit Minimums

Non-key participants in defined benefit plans were not affected by the minimum benefit rules in our analysis if their total accrued benefits exceeded the minimum. For non-key participants with 1 year of service, if the total accrued benefit in 1985 was more than 2 percent of annual compensation (2 percent times 1 top-heavy year), we concluded the participant was not affected. For participants with 2 or more years of service, if the total accrued benefit in 1985 was more than 4-percent of average annual compensation (2 percent times 2 top-heavy years), the participant was not affected. We used a 4-percent threshold for these participants because the top-heavy rules had been in effect for 2 years, 1984 and 1985, during the period covered by our data, and we assumed the plan was top-heavy both years. (Top-heavy minimum benefit rules have a maximum of 20 percent of compensation; however, this maximum will not affect participants' benefits until a plan has been top-heavy for more than 10 years.)

Table II.2 demonstrates the application of these criteria for three illustrative non-key participants. The total accrued benefits of participants A and B match the top-heavy minimum benefit. Because of time constraints and data limitations, we could not identify the actual plan benefit formula, so we could not determine whether the accrued benefits for these two participants were due to top-heavy minimums or the plan's benefit formula. We concluded that these participants may be affected by top-heavy minimums. We also concluded that participant C was not affected by top-heavy minimums because that participant's accrued benefit exceeded the top-heavy minimum benefit in 1985.

Table II.2: Applying Top-Heavy Defined Benefit Minimums

	Illustrative non-key participants		
1985 Characteristics	A	B	C
Years of service	1	2	3
Total accrued benefit (as percentage of average annual compensation)	2	4	5
Top-heavy minimum benefit (as percentage of average annual compensation)	2	4	4
Status	May be affected	May be affected	Not affected

Defined benefit plans were categorized as not affected by minimum benefit rules if every non-key participant in the plan earned a total accrued benefit in excess of the applicable minimum (2 percent or 4 percent of average compensation, depending on tenure).

Applying Defined Contribution Minimums

In our analysis, we considered a non-key participant in a defined contribution plan to be not affected by the minimum contribution rule if the annual contribution for that participant was more than 3 percent of her or his annual compensation. Defined contribution plans were categorized as not affected by the minimum contribution rule if every non-key participant received a contribution greater than 3 percent of annual compensation.

Impact of Our Proxy Identifying Non-Key Participants on Our Estimates

In about 20 percent of the top-heavy plans in our study population no participant earned $50,000 or more (our proxy separating key and non-key participants). However, by definition, each top-heavy plan must contain at least one key participant, so the results concerning non-key participants reported here included some key employees. Including some key employees in our analysis would result in an overestimate of the

number of participants that were not affected by the minimum rules. However, estimates of the number of plans not affected would remain valid. Even if some key participants were included in our analysis of non-key participants, all non-key participants had to have been "not affected" for the plan to have been categorized as not affected. Therefore, plans categorized as not affected would still be correctly categorized.

Appendix III

Vesting Status of Participants in Top-Heavy Plans Under Top-Heavy Rules and Tax Reform Act Scenarios

Figures are percentages[a]

	Vesting status		
	Top-heavy rules	Scenario 1[b]	Scenario 2[c]
All participants (total 346,000)			
Fully vested	48	57	44
Partially vested	39	4	33
Not vested	13	40	23
Total	**100**	**100**	**100**
Women (total 182,000)			
Fully vested	43	51	40
Partially vested	39	5	33
Not vested	18	43	27
Total	**100**	**100**	**100**
Men (total 164,000)			
Fully vested	53	63	49
Partially vested	39	2	33
Not vested	8	35	19
Total	**100**	**100**	**100**

[a]Totals may not add due to rounding

[b]Scenario 1: Plans using top-heavy vesting schedules of 2- to 6-year graded vesting and 3-year cliff vesting assumed to use TRA 5-year cliff vesting. Faster vesting schedules assumed to stay the same

[c]Scenario 2: Plans using top-heavy's 2- to 6-year vesting assumed to use TRA's 3- to 7-year graded vesting, plans using top-heavy's 3-year cliff schedule assumed to use TRA's 5-year cliff. Faster vesting schedules assumed to stay the same

BEST AVAILABLE COPY

PREPARED STATEMENT OF DALLAS L. SALISBURY [1]

I am pleased to appear before you this morning to review the rules governing private pension plans and their possible impact on pension participation and coverage. My name is Dallas Salisbury. I am the president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC. EBRI has long been committed to the accurate statistical analysis of public policy benefits issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies.

PENSION LAW

For over 50 years, the Federal Government has sought to encourage the establishment of pension plans through tax incentives. At the same time, public policy has been directed toward ensuring that plans are financially sound and equitable. Some observers have questioned whether these changes are having the unintended effect of impeding pension growth. Because pension plan administration has become such a complex and expensive field, some fear that recent legislation has eroded employers' incentives to provide pension plans. Others suggest that since plan provision is very limited in small businesses, additional incentives are needed to bolster pension coverage in the future.

EBRI has undertaken extensive analysis over the past 12 years to track and assess pension trends. Three facts are particularly clear: first, small employers are moving away from defined benefit plans; second, they are not immediately replacing them with defined contribution plans; and third, the cost of administering plans relative to the amount that can be contributed has been eroding.

Early legislation such as the Revenue Act of 1921 and the Revenue Act of 1926 first provided tax-deferred status to pensions. In particular, profit sharing plans gave employers the flexibility to forgo contributions in those years in which profits were low. The Self-Employed Individuals Tax Retirement Act of 1962 allowed small unincorporated business owners to start pension plans for themselves and their employees for the first time through Keogh plans.

The Employee Retirement Income Security Act of 1974 (ERISA), however, represents the most important landmark in pension legislation. ERISA provided participation and vesting standards, fiduciary and funding requirements, and it strengthened reporting and disclosure rules. In general, ERISA focused on safeguards for pension plan participants.

Since the enactment of ERISA, a steady stream of legislation has greatly influenced pension programs. From the Revenue Act of 1978 to the Omnibus Budget Reconciliation Act of 1989, Congress has changed some aspect of the retirement system almost annually.

The Revenue Act of 1978 expanded the opportunity to save for retirement on a tax-preferred basis by permitting employers to establish 401(k) arrangements. Through 401(k) arrangements, participants may contribute a portion of compensation to a qualified employer-sponsored plan. Typically, the contribution is made as a pretax deduction in (or deferral of) salary that is paid into the plan by the employer on behalf of the employee.

The Revenue Act of 1978 also created simplified employee pensions (SEPs) as a low cost way for small employers to start a pension plan.

The Economic Recovery Act of 1981 (ERTA) raised Keogh plan contribution and benefit limits and the dollar limit on SEP contributions.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) placed self-employed businesses on an equal footing with corporation by making contribution and benefit limits the same for all pension plans. Under TEFRA, so-called "top heavy" plans—those in which more than 60 percent of benefits were going to "key" employees—were required to provide minimum benefits or contributions to rank-and-file workers, provide for faster vesting standards, and placed stricter limits on allowable benefits for key employees.

The pace of legislative change continued with the Deficit Reduction Act of 1984 (further reducing the limits on maximum plan contributions and benefits), the Retirement Equity Act of 1984 (reducing the minimum age of plan participation from 25 to 21), and the Single-Employer Pension Plan Amendments Act of 1986 (restrict-

[1] The views expressed in this statement are solely those of the author and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff. The Employee Benefit Research Institute is a non-profit, non-partisan public policy research organization.

ing the terms under which pension plans can terminate and increasing the termination insurance premiums that single-employer plans must pay).

The Tax Reform Act of 1986 (TRA '86) marked a reversal in U.S. retirement policy, reducing incentives for retirement savings. It capped the amount of allowable individual pretax contributions to a 401(k) at $7,000 (indexed), significantly reduced the overall limits on both defined benefit plans and defined contribution plans, narrowed the circumstances under which money can be withdrawn from defined contribution plans, increased taxes on preretirement withdrawals in some cases, restricted income averaging, and modified the tax treatment of capital gains.

Pension changes were also included in budget bills in 1986 and 1987. In 1986, plans were required to continue benefit contributions or accruals regardless of age for workers participating in defined contribution or defined benefit plans. In 1987, the single-employer defined benefit termination insurance premium was raised and funding rules were changed substantially.

Pension legislation has served to increase the security of benefits for those with coverage, and it has created many jobs. It has not led to an increase in the proportion of workers covered by pension plans.

During the budget negotiations of 1989, various proposals that would affected pensions and retirement income, including those calling for joint trusteeship, user and exit fees, Pension Benefit Guaranty Corporation (PBGC) premium increases, and ERISA penalty fees, were carefully considered. Many of these proposals were not enacted in 1989, but continued scrutiny of their administration and design is anticipated in 1990.

TRENDS IN PENSION COVERAGE

Employer-sponsored pension plans represent an important source of retirement income for most working Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement (CPS EBS), in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of all these participants, or 32 million workers, were entitled to a benefit at retirement.

Defined benefit plans have historically been the cornerstone of the private pension system with an estimated 38 million participants and beneficiaries, and $1.36 trillion in trusteed assets. But recently, an increased number of defined benefit terminations, a slower rate of defined benefit plan formation, and fundamental redesign of traditional "final pay" defined benefit plans into "cash balance" defined benefit plans suggests that U.S. employers are reevaluating the appropriateness of these plans.

Increasingly, there has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975 (chart 1).

The nature of this apparent shift in emphasis from the traditional defined benefit plan to the newer defined benefit and defined contribution plans has been a source of continued evaluation. Experts offer varying observations on the potential reasons: increased regulation of traditional defined benefit plans, increased administrative cost due to regulation, an increasingly mobile work force who may be better served with a "cash balance" or defined contribution plans, Federal tax laws that have created incentives for new defined contribution arrangements, and the lowering of basic income tax rates, which has reduced the effective tax incentive for plans.

Many maintain that government regulation has made defined benefit plans too costly, prompting plan sponsors to offer no pension plan or to shift to generally less burdensome defined contribution plans (see EBRI, *What is the Future of Defined Benefit Pension Plans?*, 1989).

One of the most significant trends in pension coverage has been the tremendous growth of 401(k) plans over the past decade. More than 27.5 million workers were covered by 401(k) plans in May 1988, up from 7.1 million in May 1983. These figures represented 24.2 percent and 7.1 percent of all workers, respectively. Participation grew from 2.7 million workers (2.7 percent of all workers) in 1983 to 15.7 million (13.8 percent of all workers) in 1988.

An increasing number of workers are relying on 401(k) plans as their primary employer-based retirement plans, especially 401(k) participants at small firms. The 1988 CPS EBS found that more than 49 percent of 401(k) plan participants reported

that this was their primary employer pension plan. Among 401(k) participants working for employers with 250 or more employees, 43.5 percent had a primary 401(k); this proportion increased to 79.5 percent for 401(k) participants in establishments with fewer than 10 employees.

The future of 401(k) sponsorship and participation is uncertain. Passage of TRA '86 does not appear to have slowed 401(k) plan growth, although that possibility remains as more restrictive provisions of the law become fully effective. Final regulations addressing hardship withdrawals and loans, released in August 1988 and July 1989, respectively, could arguably be a deterrent to employee participation and create administrative problems for some employers. However, this cannot be assessed fully until the provisions have been in effect longer.

PENSION COVERAGE BY SMALL EMPLOYERS

The gap in private-sector pension coverage for workers appears to be largely among small employers. The latest data indicate that more than 68 percent of full-time employees in companies with 250 or more employees participate in retirement plans, while, by contrast, only 16 percent of full-time employees in companies with less than 24 employees do so (chart 2).

Some members of Congress and other policymakers have indicated concern about potential costs to society and to future retirees themselves if employer-sponsored pension coverage fails to continue the expansion of the past 15 years, supplementing Social Security and private savings.

To meet this challenge of providing additional coverage, a number of legislative proposals specifically aimed at small employers have been introduced in Congress in recent years. But the benefits that small employers provide must be viewed within the context of the nation's retirement income system and the economy as a whole if we are to judge whether national needs are being met.

THE ECONOMICS OF REGULATION

In a recent EBRI study, *Pension Policy and Small Employers: At What Price Coverage?*, author Emily Andrews examines the impact of pension legislation on pension plan growth based on the economic theory that employers will balance the costs of instituting a pension plan against the benefits they receive.

According to Andrews, the favorable tax treatment provided pension plans reduces the costs of plan sponsorship. Since pension contributions are treated as current business expenses, funded plans are a good business decision. Pension plans are also regarded favorably by employees because they can defer individual income taxes on pension contributions until retirement. By making benefits more secure, ERISA may have increased the demand for pensions among employees. The provisions that may have made pension coverage more attractive include funding standards, PBGC insurance, vesting and participation standards, and better information about plans through summary plan descriptions.

Since pension law encourages different types of plans, employers can match pension sponsorship to their business situation. In particular, developments such as Keogh plans, 401(k) plans, and SEPs may have made tax-favored pensions more attractive to small employers.

Other provisions may impose additional costs on employers, however. Funding and fiduciary standards reduce the employer's flexibility to finance corporate expansion through retained earnings. PBGC premiums are a direct cost imposed on a per participant basis for defined benefit plans. Plan descriptions and other reporting requirements also directly increase the administrative costs of the plan.

Restrictions that cap contributions and benefit payments also make pension plans less appealing, particularly for those motivated by the tax deferral on contributions.

The Retirement Equity Act of 1984 also may have raised the costs of plan provision for some employers. The required five-year break-in-service provision increases recordkeeping costs, particularly in firms with high employee turnover.

Conclusion

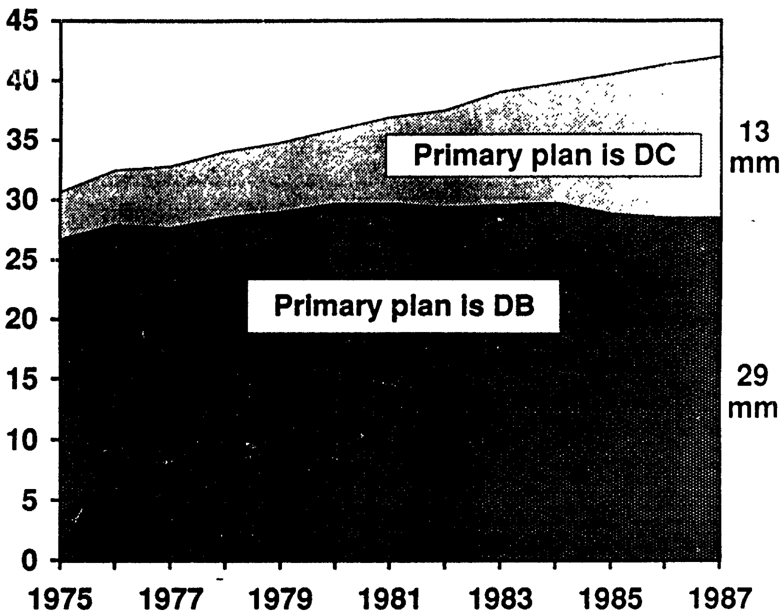
A constant theme reiterated by employers is their concern about regulatory complexity and frequency of legislative change. Large employers can and do afford the costs, which can be small on a per employee basis. For small employers, however, complex regulations require costly expert advice in establishing and maintaining a pension plan and the costly revision of plan documents. Changing regulatory and enforcement approaches by regulatory agencies add to both the cost and confusion. Thus, no matter what the nature of the change, if it is frequent or complex, it will be costly. When combined with laws and regulations that make it increasingly difficult to fund a plan, attractiveness fades further. And, when considered against

other tax preferences, in light of today's low tax rates, the reluctance of small employers to expand pension coverage may be quite understandable.
Attachment.

Chart 1

Growth in private pension participation is all DC

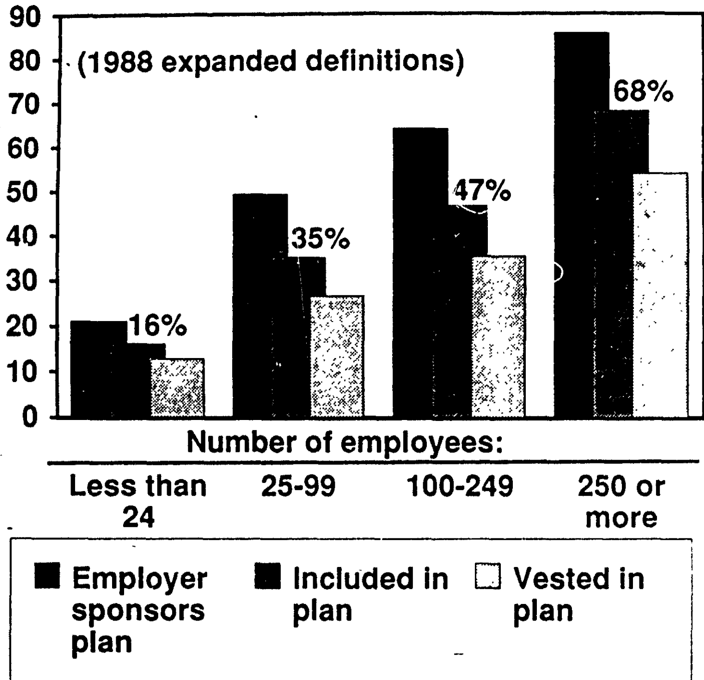
Millions of active participants



Source: Employee Benefit Research Institute

Chart 2

Firm size remains a key factor in pension coverage



Source: Employee Benefit Research Institute

PREPARED STATEMENT OF ELMER VAN EGMOND

The American Association of Retired Persons is pleased to testify on the important issue of pension simplification. The Association believes that pension simplification, while an important objective, must at the same time balance the needs of plan sponsors, plan recipients, and pension and tax equity.

BACKGROUND

AARP has long supported improvements in the private pension system in order to make it a more stable and reliable source of retirement income. While Social Security supplies a floor under retirement income, the private pension system (as well as personal savings, and continued full or part-time employment for some) must *supplement* Social Security to adequately ensure retirement income security.

The private pension system has made great strides over the years towards meeting its goal of becoming a reliable source of retirement income. Despite these advances, a number of deficiencies remain. Today, just over one-quarter of individuals receive private pension income, and the amount often tends to be relatively small. In addition, while future pension receipt is expected to rise, only about one-half of all current employees are covered by a private pension plan.

It is important to note that the tax system, and therefore the American taxpayer, has a large stake in pension plan fairness. The Federal tax subsidy for the pension system is approximately $50 billion per year, the single largest Federal tax expenditure. This large figure merely emphasizes the importance of pension savings for retirement income security. Because pension benefits receive a large tax subsidy, the American public also expects these benefits to be distributed equitably.

This goal of tax and pension equity has resulted in a number of meaningful pension changes over the past several years. In particular, the Tax Reform Act of 1986 addressed important pension issues and substantially improved pension equity. Changes such as shorter vesting periods, reduced integration of pensions with Social Security, and strengthened coverage rules will further the fair delivery of pension benefits.

A number of recent pension changes, however, have been primarily motivated by the need to raise revenue. While the Association is mindful of the need, given the current Federal deficit, to weigh carefully the value of any tax subsidy, we believe that revenue-driven changes that adversely impact long-term retirement security objectives should be avoided.

SIMPLIFICATION IN THE FACE OF COMPETING INTERESTS

Simplification must achieve a three-way balance among plan sponsors, plan participants, and pension and tax equity. It is not enough to say that simplification of the rules for plan sponsors would improve the pension system. If plan participants are adversely affected, particularly lower-paid employees, then simplification would merely reduce pension equity. Alternatively, if simplification means additional revenue loss to the Treasury, with no corresponding increase in the equitable delivery of pension benefits, then simplification would merely increase benefit discrimination in favor of higher paid employees.

In reference to tax reform, it was often said that "Nothing simple is fair, and nothing fair is simple." Nowhere in tax law may this be more true than in the pension provisions. However, the current nature of the pension system requires substantial rules. As mentioned above, the tax expenditure for pensions is the single largest in the tax code. Second, the amount of money currently in pension plans, estimated at over $2 trillion, is the largest pool of money in the world. Third, the pension system is voluntary, allowing employers to choose whether to establish a plan, and giving employers wide variety as to the type of plan (or plans) to establish.

Given the enormity of the system, both in dollars and diversity, it is easy to understand the need for substantial regulation to ensure equity. For example, if simplicity were the only concern, we could merely allow only one specific pension formula for all plans. Of course, this is not consistent with the flexibility which plan sponsors currently enjoy, and which may not meet the needs of a diverse work-force. However, it is just this desire to maintain flexibility that leads to increased complexity.

Ultimately, the desire of plan sponsors to remain free to establish individually tailored pension plans can run up against the interests of plan participants and pension and tax equity. These resulting conflicts necessitate parameters in the pension laws in order to balance the competing interests. Because of the wide range of plan design possible, defining such parameters tends to be both difficult and complex. The end result, as plan design moves to the permissible limits, is a labyrinth of pen-

sion laws designed to balance these interests. As long as maximum flexibility in plan design is maintained, correspondingly lengthy rules are needed. This is the inevitable result in a system where "Nothing simple is fair, and nothing fair is simple."

Given the difficulty of the task, current efforts to simplify pension law while balancing all three above points of view are laudable. The Association believes that there is enough common ground and need for pension simplification that efforts at simplification can be both productive and worthwhile. However, the Association would oppose, and strongly cautions against, those changes that while simple on their face, undermine the basic fairness we seek in our pension laws.

SIMPLIFICATION—RECOMMENDATIONS

In order to further efforts at simplification, the Association has several recommendations that would simplify plan design and understanding, meet the needs of plan participants, and further the objectives of pension and tax equity. The following recommendations, while not exhaustive, attempt to simplify several important aspects of our pension laws.

Eliminate Pension Integration (Permitted Disparity)

Both pre- and post-tax reform law provide nondiscrimination standards for pension plans which generally prohibit providing pension benefits that favor higher-paid employees. An exception to this general rule pre-tax reform allowed employers to include a portion of each employee's Social Security benefits in determining whether overall benefits discriminated in favor of higher-paid employees. This practice, called pension "integration," permitted employers to offset up to 83-1/3 percent of Social Security benefits. For many employees, particularly lower paid employees, this meant substantial reductions in their expected pension benefits. In many cases, lower-paid employees saw their entire pension eliminated.

Congress recognized that this practice was patently unfair and contrary to the thrust of the tax laws designed to encourage pensions. The pension integration rules were thus modified in tax reform to limit the reduction in employees' pensions. fit the same time, the new "permitted disparity" level set a different standard by which pension benefits may favor higher-paid employees.

While Congress acknowledged the complexity of pre-tax reform Social Security integration rules, they were replaced by equally complex (and still pending) rules on "permitted disparity." In fact, the proposed rules on permitted disparity take up 25 pages of the Federal Register. These rules are confounding not only for plan sponsors, but even more so for pension recipients. Individuals who could not understand how an entire expected pension was eliminated (pretax reform), will be equally mystified at the newly permitted reduction amount. Plan sponsors, both then and now, have the unenviable task of both complying with the integration rules and explaining them. In addition, the new integration rules are prospective only (as of January 1, 1989). Thus, employees will be faced with two different integration formulas (despite the fact the old test has already been declared unfair by Congress) for years worked before and after the effective date.

Aside from complexity, the very existence of the practice of integration is contrary to the goal of pension and tax equity. The phrase "permitted disparity" explains the purpose of the new formulas: the extent to which higher-paid employees, at the expense of lower-paid employees, can be compensated through the pension plan without violating the nondiscrimination rules. These rules merely work to allow a higher degree of discrimination than would otherwise be possible in the pension system. While the old rules were admittedly unfair, the new rules have the same objective, but with added limitations.

While the practice of pension integration has a long history, its continuance can no longer be justified on an equity basis. It is clear that Social Security benefits do not adequately replace the pre-retirement earnings of lower and moderate income earners, nor are they intended to be more than a floor of retirement income. The tax incentives provided to employers to encourage the formation and provision of pension benefits is intended to help supplement the retirement income needs of these employees. Rules which reduce the benefits available to these very workers undermine the basic policy behind our pension laws.

In short, the use of the old Social Security integration and new permitted disparity tests injects an unnecessary degree of complexity and confusion into the pension system. The essence of these rules, to deny benefits to lower-compensated employees, can no longer be justified as a matter of pension and tax equity. Therefore, both to simplify the pension system for employer and employee, and to improve pension

fairness, pension integration should be eliminated entirely for all current employees.

Modify Pension Coverage Test

In general, pension coverage rules are intended to address overall employee participation in pension plans, ensuring that pension plans provide benefits to non-highly compensated employees that are comparable to benefits provided to higher-paid employees. Pretax reform coverage rules essentially required employers to meet one of two tests: a percentage test, which required a plan to benefit a significant percentage of the employer's work-force, or a classification test, which required a determination (with regulatory guidance) that the classification of employees covered did not favor highly compensated employees.

Congress believed that these coverage rules, because they permitted large disparities in the coverage percentages of highly and non-highly compensated employees, were inadequate to ensure coverage of non-highly paid employees. Tax reform modified the coverage tests to better ensure nondiscriminatory treatment of non-highly paid employees. The new test is composed of two tests: the "ratio percentage test" (which requires the percentage of non-highly compensated employees benefiting from a plan to be at least 70% of the highly compensated employees), and the "average benefits test" (which has two parts, a "classification" test, to determine nondiscriminatory coverage, and an "average benefits test," under which the average benefit percentage for non-highly compensated employees must be at least 70% of the average benefit percentage for highly compensated employees.)

The regulations for the new coverage tests, and the various sub-tests, are also still pending. Again, the law increases dramatically in complexity as Congress attempts to draw lines as to what degree of discrimination will be permitted under the coverage rules. This added complexity is the direct result of legislative approval to exclude individuals from pension coverage.

The Association believes the coverage rules can be both simplified and improved to better meet the needs of plan participants and the goal of pension equity. In order to ensure nondiscriminatory treatment, it is essential' to increase the coverage of non-highly compensated employees. The Association believes that pension equity, and future retirement income security, is best served by ensuring more complete coverage of rank and file employees.

The Association therefore recommends modifying the coverage rules to simply require an employer to cover, in any one facility, 100 percent of eligible employees who earn less than the Social Security wage base. If the employer has more than one subdivision, than 80 percent of the aggregate work-force must be covered. This test is simple in its application, and will increase pension coverage for those employees who may be excluded under the current coverage rules. Those lower-paid employees who now tend to be excluded—particularly women and minority members—are generally those most in need of the additional retirement income that will be generated by increased pension coverage.

This test was originally proposed in the 99th Congress in the Retirement Income Policy Act of 1985 (S. 1784/H.R. 3594), the bill that was the basis for many of the pension reforms later incorporated into tax reform.

Simplify Definition of Highly-Compensated Employee

The term highly-compensated employee is part of a number of pension tests for determining whether benefits are provided in a nondiscriminatory manner. Tax reform provided a more uniform definition of the term highly compensated employee, but the term still requires a multi-prong determination. The Association believes that further simplifying this definition would correspondingly simplify those provisions which rely on this determination.

The Association recommends defining a highly-compensated employee as one who either earns over the Social Security wage base or is a five-percent owner. This streamlined definition should still fulfill the essential function of ensuring the nondiscriminatory delivery of benefits to non-highly paid employees.

SIMPLIFICATION—AREAS WHERE CURRENT RULES ARE ESSENTIAL

While simplification is important, there remain aspects of the pension law that must be maintained in order to ensure fairness to plan participants and tax equity. The Association is prepared to work with this committee to further increase simplification in these and other areas, but believes that in many instances rules are essential and cannot be easily modified without undermining the basic protections afforded in the law.

The Association offers the following examples of current benefit protections which must be maintained in order to ensure the equitable provision of benefits. While the tests in these areas may not be as simple as desirable, they remain the best alternatives available. In order to simplify these rules, however, the Association recommends creating model plans, or "safe harbors," to simplify compliance with the necessary restrictions.

Maintain the "Top-Heavy" Rules

The "top-heavy" rules were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The rules were designed to ensure that pension plans that provided a substantial portion of pension benefits to higher-paid employees also provided some benefits to lower-paid employees. A plan is "top-heavy" if more than 60 percent of the accrued benefits (or contributions) are provided to key employees.

In those circumstances where over 60 Percent of the plan's benefits go to higher-paid employees, certain rules apply in order to ensure that lower-paid employees receive a fairer share of the tax-subsidized retirement fund. In particular, a top-heavy plan must provide a faster vesting schedule (3 years, or 6-year graded vesting), a minimum benefit/contribution for lower-paid workers, and an additional limitation on the higher-paid employees.

While these rules apply to all plans, the practical result is that the smaller the plan, the more likely it may be top heavy. This is simply the result of the arithmetic of the plan design the fewer the number of employees, the more likely the greater percentage of benefits will go to higher-paid employees.

The top-heavy rules provide important benefits, particularly for shorter-term, lower-paid workers—again, often women and members of minority groups. Even after the improvements made in tax reform, the top-heavy rules ensure a greater number of vested individuals, and a greater minimum benefit amount in those plans in which the bulk of the tax-subsidized benefits go to higher-paid employees. A recent GAO report ("Impact of vesting and Minimum Benefit and Contribution Rules in Top-Heavy Plans, October 1989) estimated that the number of individuals who would *not* vest in their pension if the top heavy rules were repealed would increase by between 75 and 300 percent.

Even though benefits provided under the top-heavy rules tend to be low, because the individual is shorter-term and/or lower-paid, these individuals are often those most in need of the additional minimum benefits afforded by the rules. Particularly given today's mobile work-force, and the especially high turnover in the small business sector (it is estimated that only 25 percent of employees remain for 3 years), these rules may be the only way to ensure enhanced retirement security for many individuals.

The thrust of pension equity legislation over the past several years has been to ensure that pension plans deliver adequate retirement security to employees *at all wage levels.* Far from making the top-heavy rules obsolete, the tax reform changes complement the existing top-heavy rules. Both seek the same goals: increased vesting of those employees who would otherwise not vest, and increased benefits for lower-paid employees who would receive little, if any, pension benefits. In short, *repeal of the top-heavy rules would be a step back from retirement security for future retirees.*

Instead of repealing rules that have been demonstrated to provide additional benefits for lower-paid employees, this committee should pursue alternative methods for ensuring these benefits. For example, since these rules generally affect small plans, alternative model plans that provide similar benefits, without the necessary testing, will accomplish the goal of simplification. Smaller plans should have less need for individual design, and the small amount of flexibility that is lost through the use of a model plan (or plans) should be more than made up through simplification in compliance. In this way, both pension equity and administrative ease can be accomplished.

Maintain the 401(k) Average Deferral Percentage (ADP) Test:

Under current law, special nondiscrimination rules apply to limit the elective deferrals made by highly-paid employees to 401(k) plans. This limit depends, in part, on the level of elected deferrals made by non-highly paid employees. In general, these rules are intended to ensure that significant contributions made by highly-paid employees are accompanied by comparable participation by lower-paid employees.

In modifying these rules in tax reform, in addition to nondiscrimination concerns, Congress believed that excessive reliance on individual retirement savings (as opposed to employer-provided savings) could result in inadequate retirement income for many rank and file employees. The Association agrees with Congress' concern

that 401(k) plans, and other similar deferred arrangements, should be *supplementary* retirement plans, not the primary employer-maintained retirement plan.

Congress modified the rules in tax reform because it believed that prior law nondiscrimination rules permitted excessive tax benefits for higher-paid employees without ensuring adequate savings by lower-paid employees. Tax reform lowered the elective deferral cap to $7000 (indexed), which does not include employer matching contributions. Currently, with a full employer match, this permits over $15,000 in deferred benefits.

Congress also tightened the "actual deferral percentage" (ADP) test. The new test requires the ADP under a 401(k) plan for eligible higher-paid employees to be equal to or less than either: (1) 125 percent of the ADP of the lower-paid employees, or (2) the lesser of two times, or two percentage points more than, the ADP of non-highly compensated employees. While higher-paid employees may still receive a greater percentage of tax-qualified savings, these new tests were designed to ensure that lower-paid employees receive a fairer share of benefits.

The Association believes this new ADP test must be maintained in order to ensure nondiscriminatory treatment of lower-paid employees. The Association is prepared to assist this committee to create alternative simplified tests that meet similar equitable pension policy goals. For example, additional "safe harbor" tests should be pursued that ensure both participation and adequate benefit amounts for lower-paid employees. One way to accomplish this objective may be to establish model plans that provide significant employer-matching contributions (e.g. 75% match for the first 5%) for lower-paid employees. However, even in these instances, participation by those who do not have sufficient income to save for their own retirement may need to be addressed. In short, *the basic thrust of the ADP test to ensure that lower-paid employees benefit from 401(k) plans should not be undermined.*

OTHER AREAS TO ADDRESS

Several additional pieces of the pension puzzle need re-examination or improvement. Again, the following is a non-exhaustive list of areas that should also be addressed in a comprehensive package.

Part-time and Leased Employees

As the dynamics of the work-force begin to change, it is important that pension policy reflect these changes. As more individuals, whether due to personal or family considerations, begin to exercise more flexible work options (often encouraged by the employer or the Federal government), pension law should not remain inflexible. In addition, as new forms of employment begin to take hold, there must be a corresponding response from the pension system.

Current rules addressing some of these concerns should be maintained and improved. Failure of pension policy to recognize these ongoing changes may displace large numbers of the work-force from valuable and essential retirement benefit coverage.

Reporting and Disclosure

The Association continues to believe that plan documents and plan information are essential to the private pension system. Employer-provided benefits, which can be as high as one-third of an employee's compensation, should continue to be explained and reported on a regular basis.

Many critics have stated that the information is not useful to participants and should therefore be eliminated. Instead, the Association believes that this information should be improved, as well as simplified, in order to provide *meaningful* information to plan participants. In particular, in light of recent questions regarding the ability of the Department of Labor to adequately monitor pension plans, plan reporting may be the first and only line of scrutiny.

CONCLUSION

Pension simplification, an important goal to foster understanding and expansion of the pension system, must be accomplished without retreating from the necessary objectives of individual fairness and tax equity. While many current rules are overly complex, it is often the result of attempting to reconcile the often competing principles of plan flexibility and plan equity.

The Association believes that as a general rule, when these principles conflict, then flexibility must yield. This does not mean that the pension laws must remain complex. However, it does mean that efforts at simplification should not diminish the rights of *all* plan participants, nor retreat from pension and tax equity. In this

way, we can ensure that any changes in pension law will build upon the significant steps taken in the past decade to improve the equitable delivery of retirement benefits.

COMMUNICATIONS

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, bridges, heavy-industrial and municipal-utilities facilities.

The construction industry is composed predominantly of small, family-owned firms competing in local geographic markets. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualifies under the Small Business Administration's definition of a small business.

AGC appreciates the opportunity to offer its comments on the Internal Revenue Code rules governing private pension plans and options for their simplification. AGC believes that existing pension rules are so complex, they are forcing employers to reduce the number of options they offer to their employees and even to terminate their pension plans. AGC supports and encourages the Subcommittee's examination of ways to simplify the pension plan rules and to reduce the costs of compliance.

PROBLEMS

One source of the complexity is the number and rapid pace of the changes to the Internal Revenue Code provisions. There have been seven significant revisions to pension code rules in the last seven years. Each revision added new reporting and information requirements, as well as changing the substantive law.

- The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added additional qualification rules for top-heavy plans, the employee leasing rules and limits on contributions and benefits.
- The Deficit Reduction Act of 1984 (DEFRA) changed the rules relating to top-heavy plans, extended the employee leasing rules and changed the rules for cash or deferred arrangements.
- The Retirement Equity Act of 1984 (REA) added rules on spousal interests, qualified joint and survivor annuities and qualified terminable interest property.
- The Tax Reform Act of 1986 (TRA) substantially altered the pension provisions. It added new minimum coverage and minimum participation rules, revised the rules for cash or deferred arrangements, changed vesting schedules and restricted the use of individual retirement arrangements.
- The Omnibus Budget Reconciliation Act of 1987 contained the Pension Protection Act, which added special funding rules and restrictions on plan terminations.
- The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) increased the employer reversion tax and made numerous changes to the pension rules.
- The Revenue Reconciliation Act of 1989 made extensive changes to the rules on employee stock option plans and changed the penalties for failing to comply with information reporting requirements.

These changes have not furthered Congress' announced goal of encouraging broader coverage of nonhighly compensated workers; rather, they have created layers of numerical and percentage tests. This complexity has increased the costs of providing pension plans with little return in increased pension security or benefits. Employers must hire outside consultants to determine if their plans are qualified. Plans could fail the requirements through no fault of their own. The penalties for failing to comply have been draconian, including complete plan disqualification for failing to comply for one day.

PENSION CODE RULES POSE SPECIAL PROBLEMS FOR THE CONSTRUCTION INDUSTRY

The construction workforce is highly mobile and engaged in physically demanding jobs. As a construction project goes through the different phases of construction, different craft workers are needed at different times. A construction worker may leave and come back to the same employer several times in one year as different projects open and close.

The average annual workforce turnover is 300% for a construction company. For example, if the company's average workforce size is 100, the company generally mails out 300 W-2s. One individual may be both an active and a former employee for several different construction companies in the same area. Merely tracking employees has added significantly to compliance costs. Performing the testing processes which have been added to the pension code for these employees is also very complex.

The construction industry has distinct workforces with different needs. There are craft workers at the job site and in-house office staff. Many relationships between craft workers and construction employers are short-term. Craft workers must regularly move to new sites to continue working, because job sites don't need construction workers once the construction is done. It is often difficult for these workers to vest in a retirement plan, because their time in service with any one company is often too short.

Construction contractors also have salaried in-house staff, including estimators, superintendents and clerical staff. Their tenure with the company is often much longer than the hourly craft worker and they often require long-term training to become efficient at their tasks.

The construction industry has responded to the retirement needs of its highly mobile workforce by designing retirement arrangements in which they can participate almost immediately, vest almost immediately and which are highly portable. The industry has retirement plans for in-house staff as well.

Unfortunately, pension plans developed to cover both types of workforces are being terminated for failure to satisfy the technical tax rules added to the code. Companies trying to comply with the new rules have found themselves forced to streamline their plans and reduce the number of options they offer to their employees because the companies could not handle the complex testing required.

The complexity was increased because employers found it difficult to determine exactly what the rules were. In several instances, new code provisions did not adequately distinguish between multiemployer plans and single employer plans. ID places where there seemed to be a multiemployer plan exception, such as the now-repealed Section 89 and Section 401(a)(26), a conference report or subsequently written interpretation indicated that was not the case.

One of the biggest problems employers face is the lack of guidance for compliance. For example, as part of TRA 1986, Congress required the Treasury Department to issue regulations by February 1, 1988. An IRS already burdened with pension regulation changes from the three preceding acts had to open numerous new regulation projects. In almost every instance the IRS missed the deadlines.

Many of the most important regulations are still not issued, even in proposed form. For example, Section 410(b) prescribes minimum coverage rules. The rules for applying the 70% average benefit test have not been published. Employers do not know how to demonstrate that plans are comparable so that plans can be aggregated for testing purposes. Section 401(a)(4) prescribes the general nondiscrimination rules for qualified plans. Without guidance, employers do not know how to implement the broad rules of that section. Section 414(r) provides special rules for separate lines of business, but there are no IRS regulations defining separate lines of business.

This leaves employers in a difficult position. They could attempt to comply with the new act without guidance, but they run the risk of having their plans disqualified because they don't properly interpret the statute. The IRS permitted employers to postpone revising their plans until guidance was issued, but generally they had to cease accruing benefits to qualify for the postponement. That did little to reassure employees about benefit security.

Another problem faced by employers is the lack of consistency in pension definitions. For example, there are at least four definitions of "compensation" in the pension code. This inconsistency increases the complexity of trying to determine whether the employer is in compliance.

AGC believes that a major problem is that the balance between tax issues and labor/management issues has been lost. Tax code changes seldom take into account the interactions with other Federal laws in the employee benefits area. Employers

must comply with statutes enforced by the Department of Labor and the Pension Benefit Guaranty Corporation. Such statutes include the Taft-Hartley Act, the Employee Retirement Income Security Act, the Federal Insurance Contributions Act, the Self-Employment Contributions Act and others. Employers must try to reconcile the conflicting requirements. This causes major compliance problems.

Instability in the pension provisions leads to instability in the employer-employee relationship. Employees have less faith in the security of their retirement plans when those plans are rewritten on a yearly basis, but the employer may be required to do so to satisfy the most recent of statutory changes.

AGC offers two specific problems as examples of how recent tax code changes have endangered pensions in the construction industry.

Example One: The Minimum Participation Rules

The minimum participation (50/40) rules require that on every day of the plan year, every plan offered by the employer must benefit the lesser of 50 employees or 40% of the employer's employees. For small businesses, it is effectively a 40% rule, since they usually will not have 50 employees. Under the IRS regulations, every separate benefit structure within each plan must separately satisfy the 50/40 rule.

This rule has caused nearly insurmountable problems in the construction industry where the highly mobile craft worker workforce is often covered by a portable pension plan providing for almost immediate participation and vesting and the office staff is covered by a normal retirement program. Either or both of the plans would have to be terminated due to the 50/40 rule. The plan covering the craft workers would have to be terminated because of the immense administrative and tracking costs and because the employer could not be certain the 50/40 rule would be satisfied each and every day. The plan covering the office workers would be terminated because the office staff seldom exceeds 10, and is so small compared to the jobsite staff.

The 50/40 rule also did not consider the manner in which it conflicts with the requirements of the Davis-Bacon and Taft-Hartley Acts. The Davis-Bacon Act requires that hourly construction workers receive the prevailing wages and fringe benefits on Federal and federally-assisted construction projects. The Labor Department has extensive regulations implementing the Davis-Bacon Act and prescribes precise dollar amounts. Each different craft worker category would be a separate benefit structure for 50/40 rule purposes.

On a construction jobsite, a working foreman may be promoted to supervisor for a few months. Under Taft-Hartley, that worker is out of the collective bargaining unit for that period of tune. For 50/40 rule purposes, that worker is considered to be in a separate plan that must separately satisfy the 50/40 rule for that period of time.

Example Two: The Full Funding Limitation

The 1987 tax act added a new full funding limitation that applies to all qualified defined benefit plans. The full funding limitation acts as a cap on an employer's deductions for plan contributions where the plans are fully funded or overfunded.

The full funding limitation interferes with the collective bargaining process. Collective bargaining agreements are legal agreements between management and labor and cannot be altered unilaterally. The agreements spell out the contributions employers are required to make to pension plans. Under the full funding limitation, employers could be denied deductions for the contributions they are required to make under the collective bargaining agreement.

In addition, the IRS interest rates for determining the full funding limitation are tied to the historical 30-year Treasury obligation rates. That bears little or no relationship to current market and investment environments.

There are three different interest rates for determining the adequacy of plan funding: the IRS full funding limit, the PBGC rate and the ERISA rate. The interest rates are all different. An employer could find itself obligated to make payments under the PBGC rate for which it is denied deductions under the IRS rate.

CONCLUSIONS AND RECOMMENDATIONS

The complexity of the pension code rules is having a negative effect on retirement coverage. Employers cannot determine whether they will satisfy the technical tax rules. The uncertainty is forcing employers to streamline their plans and even terminate them rather than face the harsh penalties for noncompliance that are in the tax code. The high administrative costs imposed by the rules act as a further disincentive to establishing retirement plans. Employers have difficulty in determining how to comply with both tax rules and rules contained in other Federal statutes.

AGC respectfully offers the following recommendations for simplifying the Internal Revenue Code rules on pension plans.

- The minimum participation rule should be repealed in its entirety. It is an arbitrary numerical test that unfairly penals smaller businesses.
- The full funding limitation should be repealed, at least as it applies to collectively-bargained plans. Contributions to those plans are fixed in collective bargaining agreements and there are no reversions from multiemployer plans. The limit penalizes prudent investment behavior.
- The leased employee provisions need clarification. The "historical performance" test should be repealed. The current definitions make it virtually impossible to determine what a "leasing organization" is.
- The need for the top-heavy rules should be reexamined. Recent caps on compensation, contributions, vesting schedules and benefits make them largely redundant.
- Definitions in the pension code should be made consistent. For example, a uniform definition of "compensation" would reduce complexity and confusion.
- The definition of a "highly compensated employee" should be simplified. It adds unneeded complexity to examine compensation for both the current year and the preceding year.
- The actual deferral percentage tests for 401(k) plans should be repealed. Employers can fail the test because not enough nonhighly compensated workers elect to participate in the plan. Such a failure would be outside the employer's control.

In addition, any future pension code changes and additions should be examined for administrability, complexity, cost, impact on benefit security and interaction with other statutes before they are passed.

For example, a recent proposal would tax the short-term gains of pension plans. The proposal would reduce the ability of pension plans to invest in sound investments such as Treasury securities and ultimately reduce pension benefits. It also interferes with ERISA fiduciary responsibilities and would increase the costs of administering pension plans.

A number of other proposals affecting the nation's retirement plans are under consideration in Congress. AGC encourages careful examination of those proposals in light of the need for simplicity, administrability and benefit security. AGC supports and encourages the Subcommitteels examination of ways to simplify the pension code.

BAKER, CLIFFORD, KRIER & WEBB,
Lubbock, TX, March 9, 1990

MS. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
Washington, DC.

Dear Ms. Wilcox: I wish to submit my views in this written statement to be considered at the March 23rd hearing before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service regarding options for the possible simplification of current rules governing private pension plans.

I perform legal services for several hundred retirement plans established by small employers located primarily in West Texas. During the last two years, I estimate that I have terminated three retirement plans for every one new plan being established. The primary reason given by clients for termination is the increasing complexity of the rules governing private retirement plans and the increasing administrative costs. I know that many employees in West Texas have lost retirement benefit coverage because of the complex laws passed by Congress and incomprehensible rules and regulations issued by the Internal Revenue Service in the last few years. Let me give you some examples.

The Tax Reform Act of 1986 added IRC §401(l). The legislative history indicates that one of Congress' reasons for this new provision was to simplify the rules governing integration of private retirement plans with Social Security. We still do not have final regulations from the Internal Revenue Service. The proposed regulations are more lengthy and complex than anything we had before. They are incomprehensible.

The joint and survivor annuity rules were added to the law by the Retirement Equity Act. Rather than adding some simple procedure requiring a spouse's signature for payment of benefits, Congress and the Internal Revenue Service chose to impose a complex set of rules and regulations requiring notices, explanations, and waivers at various times during a participant's career.

The Tax Reform Act of 1986 added IRS subsection 401(a)(26). It consists of a short paragraph designed to prevent an abuse found in only a few plans. It resulted in over 30 pages of complex, incomprehensible proposed regulations being issued by the Internal Revenue Service which all plans must comply with.

The employee leasing and affiliated service group rules found at IRC subsection 414(m), (n) and (o) were added to prevent an abuse found in only a few instances. They have resulted in approximately 50 pages of complex regulations, riddled throughout with cross references, and which contain concepts never before heard of, which all plans must be wary of. Not even the Internal Revenue Service knows what these regulations mean, much less a "ma and pa" business trying to maintain a retirement plan for themselves and their employees.

The minimum coverage requirement set forth at IRC §410(b) appears to be such a simple concept. Why are the 20 pages of regulations proposed by the Internal Revenue Service incomprehensible? In fact, they are incomplete. We are apparently waiting on even more complex proposed regulations under §401(a)(4).

Why did Congress choose to leave the IRC §416 top-heavy provisions in the law. With the other changes made by the Tax Reform Act of 1986, the top-heavy provisions add virtually no additional benefits for participants in small plans. Yet, they add an additional level of complexity to plan documents and to plan administration which must cost millions of dollars nationwide each year.

IRC §401(k) and (m) and the regulations thereunder are to the point of being ridiculous. There is no way that a small employer can administer or afford to pay someone to administer a §401(k) plan with employer matching contributions. The 30-plus pages of regulations issued by the Internal Revenue Service are incomprehensible. I dare anyone on your subcommittee to read the regulations and understand them.

The Internal Revenue Service's recent attack on small defined benefit plans shows a total lack of honesty in government. The law itself clearly permits defined benefit plans to have a retirement age as low as 55 years of age. An employee can retire at age 55 and begin drawing his or her benefits. However, the Internal Revenue Service has now targeted small defined benefit plans maintaining that contributions must be geared to a 65 retirement age, regardless of what the plan document specifies. It is dishonest for our government to create such a "catch 22" for small employers.

It appears to be that our representatives in Congress have been bullied and intimidated by the bureaucrats and actuaries in the Department of Treasury who have lost sight of what it is like to live in the real world. Congress needs to quit letting the bureaucrats and actuaries write the law. Congress needs to assume responsibility for the mess which has been created in this area of the law. This nation is made strong by the small employers. Congress has not served the small employers well in this area.

Sincerely yours,

KARL CLIFFORD.

BUCK CONSULTANTS
Two Pennsylvania Plaza
New York, New York 10121

April 12, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
205 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

Buck Consultants, Inc., a leading international employee benefits firm with over 1,000 clients in the U.S., welcomes the opportunity to submit written comments on the subject of simplifying the qualification and nondiscrimination rules for private pension plans.

Although the Tax Reform Act of 1986 (TRA'86) generally simplified our nation's system of taxation in many areas (e.g., individual income taxation), in the area of qualified plans the opposite is true. The new qualification and nondiscrimination requirements for pension plans under TRA'86 have created major problems for employers. These requirements in themselves are far too complex.

In certain cases, the Treasury Department has made meeting these requirements even more difficult by its inability to get out a number of key regulations on time. In fact, today the Treasury Department still has not issued its key proposed general nondiscrimination regulations under Code Section 401(a)(4) and the equally vital proposed separate line of business regulations under Code Section 414(r).

In addition, the proposed TRA'86 regulations that have been issued thus far have been massive and unwieldy. The complexity of these proposed regulations renders them almost incomprehensible to even highly knowledgeable benefits professionals.

Furthermore, the Treasury Department has made these regulations in many cases much more complicated than required -- or even justified -- by the law.

In light of the inability of the Treasury Department to get its regulations out on time, many defined benefit plans are currently in limbo and have been since 1989. Many employers have had to suspend current accruals under their defined benefit plans for some or all of their employees. In some cases, employees have retired and received only a portion of their accrued benefits and are awaiting the remainder that has been promised once the plan is amended.

To help remedy these problems and achieve the goal of simplification for private pension plans, Buck would like to make the following legislative and regulatory recommendations.

Specific Recommendations -- Legislative

Social Security Integration

The proposed regulations on Social Security integration as modified by Notice 89-70 do not allow Social Security offsets equal to the lesser of an amount based on the Social Security Primary Insurance Amount or the maximum offset allowed by TRA'86.

Pension plans with offsets based on the Social Security Primary Insurance Amount have worked well for many years. Allowing these offsets under the integration rules would ease the problems of employers considerably.

Thus, we suggest that Congress permit plans that offset pension benefits by Social Security Primary Insurance Amounts to meet Code Section 401(l) without having to test the plan under Code Section 401(a)(4) -- provided certain reasonable conditions are met (e.g., the benefit from the plan is not 100% offset).

General Nondiscrimination Rule Testing

In addition, Congress should stipulate that once a plan satisfies Code Section 401(a)(4), that plan would not be required to test for compliance on an annual basis unless there has been a dramatic change in the plan sponsor's work force or the plan has been significantly redesigned. The Code Section 410(b) coverage requirements would not be affected by this change.

401(k) Nondiscrimination Tests

The current Average Deferral Percentage (ADP) test applicable to 401(k) plans and Average Contribution Percentage (ACP) nondiscrimination test applicable to 401(k) plans and certain other plans should be replaced with a design-based nondiscrimination test -- similar to the test currently used by the Federal employees' thrift plan. Buck supports legislation that will be proposed by Sen. Pryor and Rep. Chandler under which a 401(k) plan would be deemed nondiscriminatory if it is offered at a minimum on an equal basis to all employees necessary to pass the coverage test rules under Code Section 410(b).

Definition of Compensation and Highly-Compensated Employees

Rep. Richard T. Schulze (R.-Pa.) has recently introduced a bill (H.R. 4508) that would simplify for qualified plans the definition of highly-compensated employees, simplify and make uniform the definition of compensation, and delay the reporting of the number of highly-compensated employees until a study has been completed on how burdensome the reporting requirements are. Under this bill, a highly-compensated employee would generally be defined as any employee who was compensated in excess of $75,000 (as indexed) during the year or the preceding year.

This legislation would simplify considerably the administration of qualified plans. We suggest that it be enacted by Congress and that the uniform definition of highly-compensated employees be extended to all welfare plans where nondiscrimination testing is required.

Separate Line of Business Rules

The Code Section 414(r) separate line of business provisions, which permit plans to satisfy the various plan qualification requirements independently for each distinct line of business, should be statutorily amended to permit a unit to be treated as a separate line of business where the unit employs more than 50 nonexcludable employees (including collectively bargained employees) but fewer than 50 nonexcludable employees (after excluding noncollectively bargained employees) and all the employees participate in the same pension plan. Furthermore, by statute, Code Section 401(a)(26) should operate on a separate line of business basis rather than on a controlled group basis. Otherwise, gross inequities will occur.

Consider, for example, a line of business with 800 employees. 770 of the employees are subject to a collective bargaining agreement, 30 are not, and all the employees are covered by the same pension plan.

Under Section 414(r) it appears this line of business would not qualify as a separate line of business and because of the Treasury Department's disaggregation rule, the portion of the plan covering the noncollectively bargained employees would not satisfy the general minimum participation rule requiring a minimum of 50 employees or 40% of an employer's nonexcludable employees in the controlled group to be covered by the plan. This would be the case because only 30 noncollectively bargained employees would be counted as benefiting under the plan.

Congress should eliminate this inequity. This result is unfair and causes additional complications for employers in this situation. It would simplify things considerably to allow this situation under the line of business rules and the minimum participation rules.

Delay in TRA'86 Effective Date

Since the Treasury Department is already so late in getting many of its TRA'86 regulations out, Buck recommends that for plans that qualify under the pre-TRA'86 rules and have not yet been amended to comply with TRA'86, the TRA'86 effective date for the nondiscrimination, minimum participation and maximum permitted disparity (Social Security integration) rules be postponed until at least one year after the final regulations in these areas are issued. In addition, plans that qualify under pre-TRA'86 rules for plan years prior to the postponed effective date or plan years prior to the time the plan is amended to comply with the TRA'86 rules (see below), if earlier, should be treated as qualified.

In the case of plans that have already been amended for TRA'86 changes, these plans should remain qualified if they pass a liberal good faith compliance test from the time they are amended until one year after final regulations are issued and the law should so provide.

This delay will enable employers to avoid a problem not of their own making -- having to make complex and costly retroactive changes to their plans -- and will vastly simplify plan administration.

Specific Recommendations -- Regulatory

Minimum Participation Rules

The minimum participation regulations need to be simplified significantly. We have in both oral and written comments to the Treasury Department enumerated ways the minutiae could be eliminated and tests contained in these rules could be consolidated. Section 401(a)(26) is a simple section of the Code created with the explicit Congressional intent of prohibiting one-person plans -- at one time common to many partnership organizations. The proposed regulations under this Section now contain so intricate a web of tests and procedures that many legitimate plan practices are effectively prohibited.

Specifically, we suggest that the prior benefit structure tests of the minimum participation regulations be consolidated and also that defined contribution plans be removed from the scope of Section 401(a)(26) testing -- except, perhaps, where the defined contribution plan is part of a defined benefit plan (e.g., as part of a floor plan arrangement).

In addition, the final Section 401(a)(26) minimum participation regulations should include language that would grandfather benefit structures that have been in existence prior to the effective date of these regulations and which met the Section 401(a)(26) requirements when they were first applicable to the plan.

KSOPs

The final 401(k) regulations should permit so-called KSOPs (i.e., 401(k) cash or deferred profit sharing plans that are combined with ESOPs) to be treated as one plan for purposes of meeting the ADP and ACP nondiscrimination tests. The current situation, which requires disaggregation of a KSOP so that the ESOP portion and the 401(k) portion are tested separately, has made these plans more costly and complex than would otherwise be the case and, in some cases, has tended to discourage the formation of ESOPs -- which Buck and many of our clients believe are beneficial and should be encouraged.

Conclusion

As noted above, the general TRA'86 theme of simplification did not really apply to the TRA'86 pension plan rules -- particularly as amplified by the Treasury Department. The net result is a situation in which plans are bound by rules that are far more complex to administer than would otherwise be the case.

We believe our recommendations can help to simplify these rules and ease the pressures on the private pension system.

Buck would be pleased to work with staff members and the Treasury Department to further amplify our comments and to achieve real simplification for the private pension system.

Very truly yours,

Frederick W. Rumack (rem)

Frederick W. Rumack
Director of Tax and Legal Services

FWR:AC

cc Mr. Ed Mihalski
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C&B CONSULTING GROUP
Actuarial, Benefits & Compensation Consulting

Testimony Presented to the Senate Finance Committee
Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service

By
C&B Consulting Group
Warren J. Winer, F.S.A. - President and Chief Executive Officer
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March 23, 1990

C&B Consulting Group, a division of Corroon and Black Corporation, is an employee benefits consulting firm with a national client base. We are pleased that the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service is studying the growing complexity of rules governing the private pension plan system. As consultants for a wide variety of plans -- including those maintained by corporations, governmental units and tax-exempt entities, as well as multiemployer plans -- we are alarmed at the accelerating complexity of plan administration resulting from legislation aimed at employee benefit plans over the past decade. We would like to take this opportunity to point out a few examples of the needlessly burdensome consequences recent legislation has had on pension plan administration (illustrated in some cases by actual circumstances faced by our clients), as well as suggest possible alternatives for the future.

Introduction

In recent years, legislation governing pension plans has been driven by two or three very different policy initiatives. One of the major thrusts in pension legislation involves protection of employee rights to pensions, with particular emphasis on attempting to prevent discrimination in favor of highly paid plan participants and increasing portability of benefits. There have also been attempts to encourage expanded pension coverage in the U.S. work force.

On the other hand, pension legislation has also been shaped to a great extent by revenue considerations. The tax incentives that serve as the foundation to our private pension system have been an inviting target in these revenue sensitive times.

These policy objectives are not fundamentally compatible. In our view, the gradual implementation of these disparate objectives over the past decade has created an administrative nightmare that threatens the long-term health of our private pension system. No one's interests are served if the exorbitant cost of attempting to comply with burdensome, contradictory (and sometimes unknown) requirements deters employers from maintaining pension programs that contribute significantly to the well-being of employees in their retirement years. Each year, employers face increasing administrative costs associated solely with compliance with changes in the law. This is money that could be better spent on pension benefit improvements or other employee benefit plans.

Anticipation of Legislative Impact

Employee benefits legislation that seems like a good idea on paper sometimes creates practical administrative problems that make it difficult, if not impossible for employers to comply with the law. The impact of §89 was an obvious case in point; however, this problem is often felt in many other ways in the employee benefits area. Frequently, complex rules designed to prevent specific abusive practices by a minority of plan sponsors cause unintended (and unforeseen) hardships for the majority of plans that are not abusive in any way.

While it is difficult to foresee all of the implications proposed legislation may have, efforts to thoroughly investigate possible "side effects" in this area serve as an important safeguard.

- **Quarterly Contribution Rules** -- One example of the difficulties faced by many of our clients has been in the operation of the quarterly contribution rules. In 1987, Congress

passed legislation requiring quarterly contributions to pension plans (later clarified to apply only to defined benefit plans). This legislation was enacted to accelerate funding by preventing plan sponsors from delaying until 8 1/2 months after the end of a plan year to make a required contribution. While we understand that ensuring adequate funding of plans is an important policy objective, the quarterly contribution rules have placed unnecessary burdens on those plans which are making an effort to maintain their funded status.

Many sponsors of defined benefit plans typically make annual contributions that exceed the minimum contribution required under §412 of the Code. The higher contributions are often motivated primarily by benefit security considerations rather than increased employer tax deductions. Regardless of the motivation, well funded plans frequently become constrained by the "full funding limitation" of Code §412(c)(7). Because of favorable actuarial experience and as a result of the sensitivity of full funding limitation threshold (especially after full funding was modified by OBRA '87), contributions are frequently limited by the full funding limitation for a plan year immediately following a year for which the limit did not apply. Quarterly contributions for plans in this situation are particularly troublesome.

Because of the time and resources needed to compile employee data and perform actuarial valuations, plan year contribution requirements generally are not known when the first quarterly contributions for a plan year become due. As a result, the first (and perhaps subsequent) quarterly contribution(s) must be determined based on the funding requirements for the preceding year, as is permitted under OBRA '87. If it turns out that the full funding limit applies where it did not in the preceding year, the plan may have been forced to make a nondeductible contribution. Such a contribution generates a recurring penalty tax until it can be deducted -- which for some plans may be years down the road.

While the IRS has established a procedure for revoking a nondeductible contribution in this situation, the procedure is sufficiently burdensome that very few plans have opted to take advantage of it. The procedure, as described in Revenue Procedure 89-35, requires collection and submission to the IRS of a substantial amount of material intended to demonstrate the nondeductibility of the contributions involved. In addition, certification by an enrolled actuary and payment of a user fee are involved. For many plan sponsors, it is simply cheaper to pay the penalty tax than to recover the nondeductible contribution. In effect, these plan sponsors pay a tax for making a good faith effort to comply with the law.

One alternative left to plan sponsors wary of the burdens imposed by making nondeductible contributions is to simply not make quarterly contributions while they await the results of the current year's valuation report. If it later turns out that a quarterly contribution was due under the new valuation, the plan sponsor will be in violation of ERISA unless proper written notice of the missed contribution was given to each participant within sixty days of the due date. The penalty for failure to properly notify is up to $100 per day per participant. In many cases, the maximum penalty would be much larger than the required contribution for the entire year. The threat of such a penalty essentially forces employers to notify participants that they *may* be missing a quarterly contribution -- even though the company has no way of knowing whether the contribution is even due for the year.

If participants are properly notified under ERISA, the only penalty for a late quarterly contribution involves additional interest payments to the plan. For those plan sponsors for whom notification would not create a serious employee relations problem -- generally very small employers -- the only hardship this penalty imposes is increased complexity in minimum funding contribution calculations. In some respects, the added burden of computing quarterly contribution amounts and cutting quarterly checks is as much of a hardship as the penalties imposed for failure to make the required installments.

While it was only a short-term problem, the fact that 1989 plan year quarterly contribution amounts were due before the full 1988 contribution has been a source of considerable confusion for plan sponsors.

Real world examples

- *One large manufacturing corporation with with over 20,000 employees maintained a number of separate defined benefit plans which were merged in 1989. Only one of the pre-merger plans was not fully funded in 1988. While the consolidated plan was almost certain to be fully funded for 1989, there was no way to be sure before 1989 quarterly contributions became due for the 1989 plan year (because of time constraints in*

producing a 1989 valuation). Nevertheless, the company felt obligated to make a quarterly contribution on the basis of the 1988 minimum funding requirements for the non-fully funded plan in order to be confident of compliance with the quarterly contribution rules. As a result, the company was penalized for its good faith compliance effort with all of the headaches associated with having nondeductible contributions in the plan. Moreover, the consolidated plan is expected to remain fully funded for a number of years.

- *An integrated defined benefit plan's formula required major changes to satisfy TRA '86 requirements. The plan made its first two 1989 quarterly contributions on the basis of 1988 plan year funding requirements. By the due date for the third quarterly contribution, the plan sponsor had tentatively selected a new plan design to be effective 1-1-89 in accordance with the requirements of TRA '86, and preliminary studies indicated that the plan would be fully funded for 1989 on the basis of the new plan design. Based on this information and concern about nondeductible contributions, the plan sponsor did not make the third quarterly contribution. Actual valuation results for 1989, however, later indicated that the plan was not fully funded for 1989. The plan was not in compliance with quarterly contribution requirements directly as a result of the unpredictable nature of the full funding limitation.*

In total, problems that have been and will continue to be associated with the quarterly contributions certainly raise the questions of whether the intended result was worth the trouble caused.

Interest Rate Assumptions for Employee Contributions -- OBRA '87 also changed the requirements for determining employer-purchased benefits (which are typically subject to vesting requirements) in a contributory defined benefit pension plan. These rules, which were clarified in IRS guidance issued in Spring 1989, apply to the benefits of contributory plan participants terminating after the start of the 1988 plan year.

These rules were significantly revised in a "technical correction" in OBRA '89. While the changes would not have been particularly burdensome if implemented initially under OBRA '87, the fact that the rules are to be applied *retroactively* to the beginning of the 1988 plan year is a nightmare for contributory plan administrators.

Real world example

- *One large corporation maintains a contributory defined benefit plan. Several thousand employees terminate employment each year. Upon termination, vested benefits are calculated and communicated to each former employee. Since the beginning of the 1988 plan year, these calculations have been made in accordance with the OBRA '87 rules. The 1989 IRS guidance on this topic confirmed that the procedures used by the company were in accordance with the statute.*

  In order to comply with the OBRA '89 calculation rules, calculations will have to be redone for all employees who terminated employment since January 1, 1988. The company has over 30 separate plant locations and plan administration functions are not centralized.

  To further complicate matters, the revised statutory requirements for the calculations are not entirely clear. The company does not expect clarifying guidance from the IRS anytime soon. Taking into account all factors, the company has elected, at least for the time being, not to recalculate benefits for employees who terminated after 1987. The company will reevaluate this position once IRS guidance on the new requirements is issued, rather than risk having to undertake a second recalculation of benefits for several thousand employees.

- **Return of Excess Contributions** -- To prevent excessive discrimination in 401(k) and other individual account plans, Congress imposed limits on before tax-and after-tax contributions available to highly compensated employees. The limits are dictated by the level of participation of nonhighly compensated employees.

It is fairly common for these limits to be exceeded in any given plan year. In accordance with regulations, excess amounts are typically refunded to highly compensated employees during the 2 1/2 month period following the plan year to avoid penalty taxes to both the employee and employer.

Unfortunately, for calendar year plans, by the time the year-end valuation is completed, nondiscrimination testing is performed and refund amounts identified, many affected employees have already filed their tax returns for the previous year. The refunds then necessitate amended tax returns for those employees conscientious enough to file their taxes early.

Another problem involves the size of the refunds. The refund amounts are often very small. The cost of processing refunds for the company (cutting refund checks, tax reporting, etc.) often greatly exceeds the amount of the refund.

Real world example

- *A company maintains a 401(k) plan. Upon performing an actual deferral percentage (ADP) test on elective deferrals at the end of the plan year, the plan typically has to process several hundred refunds of $2.00 or less. The company estimates that each refund costs the company about $7.00 to process. Since the refunds are reported to the IRS in accordance with procedures established by the Service, many participants receiving refund checks undergo the personal hardship of filing amended income tax returns based on a trivial adjustment.*

These are problems that can be fixed. For example, return of de minimis amounts of excess contributions could be waived based on reasonable expectations of refund processing costs. Perhaps more importantly, these problems could have been avoided in the first place if fundamental practical issues had been anticipated in either the legislative or regulatory process.

Guidance Needed for Implementation

Plan sponsors rely heavily on guidance from the IRS, DOL and PBGC for the operational rules necessary to comply with pension plan statutes within the Internal Revenue Code and ERISA. Repeated changes in pension law over the last decade have made it difficult for these regulatory bodies to issue necessary guidance on a timely basis. As a result, plan sponsors have frequently found themselves attempting to comply with newly effective laws without adequate guidance. While plans are not usually penalized for attempting "good faith compliance" in implementing administrative procedures, it is often quite expensive sorting through possible compliance alternatives. Moreover, plan sponsors are often forced to modify their "good faith" approaches when guidance does become available, resulting in even greater expense.

Unfortunately, the cumulative effect of the many changes in the law is that conscientious employers who make an effort to comply with the rules on a timely basis are penalized for their efforts with added administrative burdens and constant changes to plan provisions. Those which simply ignore the law until regulations are finalized are rewarded by avoiding what often turns out to be useless (and costly) administrative activity during the interim period.

- The Conference Committee Report on the Pension Protection Act of 1987 *required* issuance of regulations providing rules concerning the full funding limitation of IRC §412(c)(7) by August 15, 1988. These rules have significant impact on the amount of deductible contributions available to many plans, effective for all plan years beginning after 1987. No such guidance has been forthcoming, even in this instance where guidance was explicitly mandated by Congress. Plan funding calculations for 1988 and 1989 plan years have been made on a "best guess" basis, without benefit of a precise definition of "current liability" or specific amortization periods for certain aspects of the required calculations. Considerable effort was required to analyze the statute and develop reasonable interpretations of the requirements. Timely issuance of guidance *as required by law* would have prevented this problem.

- In many cases, temporary or incomplete guidance has been as troublesome as no guidance at all. IRS rules on permitted disparity (integration) serve as an example of this problem.

Proposed IRS regulations to §401(l) effectively did away with benefit formulas that explicitly offset Social Security benefits. Statements by IRS staffers suggested that there would be no way for these plans to demonstrate nondiscrimination on the basis of plan design. As a result, many sponsors substantially redesigned their integrated plans so that nondiscrimination could be demonstrated through compliance with §401(l). Actuarial studies analyzing the cost of overhauling benefit formulas represent a significant cost to plan sponsors, especially smaller ones.

A year and a half after issuance of the proposed regulations (effective for the 1989 plan year), the Service is now suggesting that the issue of Social Security offset formulas will likely be revisited, and that it will be possible to demonstrate that these formulas are nondiscriminatory without specifically testing the employee group. As a result, plan sponsors who relied on tentative pronouncements may have needlessly spent time and resources to substantially rework pension formulas which were presumably designed in the first place to satisfy specific objectives of the employer.

Real world example

- *One large company relied on the §401(l) regulations and IRS verbal pronouncements about the fate of Social Security offset plans and redesigned its defined benefit plan accordingly. Because the company felt in was unfair to cut back future accruals of some of its most valued employees, the formula redesign directly resulted in an annual increase in required contributions of $600,000 (in 1989 dollars). This increase represented about 20% of total annual company costs for the plan. Now, it appears that by waiting, the plan could have retained a formula much like the original offset formula and still satisfy nondiscrimination requirements on a design basis. While final rules are not yet available, it appears that the company could have spared itself substantial ongoing cost by taking the seemingly irresponsible approach of delaying action with the hope of regulatory relief.*

- As enacted under TRA '86, §401(a)(26) (minimum participation rules) did not include any accommodation of plans assumed by an employer though the acquisition of other companies. Vigilant plan sponsors who anticipated §401(a)(26) problems for acquired plans took remedial action in 1988 in advance of legislation and regulations which ultimately provided significant relief in this area.

Real world example

- *A company heavily involved in acquisitions sponsored a large number of plans formerly maintained by acquired companies. In response to the original TRA '86 statutory requirements, the company determined that the acquired plans would fail §401(a)(26) as of January 1, 1989, unless they were merged so that a sufficient number of employees could be viewed as "participating" in the consolidated plan. TAMRA and proposed regulations (which came out in late 1988 and early 1989 respectively) provided transition rules for acquisition situations. As a result, the company wasted time and money on an unnecessary plan consolidation.*

Not all delays and gaps in regulatory guidance can be attributed to overload caused by repeated changes in tax and labor law affecting pension plans. For example, the Department of Labor has been notoriously slow, even in promulgating regulations under ERISA as it was enacted in 1974. Nevertheless, frequent changes in pension law have certainly exacerbated this problem.

Regulatory Restraint

In many cases, pension legislation has been intentionally vague, leaving the details to be filled in by regulation. The ensuing problems resulting from delayed guidance have already been outlined above. Another problem is the free reign that loosely drafted legislation provides regulators.

- A case in point is the minimum participation rules of §401(a)(26). While the statute calls for compliance on a plan-by-plan basis, the statute also leaves room for the Secretary of the Treasury to apply §401(a)(26) to separate benefit structures within a plan. In its proposed

regulations to §401(a)(26), the Service took full advantage of this latitude, identifying a myriad of separate benefit structures to be individually tested. As a result, many larger plans with special features designed to meet the needs of subsets of the employee group faced significant redesign or termination.

As in the case of Social Security offset plans, the IRS is apparently bowing to public pressure and rethinking its position on §401(a)(26) (some have called §401(a)(26) the pension equivalent of §89). In some instances, pension plans were actually terminated solely because of perceived §401(a)(26) problems that will eventually turn out to be benign under future guidance -- a result clearly in conflict with growing Congressional concern over the number of plan terminations during the last decade.

Real world example

- *An example of the obviously unintended effects of §401(a)(26) involves a nonintegrated defined benefit plan that was modified in 1984 to become integrated. Since this change would reduce future benefit accruals for low paid employees, the plan sponsor decided to preserve the nonintegrated formula for the future accruals of employees working at the time of the plan change. Now that §401(a)(26) has come along, this "grandfather" formula is doomed to fail once the covered group dwindles due to attrition. Under IRS rules, the plan will be forced to shut off a benefit formula now maintained exclusively to the advantage of the lowest paid employees-- most of whom earn less than $30,000 per year.*

Coordination of Guidance

A particularly frustrating problem for plan sponsors is lack of consistency in guidance promulgated by different regulatory concerns. Sponsors occasionally face conflicting requirements, and are put in the position of willfully violating one set of rules as a direct result of compliance with other requirements.

- Plans which offer loans to participants are facing this kind of dilemma. Recent Department of Labor regulations (and follow up guidance) generally prohibit restricting a loan program to active participants. (Plans typically have limited loans to the active participant group to facilitate repayment through payroll deduction.) On the other hand, the DOL rules only require extending the loan program to inactive "parties in interest."

  The IRS is apparently going to take a dim view of plans that make loans available to inactive parties in interest while excluding other inactive participants. Their objections are based on the fact that inactive parties in interest are almost exclusively former highly compensated employees. The lack of coordination between the IRS and the DOL on this issue, however, may by default require plans with loan programs to make loans available to all inactive participants.

  This is not a desirable result for plans with loan programs, since it complicates administration and raises loan security issues. Nevertheless, this requirement would be easier for plans to accommodate if it was an explicit requirement of either the IRS or DOL rules, rather than an implicit requirement resulting from the interrelation of the rules of these organizations. If left uncorrected, this situation will likely result in few plans making loans available. This may be detrimental to participants from a retirement security standpoint because unlike withdrawals, loans amounts are repaid to the plan and remain available for retirement.

- As another example, PBGC requirements for processing a plan termination are structured so that a plan is supposed to be closed out and assets distributed before an IRS determination letter is likely to be issued. Very few plan sponsors would be comfortable finalizing a plan termination without final blessing from the IRS. While coordination of the PBGC and IRS procedures at plan termination is apparently going to be addressed, it is unfortunate that such a difficult situation was created in the first place.

Transition Problems

The scatter gun approach to pension legislation in the 1980s has left most plans in a constant state of transition. Repeated changes in basic plan requirements have created the need for repeated modifications to plan documents and summary plan descriptions. Since careful and conscientious

plan sponsors seek IRS approval of plan language changes, frequent plan language changes are costly, especially in our new "user fee" environment.

It is helpful that plan changes required by the 1986 Tax Reform Act and subsequent legislation have been lumped together for amendment due date purposes. Fortunately, plans have also been given liberal remedial amendment periods for completion of consolidated amendments to plans. This current period of limbo, however, a necessary state for many plans as a result of limited guidance in some areas, creates additional headaches for plan sponsors.

- In response to anti-cutback requirements for accrued benefits imposed by Code Section 411(d)(6), the IRS created a series of transition "model amendment" approaches. Plan sponsors were instructed to adopt one of a number of transition amendment approaches to address the possible technical violation of anti-cutback rules during the period between the effective dates of required plan changes and the ultimate amendment of plans. (Impermissible cutbacks would be considered to occur if a plan benefit or allocation formula provided reduced benefits on an ongoing basis after being retroactively modified to comply with new rules.)

  The IRS views these temporary amendments as a necessary response to conflicting statutory requirements. However, due to the timing and lack of clarity of the guidance (the rules have come out in a piecemeal fashion), many plan sponsors have had difficulty coping with the transition amendment rules. The problems are made worse by the fact that the transition period has become considerably longer than was contemplated when the transitional amendment requirements were first put forth.

- The fact that many plans are operating in compliance with statutory and regulatory requirements without the benefit of written plan language consistent with that operation is a troublesome concept. It is clear that the interests of plan participants are not being served when all of the critical aspects of their retirement programs are not committed to writing. Certainly, the situation opens up plan sponsors to legal action by employees who press their rights to proper notification of plan provisions. It is very difficult for plan sponsors to know what to do in an environment where they cannot finalize plan provisions due to lack of guidance or anticipation of changes in requirements.

A Need for Vision

Congress needs to take into account the prevailing standards of business operation in designing rules applied in the employee benefits area. Recent legislation has focused on identifying highly compensated employees for nondiscrimination testing and defining compensation for plan purposes. Factoring compensation into employee benefit rules requires a sensitivity to the payroll practices and limitations of employers.

Developing a workable set of definitions and parameters for use in the employee benefits area and remaining committed to those concepts would go a long way toward providing some stability in the benefits area. As the following chart demonstrates, there are still four different definitions of high paid employees for use in welfare plan nondiscrimination testing. These definitions should be standardized so that employers -- most of whom are *not* providing discriminatory benefits -- would be able to perform nondiscrimination testing efficiently, and spend their energies providing employees with the benefits they need to insure their well-being and retirement security.

Comparison of Definitions of "Highly Compensated Employees" for Nondiscrimination Testing

Group Term Life Insurance	Medical Plans	Cafeteria Plans	Dependent Care Plans (same as qualified plans)
"Key Employees"	"Highly Compensated Employees"	"Highly Compensated Group"	"Highly Compensated Employees"
5% owners	10% shareholders	5% shareholders	5% owners
Officers earning more than $51,291 (1990)	5 highest paid officers	Officers	Officers earning more than $51,291 (1990)
10 employees earning more than $30,000 (1990) and owning largest interests in employer	Highest paid 25% of all employees	Highly compensated employees	Employees earning more than $85,485 (1989)
1% owners earning more than $150,000	-	Dependents and spouses of the categories above	Employees earning more than $56,990 (1990) and in the top paid group

While the preceding example does not directly involve pension plans, the definition described in the fourth column of the chart does apply to pension plans (§414(q)), as does a different definition of "key employee" for purposes of determining top-heavy status under Code §416. Ideally, sponsors of both pension and welfare plans should be able to demonstrate nondiscrimination for all benefit programs on the basis of a single determination of the highly paid group of employees.

Conclusion

The situations described in this discussion are not intended to represent a comprehensive list of problems affecting pension plans. Rather, they are intended to give members of the Subcommittee a flavor of the tremendous hardships faced by plan sponsors that can be attributed to the remarkably complicated state of legislation and regulation in this area.

The nation's private pension system serves a critical dual role in our economy. Not only do pension plans serve as a primary source of income for the nation's older citizens (along with Social Security and, to a lesser extent, private savings), pension plan assets are one of the largest sources of investment and savings in the economy. Furthermore, the role of the private pension system in our economy should be expected to increase in significance as our population continues to age.

In order to ensure the continued health and growth of the pension system, Congress needs to adopt a comprehensive, long-term approach to pension legislation. The public policy issues surrounding the pension area -- coverage, non-discrimination, portability of benefits, security of assets -- deserve to be addressed from the standpoint of a focused, coordinated approach. Policy objectives should be identified and implemented as a coherent package. The traditional approach of tackling these important issues on a piecemeal basis through attachment to unrelated legislation has created many of the vexing problems that serve to dissuade employers from continuing to sponsor existing plans or establishing new ones. If the private pension system is to be viewed as a long-term asset and major engine of the U.S. economy, legislation in this area should be afforded the undivided attention it deserves.

Such a long-range approach to legislation in any area would be challenging, even under the best of circumstances. Current federal deficit concerns make this approach even more difficult in an area so imbued with tax incentives. Continued tinkering with the tax incentives built into the private pension system may seem like a painless way to generate needed federal revenues. Congress must, however, continue to carefully consider the threats this approach to legislation pose to the stability of our nation's pension plans.

As a practical matter, Congress must be cognizant of the administrative burdens created by any legislative changes in the pension area. We think the following steps would greatly ease the financial and resource burdens which seem to go hand in hand with any changes in pension legislation.

- Pension legislation should be considered separately, on its own merits, outside of the annual budget reconciliation process. Several states have recently passed laws that forbid the consideration by the state legislature of a new "mandated benefit" in the health insurance field without an accompanying "cost-benefit" analysis of the effects of the bill. Perhaps a requirement of this kind could be implemented at the federal level with respect to changes in employee benefits law.

- Congress should actively seek additional input from professional organizations working in the pension area (American Academy of Actuaries, American Society of Pension Actuaries, Association of Private Pension and Welfare Plans, Society of Actuaries, etc.), as well as from individual professionals with expertise, in the formative stage of pension legislation.

- New legislation affecting pension plans should not become effective until final guidance is promulgated by the responsible agency (IRS, DOL, PBGC, etc.).
- Coordination among regulatory agencies should be mandated when legislative changes affect areas of shared regulatory jurisdiction (such as the IRS and DOL in the area of plan loans). Guidance in such instances should be issued jointly by the agencies involved.

C&B Consulting Group thanks the Subcommittee for the opportunity to express its views on the very important topic of pension simplification.

STATEMENT OF CHEVRON CORP.

Senator DAVID PRYOR,
Senate Finance Committee,
Washington, DC.

Re: Simplification Of the Rules Governing Retirement Plans

Dear Senator Pryor: On behalf of Chevron Corporation, this letter comments on two areas of the Internal Revenue Code relating to retirement plans that we believe particularly merit simplification—the "leased employee" rules of Code section 414(n), and the taxation of distributions.

Chevron is a multinational petroleum company headquartered in San Francisco, California.

LEASED EMPLOYEES

I. Summary of Comments

Under present law, "leased employees" must be counted for purposes of nondiscrimination rules that apply to almost all types of major employee benefits. If a company has a sufficiently large number of leased employees, such that these tests are not satisfied, the company's pension and profit-sharing plans may be all deemed "discriminatory" for tax purposes. This could result in the company and certain persons participating in these plans being subject to severe tax penalties.

In order to avoid incurring these penalties, law-abiding companies have tried to comply with the leased employee rules in the statute and in implementing regulations proposed by IRS. This has proved, however, to be a daunting task. The current definition of "leased employee" is both extremely vague and extremely broad. It includes for many companies a host of persons that one would not ordinarily conceive of as "leased employees."

Chevron has spent hundreds of thousands of dollars trying to count its "leased employees" and gather the data necessary to apply the related nondiscrimination rules to them. Notwithstanding repeated requests and occasional threats of withdrawal of business to 12,000 business organizations with which Chevron generally has longstanding and close ties, only about 6,000 organizations responded at all. Of these, only 70 were willing to provide the sensitive financial information regarding benefit costs that is necessary to apply the nondiscrimination rules.

A rule that cannot be administered also cannot be enforced. The definition of "leased employee" now in the law should be replaced with a definition that clearly identifies and effectively prevents genuine abuse of the employee benefit laws, but which is clear enough to be administered by the public at a reasonable cost and enforced by the Government. Code section 414(n) should be amended to accomplish this result.

We recommend that the statute be amended such that a person is considered a "leased employee" of an entity receiving services if and only if the recipient entity exercises *primary control over the manner in which the services are performed.* As under present law, an hours standard would also be applied. We believe our test correctly identifies the relevant employment "nexus," avoids absurd results, and is about as straightforward as one could hope for.

II. Problems Under Present Law

A. The Present Definition of "Leased Employee" Is Vague and Overbroad

The Internal Revenue Code defines a "leased employee" as a person who, pursuant to an agreement, performs substantially full-time services for a recipient "of a type historically performed, in the business field of the recipient, by employees." I.R.C. §414(n)(2). The legislative history does not illuminate this definition. The Treasury Department testified in 1986, however, that the intent of Code section 414(n) is "to prevent avoidance of the rules governing qualified pension plans through leasing of employee services." The example given by Treasury was the leasing of nurses and other staff by a doctor.

Proposed IRS regulations actually broaden, rather than clarify, the vague terms in the statute. As to the statutory requirement that "services" be provided "pursuant to an agreement," "agreement" is defined to include "any mutual understanding," and need not be in writing. Prop. Treas. Reg. §1.414(n)-1(b)(5). "Services" may be performed directly or indirectly. Prop. Treas. Reg. §1.414(n)-1(b)(17). "Business field" is not defined at all. Thus, under the regulations, any person who works on matters involving another company on a substantially full-time basis will be

"deemed" a leased employee of that company if the services provided are of a type "historically performed by employees"

An activity was "historically performed by employees" if it was "not unusual" for the service to be performed by employees in that business field on September 3, 1982. An activity is also deemed "historically performed by employees" if that service "was *ever* performed by *any* employee" at any time during the last five years. Prop. Treas. Reg. §1.414(n)-1(b)(12) (emphasis added).

A medium-sized or large company will have great difficulty determining whether it was "not unusual" for a particular service to be performed by employees in that company's business fields. Indeed, because the term "business field" is not defined, the task may be impossible. In addition, every medium-sized or large company has at some time used its own employees to perform common business activities that are also routinely performed by outside companies. For example, such companies may employ in-house accountants, bookkeepers, computer programmers, carpenters, chemists, doctors, draftsmen, electricians, engineers, lawyers, maintenance workers, mechanics, movers, machinists, masons, painters, security personnel, truck drivers, and writers. Under the definition in the regulation, "any [in-house] employee" will have performed many of these activities during the last five years. Accordingly, the employees of outside organizations providing the same services, such as lawyers in a law firm providing legal advice to a company with an in-house counsel, may be "leased employees" of the client company. As a result, the client may be subject to legal consequences because of the outside lawyers' employee benefits.

We do not believe that Congress intended to make independent service providers, ranging from lawyers to construction crews, "leased employees" of the company they are serving. Nor do we believe that Congress intended to interject one independent company into the private financial affairs of another.

B. Companies That Try To Comply In Good Faith With The Current Rules Cannot Do So

Chevron made a serious and costly effort to determine, as best it could, how many leased employees it has. Chevron has over 40,000 actual employees in the United States. It also has close and long-standing business relationships with literally thousands of other organizations that provide it with specialized products and services. Chevron is a big customer to many other businesses, and many of those organizations employ hundreds of people who spend all or most of their time taking care of Chevron's needs.

Chevron requested data regarding the possible existence of leased employees from approximately 12,000 service companies and contracting organizations. A number of assumptions as to the proper interpretation of the present rules had to be made before this process could even begin. After numerous follow-up requests, and occasional threats of withholding business, Chevron received responses from only about half of the 12,000 organizations. Many service companies and contracting organizations were extremely confused as to the questions asked. They were frequently unable to understand the need for the data where the work was not performed at Chevron locations.

About 1,200 respondents reported that some of their employees would seem to be "leased employees" of Chevron. With respect to qualified plans and other tax-favored arrangements (using the one-year/1500 hours service standard), about 4,000 persons appeared to be leased employees. This figure is based solely on the information provided by the respondents; it is impossible to predict with any certainty what the figures would have been if all 12,000 organizations had responded. The responses were too confused to estimate how many of these 4,000 possible "leased employees" were receiving qualified plan benefits from their actual employers.

Even the organizations that responded were generally unwilling or unable to provide data regarding the cost of benefits for their employees that is necessary to apply the nondiscrimination rules. They viewed such detailed financial information as confidential and proprietary. In addition, many were unable to determine the exact costs of various plans and programs covering the employees in question, such as for self-funded plans. Thus, only about 70 of the 6,000 respondents provided the financial information requested, and the information that was submitted appears highly unreliable.

Chevron and the responding organizations spent more than $500,000 attempting in good faith to comply with the leased employee rules. Despite this massive effort, Chevron is uncertain whether it is in compliance with the present leased employee rules.

C. Specific Problems Under Present Law

Although section 89 has been repealed, substantial problems with the present "leased employee" rules remain:

—A company's qualified plans may fail the coverage tests under Code section 410(b), even if its qualified plans cover all of its actual employees. This is an intolerable situation. Plan disqualification could affect thousands of innocent employees, and could cause law-abiding companies to lose hundreds of millions of dollars in deductions. Again, this problem arises because the proposed regulations are impossibly vague and overbroad.

—Even assuming that the proposed regulations have no validity, the statutory "historically performed in the business field" test has no clear meaning. In particular, it cannot be reasonably applied by supervisors in the field to determine when persons employed by contracting organizations should be deemed employees of the entity receiving the services.

—The annual report of an employee benefit plan on Form 5500 asks in item 22 (for 1988) for the number of leased employees of all employers in the controlled group. These persons must be included in the exact numbers of persons covered and not covered under the plan. Substantial fines and possible criminal penalties may be imposed where this information is not accurately reported.

—Leased employees must be counted as actual employees for purposes of a variety of other nondiscrimination tests in the benefits area, including tests relating to tuition reduction programs (sec. 117(d)), group legal plans (sec. 120), cafeteria plans (sec. 125), educational assistance programs (sec. 127), dependent care assistance (sec. 129), certain fringe benefit programs (sec. 132), employee awards (sec. 274(j)), cash or deferred arrangements (sec. 401(k)), and VEBAs (sec. 505). The current leased employee rules create uncertainty in complying with these nondiscrimination tests.

III. Purpose of Rules

A. The Purpose Should Be To Prevent Abuse, Not to Mandate Standardized Benefits

What is the purpose of the leased employee rules? It has always been our understanding that the purpose of the rules is to prevent avoidance or manipulation of the general coverage and nondiscrimination standards applicable to qualified plans. As noted, the Treasury Department testified in 1986 that the leased employee rules are intended to prevent such abuse. Viewed from this perspective, is clear that the present rules are overbroad, and include for many companies a host of persons that one would not ordinarily conceive of as being "leased employees."

Another possibility is that the leased employee rules are intended to mandate employee benefits in companies that do not now offer them, but which transact business with companies that do. Even if the current leased employee rules were administrable, we believe they would be an extremely inefficient and ineffective means to this end. Companies should not be required to have the same benefit plans simply because they do substantial business with one another. Indeed, where portions of a company work substantially full-time for different customers, the result would be a patchwork of benefit packages that would probably violate various nondiscrimination rules, and, for qualified plans, the minimum participation requirements of Code section 401(a)(26). Finally, and most significant, companies operating in different fields can be expected to vigorously oppose any suggestion that benefits be standardized simply because one is a client of the other.

B. The Common Law Rules, By Themselves, Have Generally Prevented Abuse

Some appear to believe that the common law definition of employee was greatly abused in the employee benefits area, and that this abuse necessitated the enactment of Code section 414(n). This is false. To the contrary, there are several cases and rulings that demonstrate the success of the IRS in dealing with "leased employees" in the pension and employment tax areas without resort to Code section 414(n).

- In *Sargent,* 93 T.C. No. 48 (1989), the Tax Court held that a professional hockey player was an employee of his hockey team, and not of his professional corporation that leased his services to the team. This case upholds the IRS position in GCM 39553.
- In *Professional and Executive Leasing, Inc.* 862 F.2d 751 (9th Cir., 1988), *aff'g* 89 T.C. 225 (1987), the 9th Circuit and the Tax Court held that professionals leased to their own corporations were not employees of the leasing organization, and thus could not be covered by a generous or "rich" plan of the leasing organization.

• In *Burnetta,* 68 T.C. 387 (1977), the Tax Court disqualified the plans of certain doctors' professional corporations, because those plans did not cover medical office personnel who received their checks from a separate organization. The Tax Court held that, under the facts, the office personnel were really employees of the doctors' corporations.

With this background, it is clear that the leased employee rules should resemble present law, rather than apply vague and overbroad principles. We think the proper purpose of leased employee rules is to clarify that certain relevant factors under the common law, that may in some cases be relegated to an artificial "leasing organization"—such as hiring and firing, paying wages, training, setting hours, uniforms, etc.—are not relevant in determining whether a worker is really performing services under the control of the recipient organization. In other words, such factors should not be relevant in determining whether an individual should be counted as an employee for benefit purposes.

IV. Suggestions for Simplification and Reform

The statute should return to fundamental principles as to when a person should be counted as an employee for benefit purposes. If an individual is hired to follow the employer's specific instructions as to how the work is to be performed, counting is appropriate. But if an employer contracts for a task or service to be performed, and is not particularly concerned over the exact manner in which that task or service is performed, counting is not appropriate.

We suggest that the essential statutory test under Code section 414(n) be whether the employer exercises *primary control over the manner in which the services are performed.* We would highlight the following points:

• *Different than common law test.* Our suggestion leads to different results than the control test under common law, as summarized in Revenue Ruling 87-41, 1987-1 C.B. 296 (listing 20 factors under the broader common law definition of control), and Revenue Ruling 75-41, 1975-1 C.B. 323.

• *The "bright line" issue.* It would be nice if a definition of leased employees could be based on a mechanical, "bright line" test that would be extremely simple to administer. Unfortunately, we do not think the purpose of the statute—counting persons for benefit purposes if they have a direct connection with a company, an appropriate "employment nexus"—can be achieved through a mechanical test. We think our test correctly identifies the employment nexus, avoids absurd results, and is about as straightforward as one could hope for.[2]

• *Administrability.* Our test is based on common sense principles as to when a person should be considered an employee. We believe it is capable of reasonable interpretation by employers, including supervisors who must provide "head counts" to headquarters.

We suggest several features to ensure that this test could be administered by the Service. For example, the burden of proof could be placed on the employer. Also, if there is a concern about fire/leaseback situations, persons who were formerly common law employees and who return within one year of termination of employment to perform substantially full-time services could automatically be considered leased employees. Finally, we suggest that there be a statutory statement that attempts to evade or avoid the coverage and nondiscrimination rules, through leasing arrangements or otherwise, will be disregarded. See, e.g., ERISA 4212(c).

• Examples would be helpful. Some clarifying examples, such as in the legislative history, would be quite helpful in illustrating our proposed test. We suggest the following:

(1) Oil Company A contracts with Company B for the periodic cleaning of tanks holding petroleum and petroleum products. Company B performs this task on Company A's premises by sending over crews of employees and their supervisors. Employees of Company A periodically review and monitor this work, and often discuss the work with the supervisors. The supervisors direct and exercise primary control over the crews in the performance of the tasks involved. Under these facts, these employees of Company B (both the crews and the supervisors) are not leased employees of Company A.

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[2] We note an article regarding complexity in the tax law that appears in the Fall 1989 issue of *The Tax Lawyer.* The author discusses the concept of "conservation of ambiguity." Briefly stated, the concept is that elaboration, such as extensive statutory provisions and hundreds of pages of regulations, "does not extinguish debate, it only shifts the terms in which the debate is conducted."

(2) Financial Company C utilizes the services of word processing and secretarial personnel provided by Company D. Company D hires these workers, sets their wages, pays the workers, directs the hours that the individuals will work, specifies the dress code of the workers, and retains the sole ability to terminate the workers. The work is performed under the day to day, ongoing supervision of employees of Company C. Under these facts, these word processing and secretarial workers are leased employees of Company C if the hours standard is satisfied.

TAXATION OF DISTRIBUTIONS

I. Problems With Present Law

There are at least three reasons why the taxation of distributions should be another prime candidate for simplification. First, the rules in this area are unbelievably complex; even the IRS experts involved in providing rulings change their interpretations from time to time. Second, more than any other area relating to qualified plans, the taxation of distributions directly affects individual participants and beneficiaries, and should be capable of being understood by them. Finally, the present rules prevent the portability of benefits in certain instances, and to that extent are contrary to sound retirement policy.

These problems may be illustrated by some current issues affecting Chevron. Chevron's defined benefit plan currently does not provide a lump sum option for persons under age 55. Chevron is considering making such an option available, both to active participants and to thousands of terminated employees with "vested" rights under the Chevron plan. However, under present law, it is unclear whether persons who have already terminated employment would be able to "rollover" funds into an IRA if they were to exercise such an option. Technically, the issue is whether the distribution is "on account of" separation from service, or "on account of" plan amendment. Chevron believes the recipients should have the option to rollover the amounts received —to preserve their retirement income, to defer income tax, and to avoid the 10% penalty tax on early distributions.

Chevron many also like to make a lump sum "cash out" option available to retirees currently receiving annuities. Such retirees could then elect to receive the present value of their remaining benefits in a lump sum. However, under present law, it appears that such amounts could not be rolled over.

II. Suggestions For Reform

To simplify the rules and to encourage the preservation of retirement savings, Chevron suggests that the law be amended to allow rollovers of all amounts received from qualified plans, other than minimum distributions required under Code section 401(a)(9). In other words, rollovers should be allowed of after-tax money and pre-tax money and other employer contributions, without regard to whether the distribution is a lump sum or one of a series of payments. Such a general rule would be easy for participants to understand and would facilitate the preservation of retirement savings.

We realize that allowing rollovers of after-tax contributions would involve some revenue loss. We think that loss is justified for the reasons noted above. However, if such a revenue loss is deemed unacceptable, then we would suggest that, at a minimum, the law should be amended to allow rollovers of all taxable amounts received (again other than minimum distributions under Code section 401(a)(9)).

In connection with the simplification and expansion of the rollover rules, Congress might consider cutting back on the special rules applicable to lump sum distributions and replacing them with an appropriately adjusted "minimum distribution allowance" with streamlined eligibility rules (with no other special tax treatment) to benefit individuals with smaller lump sum distributions. Chevron would favor eliminating complex rules, including the transition rules, relating to averaging of lump sum distributions. One way to avoid new and complex transition rules with respect to the elimination of these tax advantages would be to provide that the current advantages will no longer apply as of some date several years in the future.

Finally, we suggest that Congress consider eliminating the rule, under Code section 402(a)(1), that allows postponement of tax on the net unrealized appreciation portion of employer securities in a partial distribution, to the extent that those securities were purchased with after-tax contributions.

We hope these comments are helpful. If you or your staff wish to discuss any of these issues, please do not hesitate to call.

Very truly yours,

DOUGLAS W. ELL.

STATEMENT OF GENERAL MOTORS CORPORATION

Congress is currently considering several proposals to tax pension plans. General Motors is providing these comments to state our concern about this trend and specifically to oppose the proposal to tax short-term gains of pension funds.

As the nation's largest private employer, GM provides pension programs covering more than 800,000 participants — employes and vested former employes, retirees, and their surviving spouses. The legislation to tax short-term gains would include GM programs covered under ERISA, including defined benefit and defined contribution plans, such as retirement plans and GM employe savings plans. Our pension investments are in excess of $33 billion with over $6 billion for other non-pension benefit funds. For this reason, GM has a significant interest in current legislation in Congress to tax pension and other benefit plans.

Impact of taxing short-term gains from benefit fund investments

In the investment context, securities are purchased with the expectation of a gain that will be realized upon sale, which could follow either a short- or a long-term holding period. The stated purpose of the proposed pension tax is to inhibit the realization of short-term investment gains. However, under effective investment management, gains are earned both over short- or long-term holding periods. The tax would thus interfere with the proper realization of certain gains on securities. Therefore, this tax will reduce the plan sponsor's investment return, since the pension funds must either pay the tax or forego a short-term gain which the investment manager believes should be realized.

The tax would increase corporate costs in providing pension benefits and would have an especially damaging effect on underfunded plans. Over the long run, reduced investment returns would increase employers' expense for defined benefit plans. Even without such an increase, health, pension, and other employment benefits present a significant competitive disadvantage to traditional manufacturers based in the U.S. compared with transplants — foreign-owned U.S. manufacturing plants that do not have the older or longer service employes with large accumulated benefits. Increased costs would further impair U.S. employers' competitive position.

Employers have limited resources. Increases in costs to maintain pension investments mean less is available for other business purposes, such as additional investment in the business.

Defined benefit plans are generally considered more advantageous for employes than defined contribution plans, particularly for lower income employes, because the employer bears the investment risk. Under defined contribution plans, the employe usually bears the risk. In addition, with a defined benefit plan, the participant can better plan for retirement because the benefit is known in advance.

The excise tax may hasten the decline of defined benefit plans. According to a recent Employee Benefit Research Institute (EBRI) report, defined contribution plans are growing more rapidly (representing 73 percent of all plans in 1987 versus 68 percent in 1975) than defined benefit plans (representing 27 percent of all plans in 1987, down from 32 percent in 1975). The Pension Benefit Guaranty Corporation (PBGC) also noted this trend in its recent Annual Report. Because taxation of pension fund gains would increase many employers' expense of maintaining their defined benefit plans, the tax would provide further incentive for employers to abandon defined benefit plans.

The impact of the excise tax would likely make defined contribution plans less attractive to participants. They could incur a tax by transferring assets within the defined contribution plan in addition to the tax incurred by the investment managers on the overall investments of the plan. Therefore, the tax may result in less flexible defined contribution plans, higher cost structures, and lower benefits.

In addition to the impact on beneficiaries and employers, the proposed excise tax could affect the financial market as a whole. The tax could negatively impact the securities markets by making them less liquid and less efficient, thus increasing the cost of raising capital.

Extensive revisions in accounting and record-keeping would be very costly and burdensome to the pension industry. The tax would require complex systems to identify the tax liability, and vastly increased numbers of auditors and other personnel to administer the tax properly. These costs resulting from the tax would also be passed back to each pension fund.

Taxes on the pension system are poor tax policy

The proposal to tax short-term gains of pension funds is a step backward from the reforms achieved when Congress passed the Tax Reform Act of 1986 that, in part, reduced the impact of tax law on economic decision-making. The stated purpose of the bill — to influence the decision-making of pension fund managers — goes directly against this concept. Enacting a tax on short-term pension fund gains could lead to further unraveling of Tax Reform, to the detriment of the economy as a whole.

Taxing short term gains of pension funds also reverses sound tax policy of the last 70 years. Even in times of acute national distress such as World War II and the Korean War, when the top marginal tax rate was above 90% for individuals and above 80% for corporations, legislators did not impose taxes on such funds. The proposal is also contrary to the spirit of significant pension legislation enacted in 1987 to ensure an adequately-funded private retirement system so as to strengthen employe security.

Congress is currently considering a number of additional taxes that would affect the pension system besides the excise tax on short-term gains. These include a new excise tax on investment income and a securities transfer tax, as well as increased taxes on underfunded plans and on assets reverted from pension funds. GM believes this is poor tax policy. All pension fund income — whether resulting from contributions by the plan's sponsor or earned through investment — is ultimately subject to tax when the beneficiaries receive their benefits.

The pension system has worked effectively to assure an adequate retirement income for many. Several factors outside of the tax system currently are increasing the risk to employes and retirees of having a secure and worry-free retirement. These include the increased burdens being placed on the current benefits system due to the nation's aging population, and the increasing preference of many employers for defined contribution rather than defined benefit plans. Taxing a cornerstone of the retirement income system can create an even more risky and insecure retirement environment for employes and retirees.

We oppose this type of tinkering with the pension system. We also urge Congress to exercise extreme caution in using the pension system to further non-pension goals as well as in considering the pension system as a source of general revenue funding.

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March 7, 1990

Senate Finance Subcommittee
on Private Retirement Plans
and Oversight of the Internal Revenue Service
c/o Ms. Laura Wilcox, Hearing Administrator
Senate Finance Committee, SD-205
Washington, D.C. 20510

RE: March 23, 1990 Pension Simplification Hearing

Gentlemen:

I have read with interest the continuing calls from both the public and private sectors for "reform" and "simplification" of pension law. Invariably, the proposals call for further legislation to accomplish the "reform" and "simplification." The purpose of this letter is to express my views for consideration at your hearing scheduled for March 23, 1990.

Speaking not as a representative of any special interest group or as a member of an elite think tank, but as a lawyer on the front line in advising employers on employee benefit matters, I have a different proposal for reforming and simplifying our country's pension system. That proposal consists of the following:

(1) Stop enacting pension legislation (even so called "reform" and "simplification" legislation).

(2) Assuming (1) above is violated and new legislation is enacted, legislation should have delayed effective dates of at least 2 years after the Treasury Department (IRS) has issued its Final Regulations under the legislation.

(3) Assuming again that (1) above is violated and new legislation is enacted, the legislation should not give the Treasury Department the authority to issue legislative regulations.

My underlying premise is that the most complicating factor in pension law is the constant change in law and regulations. At this time, for example, employers are expected to operate their qualified retirement plans in compliance with the following, to name a few:

(1) The Tax Reform Act of 1986;

(2) OBRA 1986;

(3) OBRA 1987;

(4) TAMRA 1988;

(5) RRA 1989;

(6) Final REA Regulations; and

(7) Final Regulations under IRC §411(d)(6).

Because the Treasury Department has not yet issued final regulations on most of the legislative changes, they have recently delayed the required amendment date for plan documents to comply, through the end of the 1991 plan year. While the plans do not yet have to contain most of the provisions, employers are required to somehow operate their plans in compliance with all of these changes even though the IRS has not yet issued helpful guidance on most of the legislation.

Although there are numerous provisions of the law and regulations that are objectionable, the biggest objection is to the constant change. If the legislation stops, and regulations and other guidance are issued to catch up with all of the legislative change, the pension law will automatically become simplified. Employers will begin to understand how the complex law applies to their particular plans; and once in compliance, they can stay in compliance if the laws do not continue to change.

The top-heavy provisions, first enacted with TEFRA, are a good example. When these provisions were first enacted, they were seen as adding a great deal of complexity to the pension system. Now, however, since final regulations were issued some time ago and the substance has not been altered a great deal by legislation (although various "technical corrections" have been enacted in some of the pieces of pension legislation), clients have generally reacted to the rules and have designed their plans to comply. As a result, the top-heavy provisions, to most clients, no longer represent a complicating factor; they are simply boilerplate provisions in their plans. If legislative change stops now, I believe that all of the complicated provisions in the law will eventually become uncomplicated to most employers.

My second point deals with the effective dates of any future legislation. Very few final regulations have been issued under the various pieces of legislation, and much of the guidance which has been issued has added more complexity rather than clarity. Yet, plans are somehow expected to operate in compliance with the law. If future legislation does not become effective until well after the IRS has issued its final regulations, employers will be in a much better position to operate their plans in compliance with the law.

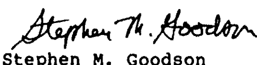
If the law is so complicated that the IRS is unable to issue final regulations in a timely manner, employers should not be expected to comply with that law prior to issuance of the final regulations. A good example of the problems associated with making legislation effective before the IRS has written the rules can be found in IRS Notices 88-131 and 89-92 and Revenue Procedure 89-75. This guidance is intended to provide transitional rule relief to employers. However, it is so complex that it is almost impossible to rely on in many situations. If the law were not required to be effective prior to the time the IRS issues final regulations, this sort of complexity could be avoided entirely.

Finally, the delegation of broad regulatory authority to the Treasury Department is an open invitation to them to further complicate matters. The trend these days is for the Treasury Department to attempt to address every conceivable abuse and situation in their regulations with the result that the regulations tend to take a complex matter and make it even more complex. It takes only a short review of the proposed regulations under IRC §§401(a)(26) and 401(l) to reach this conclusion. _See also_ Proposed Regulations under IRC §89.

If future legislation does not provide the broad regulatory discretion as it has in the recent past, the Treasury Department may stop over-regulating. If a matter is so complex that it cannot be properly addressed in the statute, the better course would be to refrain from legislating rather than giving the Treasury Department the authority to "fill in the blanks" with volumes of Regulations.

In summary, the best thing Congress can do to simplify the pension system is to stop legislating in this area. We represent hundreds of employers with pension plans, and although we hear complaints about specific provisions of the various pieces of legislation, the complaint we hear most often deals with the constant change. Calling a legislative change "reform" or "simplification" has not worked in the past to simplify the situation.

Very truly yours,



Stephen M. Goodson

SMG/ak
Enclosure

c: Mr. Ed Mihalski,
Minority Chief of Staff

Robert Portman, Esq.
Deputy Assistant to the President for
Legislative Affairs

April 24, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
205 Senate Dirksen Office Building
Washington, D. C. 20510

Dear Ms. Wilcox:

I understand through our actuary, Buck Consultants, Inc., that the Senate is looking into pension simplification. This is important to our company of 110 employees, and I am writing you to support any and all pension simplification measures.

Due to TRA '86, our 401K profit sharing plan document almost doubled in size from 35 pages to 63 pages. The regulations are too complex. They should and can be simplified without sacrificing the intent of the law.

In addition, our defined benefit pension plan became more complicated with the restrictions placed upon social security integration. Any easing of these restrictions would be appreciated.

I am not informed enough to make specific recommendations to you in this regard, so I urge the Senate to keep this phrase foremost in mind--KEEP IT SIMPLE.

Sincerely,

GROVE FARM COMPANY, INCORPORATED

Mark S. Hubbard
Director of Human Resources

MSH/ac

cc: Senator Daniel Inouye

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Hardrives Pension Plan
2350 So. Congress Ave.
Delray Beach, Fl 33445

3-21-90

Ms Laura Wilcox, Hearing Administrator
Senate Finance Committee, SD - 205
Washington, DC 20510

Subj: Pension Plan Complexity for Private Pension Plans

Dear Sirs:

I understand you are addressing the subject of pension plan complexity. Even though the plans I administer are but a microcosm of the pension plan universe, I wish to present some points I have noted while working in pension administration.

I am a plan administrator for two pension plans. One is a defined contribution plan with employee and employer contributions. The other is a profit sharing plan funded totally by the company. The firm I work with is a local road builder with 500 employees. I am the financial officer for the business and have been the trustee and administrator of both plans for sixteen years. I also served as a trustee for the City of Boca Raton General Employees Pension Plan for six years. The city had a contributory pension plan. It has approximately 1000 employees.

I have several thoughts regarding pension plan complexity as I see it affecting my company, the local construction industry and related businesses:

1. In our local construction industry the ERISA regs and related legislation have not encouraged the development of new pension plans or the continuation of older plans. I feel the reason for this is twofold. First, the complexity of the regulations requires a substantial time commitment on the part of the business and many small contractors can not afford this commitment. Secondly, the expertise (of pension regs, pension accounting, and computerized bookkeeping systems) involved in the pension administration exceeds the knowledge of many of the business owners or their staff. If an outside administrator is hired, the expense is substantial and the business still has to do the majority of the record keeping. We do our own plan administration in-house to save expenses and increase the the return to the retirees. We subscribe to plan administrators' guides and follow the pension plan trade journals. Our accounting profession continuing education assists us since plan accounting is a major activity in the accounting profession. In this effort to keep up-to-date with what is happening in the pension arena I believe we are an exception to the norm.

2. The number of law changes has forced me to make continual and costly plan amendments and filings. It seems that every five years or so I have completely rewritten the plan and asked for recertification because the amendments to the old plans were so many and varied. I do not believe our plan participants have benefited from all these changes, or are even concerned about them.

3. The "prudent-man" investment area is a complex one that the trustees continually struggle with. It seems from my readings, and the IRS and Dept of Labor audits I have been through, that the prudent thing to do with pension funds is to give them to one or more stock and bond pickers to handle. The fees for this will of course reduce the return to the retiree. I have not seen good evidence either in the press or from the relationship I have had with these investment advisers that they can achieve a long-term success rate much better than just putting the money in intermediate-term CD's. I am sure the vast investment industry will take exception to this. However, I would like to see more funds invested in the local banks and S&L's without the administrator and trustee's being considered backwards. Our plan participants favor security of principal and reasonable rates of return over volatility and potential higher rates of return. I believe that a survey of investment

choices among the participants of any pension plan will confirm this. I do not believe this investment area should be legislated except for blatant and obviously prohibited transactions.

4. My plans pay substantial government mandated auditing fees to produce certified financial statements to send in with our annual Form 5500 filing. This extra accounting cost reduces the amount of benefits paid to our participants by two percent per year (and we work very hard to keep the fees down). The accountants basically duplicate the financial statements I have prepared for the trustees. These of course are available to the IRS and Dept of Labor whenever they want to audit us to ensure compliance. It is unfair to think the accountants can uncover any wrong doings. Even their reports disclaim responsibility for such investigations. I would like to see the audited financial report requirement eliminated. If a plan administrator needs the CPA's expertise he can always hire him, but if not, why force him to incur the cost and time commitment? Ask yourselves this question, "Were the plans the PBGC has taken over preparing annual certified audits?". I would bet they were!

5. The tax withholding tables for lump-sum distributions are too low. Several of our retirees have ended up paying penalties and interest for not making estimated tax payments when they thought everything was okay. We had withheld according to the tables, but it was insufficient. Now I encourage them to consult with their tax advisers and voluntarily elect higher deduction amounts if necessary.

6. The recent legislative mandated change in vesting requirements is adding to the plan complexity. Let me explain. Our old plans had an entry date after five years of employment. At this time the participant was 50% vested. As you know the current law requires two vesting choices. These are 3-7 year graded vesting at 20% per year or 5 year cliff vesting at 100%. These new vesting schedules have encouraged several of the less stable or dedicated participants to quit after being only nominally vested (20-40% range). I am not sure what they do with the funds, but they have all elected lump-sum distributions without any tax withholding. I do not believe these new mandated vesting schedules are assisting many individuals in their retirement planning. I think pension plans are viewed by some participants more as a saving account that can be cashed out whenever desired. This plan participant turnover adds to the bookkeeping complexity.

7. The recent legislative mandated entry dates have greatly added to the plan complexity. Now an employee can join a plan after one year instead of the previous five years. This has doubled the number of participants that we must now track. Since they are not vested until after three years I do not believe this benefits the average plan participant. I would like to see this one year entry date eliminated.

8. The break-in-service rules also require substantial bookkeeping. Not once in my 15 years as an administrator have I known of an employee with an unvested account balance to rejoin the company. We have had vested participants quit, take their retirement funds out, and rehire after a period of time (generally less than one year). However, none of these vested participants have ever paid the funds back into the plan.

I wish to thank you in your efforts to reduce the complexity of pension plans. Perhaps you could look at the tax code next?

Sincerely,

Douglas G. Gordon
Trustee/Administrator

STATEMENT OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.

My name is Charles E. Haldeman, Jr. I am president of the investment firm Cooke and Bieler. I also serve as president of the Investment Counsel Association of America ("ICAA"). The ICAA was organized in 1937. For over 50 years, ICAA has been dedicated to the promotion of high professional and ethical standards for investment advisors. During these years, ICAA has grown to approximately 150 investment advisory firms who manage some $326 billion, a substantial amount of which represents assets of qualified pension and profit sharing plans.

I am pleased to have this opportunity to comment on the proposed Excessive Churning and Speculation Act of 1989 (S. 1654).

The Employee Retirement Income Security Act of 1974 ("ERISA") places strict requirements on investment advisers to ERISA plans. Among these requirements is that investments be made solely in the interests of plan participants and their beneficiaries. Pursuant to this fiduciary requirement, investment advisers invest plan assets with a view towards producing the best total return consistent with the investment objective and policies of the plan. Depending upon the style of the investment manager, its strategy in producing the best total return can involve short-term trading. ICAA strongly opposes S. 1654 as an unwarranted handicap placed upon active investment advisors which could ultimately harm the economic interests of pension plans and their beneficiaries.

ICAA recognizes the growing Congressional interest in the concept of differential capital gains rates which would tax long term assets at a lower rate than short term assets. A majority of our membership questions the wisdom of such variable rate proposals generally. We feel strongly however, that if Congress believes there is a merit in that concept, then they should apply it to all investments, not just pension funds as does S. 1654. Singling out pension funds is not only discriminatory, but will distort investment strategies and result in unintended harmful impacts on pension funds and ultimately retirees.

The effect of the bill, if enacted, will be to force pension funds to absorb higher costs either in the form of taxes or lower returns from mangers who are handcuffed by the legislation. In the case of defined contribution plans, these costs will clearly fall on the ultimate recipients. In the case of defined benefit plans, the sponsors will absorb the resultant costs which will force increased contributions to the plans to meet funding requirements; such costs will be a drag on profits and ultimately would lead to higher prices and upward inflationary pressures.

Much has been written and said concerning the health and welfare of the social security system, the low savings rate of Americans compared to our nation's trading partners and the need for all Americans to prepare for retirement and not to rely upon social security benefits alone. With the passage of ERISA and subsequent legislation, particularly in the 1980's, the complexities of laws relating to pensions have convinced many employers either to terminate, or forgo implementing, pension plans. By imposing a tax on the assets of pension plans, S. 1654 will be another step in the direction towards weakening private pension systems. Whatever the size of the tax on individual plans, it will send a message to employers that they cannot rely upon the continuation of the long-established policy of Congress to exempt pension plan assets from taxation. This will be yet another incentive for employers to either curb or not establish pension plans, thereby discouraging savings and putting additional pressure on government to meet the retirement needs of Americans. This is one of the greatest flaws of any such legislation.

Other problems with the bill include a probable decrease in volume and liquidity thereby making the capital markets less efficient. As you may know, the Australian government recently imposed a capital gains tax on pension funds. Liquidity diminished, triggering a major bear market in relation to other markets worldwide, making the Australian market one of the worst performing in the world.

If after careful study, Congress determines that curtailment on such trading is desirable, such curtailment should be confronted directly rather than through the tax code. One of the stated purposes of the 1986 Tax Reform Act was to remove the economic inefficiencies caused by fostering perceived desirable social ends through the tax code rather than through direct means. If Congress decides that curtailing certain short-term trading practices is in the public interest, it should address this problem directly. Any such changes should apply to all investors, not just pension funds.

Private pensions are an extremely important means of ensuring that as Americans reach retirement age they will have adequate incomes. The government's commitment to the health and integrity of private pension funds should be no less than

its commitment to Social Security. To borrow a thought from the President, we shouldn't be messing around with peoples' retirement income.

Again, I appreciate the opportunity to present our views to the Committee as you consider this important issue.

J&L SPECIALTY PRODUCTS CORP.,
Pittsburgh, PA, April 23, 1990.

MS. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
205 Senate Dirksen Office Building,
Washington, DC.

Dear Ms. Wilcox: J&L Specialty Products Corporation welcomes the opportunity to submit written comments on the subject of simplifying the qualification and nondiscrimination rules for private pension plans.

Although the Tax Reform Act of 1986 (TRA'86) generally simplified our nation's system of taxation in many areas (e.g., individual income taxation), in the area of qualified plans the opposite Is true. The new qualification and nondiscrimination requirements for pension plans under TRA'86 have created major problems for all employers. These requirements in themselves are far too complex.

In certain cases, the Treasury Department has made meeting these requirements even more difficult by its inability to get out a number of key regulations on time. In fact, today the Treasury Department still has not issued its key proposed general nondiscrimination regulations under Code Section 401(a)(4) and the equally vital proposed separate line of business regulations under Code Section 414(r).

In addition, the proposed TRA'86 regulations that have been issued thus far have been massive and unwieldy. The complexity of these proposed regulations renders them almost incomprehensible to even highly knowledgeable benefits professionals.

Furthermore, the Treasury Department has made these regulations in many cases much more complicated than required—or even justified by law.

In light of the inability of the Treasury Department to get its regulations out on time, many defined benefit plans are currently in limbo and have been since 1989. Many employers have had to suspend current accruals under their defined benefit plans for some or all of their employees. In some cases, employees have retired and received only a portion of their accrued benefits and are awaiting the remainder that has been promised once the plan is amended.

To help remedy these problems and achieve the goal of simplification for private pension plans, J&L would like to make the following legislative and regulatory recommendations.

SPECIFIC RECOMMENDATIONS—LEGISLATIVE

General Nondiscrimination Rule Testing

In addition, Congress should stipulate that once a plan satisfied Code Section 401(a)(4), that plan would not be required to test for compliance on an annual basis unless there has been a dramatic change in the plan sponsor's work force or the plan has been significantly redesigned. The Code Section 410(b) coverage requirements would not be affected by this change.

401(k) Nondiscrimination Tests

The current Average Deferral Percentage (ADP) test applicable to 401(k) plans and Average Contribution Percentage (ACP) nondiscrimination test applicable to 401(k) plans and certain other plans should be replaced with a design-based nondiscrimination test—similar to the test currently used by the Federal employees' thrift plan. J&L supports legislation that will be proposed by Sen. Pryor and Rep. Chandler under which a 401(k) plan would be deemed nondiscriminatory if it is offered at a minimum on an equal basis to all employees necessary to pass the coverage test rules under Code Section 410(b).

Definition of Compensation and Highly-Compensated Employees

Rep. Richard T. Schulze (R.-Pa.) has recently introduced a bill (H.R. 4508) that would simplify for qualified plans the definition of highly-compensated employees, simplify and make uniform the definition of compensation, and delay the reporting of the number of highly-compensated employees until a study has been completed on how burdensome the reporting requirements are. Under this bill, a highly-compensated employee would generally be defined as any employee who was compensated in excess of $75,000 (as indexed) during the year or the preceding year.

This legislation would simplify considerably the administration of qualified plans. We suggest that it be enacted by Congress and that the uniform definition of highly-compensated employees be extended to all welfare plans where nondiscrimination testing is required.

Delay in TRA'86 Effective Date

Since the Treasury Department is already so late in getting many of its TRA'86 regulations out, Buck recommends that for plans that qualify under the pre-TRA'86 rules and have not yet been amended to comply with TRA'86, the TRA'86 effective date for the nondiscrimination, minimum participation and maximum permitted disparity (Social Security integration) rules be postponed until at least one year after the final regulations in these areas are Issued. In addition, plans that qualify under pre-TRA'86 rules for plan years prior to the postponed effective date or plan years prior to the time the plan is amended to comply with the TRA'86 rules (see below), If earlier, should be treated as qualified.

In the case of plans that have already been amended for TRA'86 changes, these plans should remain qualified if they pass a liberal good faith compliance test from the time they are amended until one year after final regulations are issued and the law should so provide.

This delay will enable employers to avoid a problem not of their own making—having to make complex and costly retroactive changes to their plans—and will vastly simplify plan administration.

CONCLUSION

As noted above, the general TRA'86 them of simplification did not really apply to the TRA'86 pension plan rules—particularly as amplified by the Treasury Department. The net result is a situation in which plans are bound by rules that are far more complex to administer than would otherwise be the case.

We believe our recommendations can help to simplify these rules and ease the pressures on the private pension system.

Very truly yours,

JOSEPH F. BROZICK, *Director—Corporate Taxes.*
STEVE RODICH, *Manager—Employee Benefits.*

Richard Joss
1055 Nakala
Winslow, Washington 98110

March 14, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
SD-205
Washington, D.C. 20510

Mr. Ed Mihalski
Minority Chief of Staff
SH-203
Washington, D.C. 20510

Re: Pension Simplification

Dear Ms. Wilcox and Mr. Mihalski:

If possible, I would like to see the following ideas considered as part of any pension simplification discussion:

1. <u>Create Employer-Contributed Retirement Accounts</u>

   These accounts would be handled just like Individual Retirement Accounts, except they would consist only of employer-contributed funds paid as the result of an employee's termination of employment. This would put the management responsibility for vested terminee lump sum payouts into individual hands and could relieve plan administrators of much detailed recordkeeping. The funds would be distributed to the participant (or his or her beneficiary) only upon attainment of age 59-1/2, death, or disabilities approved for payment by the Social Security Administration.

2. <u>Publish Uniform Cashout Rates</u>

   Uniform Cashout Rates would be established once each calendar year by the Department of Labor. These would be used by plan administrators, if desired, to cash out vested terminated defined benefit amounts for transfer to the employee's Employer-Contributed Retirement Account. If the total cashout was less than 1/10 of the year's Social Security Taxable Wage Base (SSTWB) the plan administrator could transfer the lump sum without participant consent. Cashouts greater than 1/10 of the SSTWB would require both the participant's consent and the employer's consent. In particular, employers who felt that the cashout rates were too generous to the employees could retain the liability for vested terminated benefits.

3. **Reestablish Individual Retirement Accounts**

New Individual Retirement Accounts (IRA's) would represent tax-deferred employee contributions to either an Individual Retirement Account (in the old IRA sense) or to an employer-sponsored and -maintained account. Contributions to the employer-sponsored and -maintained account would be in lieu of current 401(k) type salary deferrals, and thus, these contributions would be treated exactly as the employee thinks of them (i.e., employee-contributed, tax-deferred contributions). The employee would claim the tax deduction on his or her 1040 form. To be sure that the privilege of making such contributions is not abused, they would be limited to 5% of compensation subject to a 1/10 of SSTWB dollar maximum.

4. **Simplify Maximum Benefit Limits**

Maximum Benefit Limits would be adopted separately for each type of retirement plan, such that a reasonable level of employer-sponsored benefit could be earned throughout a working career.

The defined benefit limit could be 60% of highest three-year average pay subject to a SSTWB dollar maximum.

The employer-contributed defined contribution benefit maximum could be 15% of participant pay subject to a maximum annual contribution of 1/3 the SSTWB.

All of the current defined benefit/defined contribution fractions would be eliminated, along with the highly compensated/non-highly compensated testing. Anti-discrimination would be presumed by the plan design and the relatively low maximum dollar limits tied to the Social Security Taxable Wage Base.

5. **Eliminate the Pension Benefit Guaranty Corporation**

The Pension Benefit Guaranty Corporation (PBGC) currently provides a limited form of benefit protection for participants in defined benefit pension plans should those plans terminate with assets insufficient to provide promised benefits.

While the motives behind the implementation of the PBGC were the highest, its very existence encourages employers to either fund plans at a minimal level or adopt a retirement plan which has provisions which will assure that PBGC premiums will be avoided or minimized, regardless of the need of employees currently contemplating retirement. Thus, although the primary goal of the PBGC is to promote retirement security, its very existence may be encouraging exactly the opposite.

Clearly, if defined benefits are going to be promised, the workers need to have some reasonable assurance that these benefits will be paid, but the following outline may be a preferable and less burdensome approach:

(a) Employers adopting defined benefit plans must comply with minimum funding legislation.

(b) If at any time assets do not cover at least 125% of cashout liability, the employees must be notified in bold, basic terms of the plan's current funded status and the employer's plan to improve it. Thus, the employee will have been put on notice that the pension promise may be hollow.

(c) Existing accrued benefits as of the date of any change in PBGC protection would have to be guaranteed in some fashion.

6. **Eliminate Qualified Pre-Retirement Survivor Annuities**

Qualified Pre-Retirement Survivor Annuities (QPSA's) are designed to provide some measure of protection for the surviving spouse of an employee who dies close to retirement. In actuality, due to the fact that the benefits can be adjusted for the ages of the participant and beneficiary, the fact that benefits can be adjusted for alternate forms, and the fact that the survivor portion could be as little as 50% of the remaining benefit, the actual dollars backing up the promise are appallingly small.

Given that relatively few employees die while actually employed (as opposed to voluntarily terminating employment because of a serious illness) why not require that the full lump sum value of the benefit be paid upon death, regardless of vested status or age at death? There would be no employee/spouse elections and no benefit reductions to provide the coverage.

7. **Create Qualified Employer Withdrawals**

Qualified Employer Withdrawals could be made at any time by an employer sponsoring a defined benefit pension plan subject to the following:

(a) Remaining assets must total 125% of cashout value of benefits not covered by guaranteed insurance contracts.

(b) The withdrawal would be subject to a 33% tax.

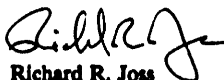
This would allow employers to tap quickly into pension funds for plans that are well funded, but for a price.

8. **Coordinate FAS #87, IRC 404 and IRC 412**

Current defined benefit plan sponsors are required to go through several gyrations to determine the minimum required contribution, maximum deductible contribution and the pension expense for generally accepted accounting purposes. While some plan sponsors may wish to have a high degree of flexibility, those who don't are forced into several different sets of calculations to make sure that the booked pension expense is between the minimum required and maximum deductible contribution levels.

Thanks for considering the above points.

Respectfully submitted,



Richard R. Joss

RRJ/jrw-T
(00097/85)

cc: Rod Chandler

STATEMENT OF KERR-MCGEE CORPORATION

I. Introduction

Kerr-McGee Corporation welcomes the opportunity to comment on the impact of a pension provision desperately in need of simplification. Specifically, Kerr-McGee believes there is a qualified employee benefit plan testing problem associated with leased employees that is pervasive throughout the country and through all industry groups. While a remedy for this problem was proposed in conjunction with the repeal of Section 89 and later with the Senate version of the Child Care Tax Credit, the problem has not been rectified.

Under current law, "leased employees" must be counted for purposes of nondiscrimination tests that apply to many employee benefits. If these tests are not satisfied because a company has a large number of leased employees who are not covered under a plan, the company's pension and profit-sharing plans may all be deemed "discriminatory" for tax purposes. This can result in the company and the persons participating in these plans being subject to harsh tax penalties.

Current law makes it virtually impossible for an employer to determine its "leased employees". The current definition of "leased employee" is unclear and extremely broad. It includes for many companies groups of persons that one would not ordinarily conceive of as "leased employees". Unless the law is amended, many traditional and non-abusive commercial relationships are likely to be treated as employee leasing arrangements.

Major employers contract with outside parties for a variety of legitimate business reasons. For example, an employer may not have the expertise, or facilities possessed by an outside contractor. Alternatively, an employer may need a short-term assistant that only an outside contractor can provide economically and on short notice. These arrangements are not associated with the abusive employee leasing arrangements that we believe Congress intended to address, when it added the employee leasing provisions to the Internal Revenue Code (IRC) in the Tax Equity and Fiscal Responsibility Act (TEFRA).

The definition of leased employee now in the law should be replaced with a definition that clearly identifies and effectively prevents genuine abuse of employee benefit laws, and provides enough clarity to be administered by the business community at a reasonable cost and to be enforced by the government. IRC Section 414 (n) should be amended to accomplish this result.

II. Leased Employee Definition is Vague and Overly Extensive

The Internal Revenue Code defines a "leased employee" as a person who, pursuant to an agreement, performs substantially full-time services for a recipient and such services are "of a type historically performed, in the business field of the recipient, by employees." IRC Section 414(n)(2). The legislative history does not clarify this definition. The Treasury Department testified in 1986 that the intent was "to prevent avoidance of the rules governing qualified plans through leasing of employee services." The example given was a doctor who would lease nurses and other staff personnel. Treasury's testimony further stated that "before the enactment of Section 414(n), a qualified retirement plan could be established that applied to the doctor but not to the leased nurses or staff. Since the doctor technically had no other employees, such a plan would not be discriminatory. Section 414(n) addressed this problem by generally deeming the leased employees to be employees of the employer for purposes of certain requirements including nondiscrimination."

Proposed Treasury regulations actually broaden, rather than clarify, the vague terms in the statute. "Agreement" has been defined to include any "mutual understanding" and need not be in writing. Prop. Treas. Reg. § 414(n)-1(b)(5). "Services" may be performed directly or indirectly. Prop. Treas. Reg. § 1.414(n)-1(b)(17). "Business field" is not defined at all. Thus, under the regulations, any person who works on matters involving another company (the recipient) on a substantially full-time basis will be deemed a leased employee of that recipient company if the services provided are of a type "historically performed by employees." An activity is "historically performed by employees" if it was "not unusual" for the service to be performed by employees in the business field of the recipient on September 3, 1982. An activity also is deemed "historically performed by employees" if that service "was ever performed by any employee" of the recipient at any time during the last five (5) years. Prop. Treas. Reg. § 1.414(n)-1(b)(12).

It will be difficult for a company to determine whether it was "not unusual" for a particular service to be performed by employees in that company's business field. Indeed, because the term "business field" is not defined, the task may be impossible. In addition, most companies have at some time used their own employees to perform common business activities that are also routinely performed by outside organizations. For example, such companies may employ in-house lawyers, accountants, computer programmers, carpenters, chemists, doctors, draftsman, engineers, maintenance workers, machinists, and security personnel. As required by the definition in the regulations, "any in-house employee" will have performed many of these activities during the last five years. Accordingly, employees of outside organizations providing the same services, such as lawyers in a law firm providing legal advice to a recipient company with in-house counsel, may be "leased employees" of the recipient. As a result, a recipient and its employees may be subject to legal consequences because of the outside law firms' employee benefits.

We do not believe that Congress intended to make independent service providers, ranging from lawyers to construction crews, "leased employees" of the company they are serving. Nor do we believe that Congress intended to intertwine one independent company's employee benefits with another independent company's employee benefits.

III. Compliance With Current Law is Impossible

The vague statutory definition currently in place creates an impossible information gathering task for a business trying to comply with the law. All businesses contract for services where the control and supervision of the workers is by the contracted company. Under the broad statutory definition, these workers become potential "leased employees" notwithstanding that the recipient does not control or supervise them. For example, if a third party service company, having many business customers, performs services for recipients, the service company workers become potential "leased employees" of each recipient. Even small businesses contract with dozens or hundreds of such third party organizations. Large companies are involved with thousands of these organizations.

Since a third party organization worker could be a potential "leased employee", each U.S. business must attempt to obtain detailed information (hours, salary, cost of benefits, plan options, etc.) from all of the third party organizations with whom it does business. The collective effort that would be required by U.S. businesses to do this is beyond comprehension. Current industry experience is that third party organizations are reluctant to provide such information and often do not understand the reason their own workers would be deemed employees of another unrelated organization.

There is no indication that Congress intended to burden U.S. business with an administrative problem of the magnitude now being confronted, particularly as it applies to obtaining information from third party organizations about workers that the recipient business does not control or supervise. U.S. businesses need a definition of "leased employees" that is workable and in accordance with the generally understood concept of an employer-employee relationship.

IV. Uncertainty Created by Current Law is Poor Tax Policy

In its present form, the "leased employee" rule and related regulations do not identify companies that are "leasing" employees to avoid or abuse the employee benefit laws. Rather, the rule has the effect of making one independent company responsible for the employee benefits of another independent company with which it contracts for services. The present rule is so overbroad and difficult to administer that law-abiding companies cannot comply with it at a reasonable cost. For the same reason, the present rule will be difficult to enforce. Courts will fill in the gaps left by Congress and Treasury, and given the lack of guidance, results may vary from one jurisdiction to another.

The "historically performed in the business field" standard is especially disturbing. Precise data regarding past practices do not exist, and there is no meaningful concept of a business field.

Such major uncertainty, affecting the nondiscrimination testing of major employee benefits for most U.S. businesses, is fundamentally poor tax policy. The wide scope of the proposed regulations indicates that thousands of legitimate benefit plans, some covering tens of thousands of workers, should lose their tax-qualified status in whole or in part.

V. Proposed Definition of Leased Employee

Kerr-McGee believes that an appropriate definition of "leased employee" would be reflected in a statutory change as follows:

(a) TREATMENT OF LEASED EMPLOYEES.--

(1) REPLACEMENT OF HISTORICAL TEST WITH CONTROL TEST.--Subparagraph (C) of section 414 (n)(2) is amended to read as follows:

"(C) such services are performed by such person under the control of the recipient."

(2) SERVICES INCIDENTAL TO SALE OR CONSTRUCTION DISREGARDED.--Paragraph (2) of section 414(n) is amended by adding at the end thereof the following new full sentence:

"The term 'leased employee' shall not include an individual solely because such individual is performing services incidental to the sale of goods or equipment or incidental to the construction of a facility. Such term includes the support staff of professional service organizations."

This proposed language is from S. 1750 and was included in the Senate version of the Child Care Credit legislation of 1989. As stated in the committee reports to these bills, factors that should be considered in determining control are whether the recipient organization: (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's level of compensation. Thus, the proposed amendment prevents the abusive situations discussed above and focuses on appropriate factors to consider in determining whether abuses of employee benefit laws exist. By contrast, the vague areas of existing law (i.e., standards such as "historically performed" and "business field") are generally irrelevant in measuring current abuse.

VI. Conclusion

The "leased employee" rules are virtually impossible to apply and administer as presently drafted and interpreted. The definition of "leased employee" in IRC section 414(n)(2) should be amended as proposed above to prevent potential abuse in a reasonable and administratable manner.

Supplemental Sheet For Hearings Statement

Kerr-McGee Corporation Representative

Ronald F. Hartman
Assistant Tax Director, Research and Audits
Kerr-McGee Center
Oklahoma City, Oklahoma 73125
405-270-3018

Topical Outline of Statement Regarding Statutory Definition of Leased Employee

I Introduction

II Leased Employee Definition is Vague and Overly Extensive

III Compliance with Current Law is Impossible

IV Uncertainty Created by Current Law is Poor Tax Policy

V Proposed Definition of Leased Employee

VI Conclusion

KLEIN, MCGUIGAN & LANDAU,
Washington, DC, March 29, 1990.

Hon. DAVID H. PRYOR,
U.S. Senator,
U.S. Senate,
Washington, DC.

Dear Senator Pryor: It has come to my attention that you are interested in simplification of the laws, rules and regulations governing certain retirement plans. I write to offer my opinions and experiences with such plans as a small business owner.

In 1986, at a prior company, we were advised by our accounting firm, also a small business, to adopt a SARSEP plan. The accounting firm recommended the plan to all its small businesses and stated that it was, itself, adopting such a plan. It was anticipated that when final rules and regulations were promulgated, this plan would be simple and cost effective. Our plan was placed with a national broker. The problem with the plan was that the accountants and the broker disagreed with each other on almost all matters regarding the plan and we were never able to obtain authoritative answers to most questions.

When we discussed the plan's problems with our accountants after two years, we learned that they had terminated their plan and we were the last clients to still have a SARSEP. subsequently, we terminated our plan and incidentally the accountants.

Our new company has adopted a pension and profit sharing plan even though it seems to be incredibly complex and of questionable financial benefit. To date, our broker appears to be able to definitively answer our inquiries.

It is my opinion that the government has a legitimate interest in promoting savings through tax incentives. I also think that it is laudatory, albeit expensive, to link participation of non-highly compensated individuals to the amounts that highly-compensated individuals can contribute. However, a major problem that must be addressed is the complexity of the plans which create great burdens and expenses particularly regarding plan administration.

In our case, administration fees would equal twenty five percent of the amount of money we have put into the plan, if we chose to pay an administrator. several professionals familiar with administration, actually laughed when we suggested that we intended to administer the plan in-house. Since we have just started, I am not sure if that position will prove accurate.

To the extent that the costs of adopting a tax advantaged plan outweigh the gains, businesses will not initiate them or will continue to terminate them. This is a trend which would clearly frustrate national policy. Therefore, if tax advantaged retirement plans can be simplified, the country will be very well served.

Sincerely,

GARY ETHAN KLEIN, ESQ.

LEWIS & ELLIS, INC.,
Richardson, TX, April 19, 1990.

Senate Finance Committee,
Washington, DC.

RE: Pension Simplification Hearings

Dear Committee Members: The Committee is to be commended for examining ways to simplify the nation's private pension system. The complexity of pension law has grown since the passage of the Retirement Income Security Act of 1974. However, it is the drastic increase in complexity that has occurred since the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) that has crippled the private pension system.

Since TEFRA, plans have also been affected by the Retirement Equity Act of 1984, the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1987, the Technical and Miscellaneous Review Act of 1988, and the Omnibus Budget Reconciliation Act of 1989. This has required almost continuous amendment of plan documents. Plan sponsors have not been able to keep up with the required plan changes; the Internal Revenue Service has not been able to issue regulations on a timely basis; and members of Congress have not been able to keep up with all of the requirements affecting their constituents. Most of today's pension problems stem from yesterday's solutions.

As an example of the complex nature of pension law, consider the number of different interest rates required to operate a defined benefit plan. First, it should be noted that the assets of a plan grow at a single rate each year. But note how many different rates are required for the various calculations under a plan. (Representative or required rates, as of January 1, 1989, for a plan operating on a calendar basis are given as examples.)

1. The valuation interest rate is used to calculate the plan's normal cost for the year. ERISA makes the plan's actuary responsible for setting this assumption. (Typical rates vary from 7 percent to 9 percent.)
2. The Tax Reform Act of 1986 added a quarterly contribution requirement for defined benefit plans. The interest rate charged on missed quarterly contributions is based on 175 percent of the Federal Mid-term Rate (the 1989 effective rate comes to 16.41 percent for calendar year plans). Under complicated IRS rules, this rate is not 1.75 times the corresponding Federal Mid-term rate (9.22%).
3. The minimum rate charged to the funding standard account with respect to waived contributions or extensions of an amortization period is 150% of the Federal Mid-term Rate. Needless to say, the IRS doesn't define this rate as simply 1.5 times the Federal Mid-term Rate.
4. The maximum interest rates that may be used in calculating a participant's lump sum distribution are published monthly by the Pension Benefit Guaranty Corporation. As many as four separate rates are required in these calculations. (January 1, 1989 values were 7.75 percent, 7.00 percent, 5.75 percent and 4 percent.) These rates are multiplied by 120% for lump sum amounts greater than $25,000.
5. Although the plan must pay benefits based on rates ranging from 7.75 percent down to 4 percent, contributions to fund those benefits are limited by a separate set of interest rates which, as of January 1, 1989, could not be less than 7.92 percent. This is the "current liability" full funding limitation.
6. In calculating liabilities for the purpose of paying plan termination insurance premiums to the Pension Benefit Guaranty Corporation, a plan has to use yet another rate. (The January 1, 1989, "Required Interest Rate" was 7.21 percent.)
7. If the plan calls for employee contributions, is subject to Financial Accounting Standard Board Statement Number 87 or specifies a distinct rate of interest for calculating actuarially equivalent benefits, additional interest rates are involved.

We submit that this maze of requirements does not serve the best interests of plan participants. The plethora of interest rates is only one example of the overly complex nature of pension law.

We sincerely hope that the Committee's hearings lead to pension simplification. It is an ambitious undertaking but one the nation desperately needs.

Sincerely,

JOHN M. CRIDER, JR., *Associate of the Society of Actuaries.*
DAVID L. LIVELY, *Fellow of the Society of Actuaries.*

NATIONAL ACTUARIAL PENSION SERVICES, INC.,
Houston, TX, March 28, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
Washington, DC.

Re: Pension Simplification

Dear Ms. Wilcox: The purpose of this letter is to suggest consideration of certain changes that might result in pension simplification. My comments are intended to be limited to the issue of pension simplification (as distinguished from a list of all changes that I think would be appropriate) and to deal with those changes that would result in simplification benefits that exceed the cost of surrendered social objectives.

(1) Codify that contributions will be deemed to have been made to a Plan on the date on which control is surrendered (i.e. usually the date on which the check is mailed) as opposed to the date received by the Plan. There is uncertainty regarding this point and the complications caused are made more significant by the requirement of quarterly contributions.

(2) Limit the requirement of quarterly contributions to those plans for which a Deficit Reduction Contribution (as defined in Section 412(l) of the Internal Revenue

Code) is required. The only benefit obtained from quarterly contributions is to strengthen benefit security, and they are a significant complication with no social value for well-funded plans. In addition, there should perhaps be some materiality threshold, such as a Deficit Reduction Contribution that exceeds $50,000 per year, before quarterly contributions are required.

(3) Remove the requirement that participants in a Plan that requires Employee contributions share in any reversion on plan termination, at least for those plans which have not required employee contributions for at least five years prior to plan termination and remove the requirement of reversion sharing for those retired participants who have received plan benefits that exceed the amount that they contributed. The whole concept of sharing the reversion is problematical in view of other parts of pension law, records may be difficult to obtain for contributions made many years ago, plan design decisions frequently give implicit recognition to employee contributions and the results obtained by the current (cumbersome) technique produces only a rough equity. Specialists in providing consulting. administrative and actuarial services to retirement plans

(4) Do away with current top-heavy minimum benefit and vesting rules. The provisions of the Tax Reform Act of 1986 makes the top-heavy requirements much less valuable from a social policy perspective and probably no longer worth the complications.

(5) Establish a pre-approved list of funding methods which can be used for any valuation without the current requirement that the existing method be used for three years without change in order that automatic approval of the change be granted. Also, codify that a change that has an insignificant effect, such as an improvement in a computer system, does not constitute a change in funding method. The only alternative currently available, that of applying for approval of a change, is burdensome and involves a user fee, and the resulting protection for plan participants and tax revenue could be achieved with less of a burden on the pension community.

(6) Permit Section 401(a)(9) of the Internal Revenue Code to provide that it only applies to benefits that exceed some amount, such as $2,000/month. It is not unusual for companies to employ older, frequently long-term, employees and doing so complicates the operation of their pension plan. The lost tax revenue should not be large if the benefits are small, and it would remove a complication for companies that wish to provide casual, part-time or non-demanding employment to older individuals.

(7) Remove the actuarial equivalence requirement for post-NRA benefit accruals and permit plans to simply recognize such service through their formulas without the burden of suspension of benefits notification. See the comments under (6) above.

(8) Codify that there is no pre-retirement death benefit notification requirement if the death benefit is provided automatically and without cost to the participant. I think that this was the legislative intent and the current system is burdensome, would only be a factor in unusual situations, and seems to confuse plan participants.

(9) Codify that terminating plans do not need to vest terminated employees who have had a one-year break in service and who are not due a deferred vested benefit. The present system is burdensome and does not appear to serve a social purpose.

(10) Delete the requirement that annuities purchased for employees due a deferred benefit must duplicate the terms of the plan. Such annuities are available only on a basis that provides an unjustified bonanza for the participant and is costly to the plan.

I appreciate the opportunity to offer suggestions.

Please let me know if you have any questions concerning the above.

Sincerely,

LEONARD R. CARGILL, JR., *Executive Vice President & Actuary.*

STATEMENT OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

My name is Robert A. Georgine and I am presenting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee is a nonprofit, tax-exempt organization established shortly after Congress enacted ERISA in 1974. It consists of representatives of more than 190 pension and welfare plans, or their sponsors. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multi-

employer plans generally, the NCCMP is entirely engaged in monitoring the development—legislative, administrative, and judicial—of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

Mr. Chairman, on behalf of the Coordinating Committee, I applaud your efforts to simplify the Internal Revenue Code ("Code") rules governing private pension plans. We certainly agree that simplification of these rules is crucial. However, I am sure that you will get many comments detailing the need for simplification of the generally applicable rules. I will therefore focus primarily on the need to simplify pension plan rules and make them more workable in the context of multiemployer plans.

I. SIMPLIFICATION IS NECESSARY TO ENCOURAGE THE MAINTENANCE OF PRIVATE PENSION PROGRAMS

Our nation has had a long-standing policy to encourage and protect private pension programs. Favorable tax and other rules resulting from this policy have been successful in fostering a private sector employee benefit system that provides essential benefits primarily to nonhighly compensated employees and stands today as a model for the world. As of 1988, nearly two-thirds of all nonagricultural full-time employees were covered by an employer-paid pension plan. Approximately 75 percent of those with pension coverage in 1988 had annual salaries of less than $30,000.

Despite this success, in recent years there has been a dangerous tendency to impose tax and other burdens on these essential programs on an ad hoc, piecemeal basis, in the context of so-called "tax reform" and deficit reduction. As you point out, this is having a serious negative effect on retirement coverage. Many employers are scared away from starting pension plans and many employers who already maintain pension plans, especially defined benefit plans, are terminating them. As you point out, employers who continue to maintain retirement plans are spending more and more of their benefit money on administration and less on benefit increases.

Attempts to reduce budget deficits in this fashion are therefore short-sighted and misguided. In the long run, the additional burdens imposed on these plans will cause a reduction or elimination of the benefits they provide and increase demands for direct expenditures through governmental programs. Thus, budget deficits will ultimately be increased.

In addition, the so-called "reforms" we have seen recently often impose far greater burdens on far more plans than is necessary to resolve the perceived abuses at which they are aimed. To the extent abuses actually exist, the Coordinating Committee has no interest in protecting them. However, we believe that actual abuses must first be precisely identified, and that any remedy must be carefully tailored to excise only the abuse situation. Such remedies should be no more complex than absolutely necessary and should not apply to plans and/or situations in which no significant instance of abuse has been identified.

The most obvious recent example of abuse overkill in the employee benefits area is the recently repealed Code section 89 welfare plan nondiscrimination requirements. These rules grew out of a concern that some plans—primarily small plans maintained by doctors and lawyers—provided health care benefits that disproportionately favored highly compensated employees. In response, an enormously complex set of rules was developed and applied to virtually all employee health benefit plans, including collectively bargained and many other types of plans in which no significant instance of abuse had been identified. This is a classic example of the proverbial killing a fly with a hammer on a glass coffee table.

Similar so-called "reforms" have been made in the pension area. In response to perceived discrimination, again, primarily identified in a few small plans maintained by doctors and lawyers, a plethora of cruelly complex rules has been developed and applied to a far larger portion of the private pension plan universe than necessary. A few recent examples include the extraordinarily complex minimum participation, minimum coverage, controlled group, affiliated service group, leased employee, and leased management employee rules and the phase-in over years of participation of the Code section 415 limit on maximum pension benefits with respect to changes in benefit structures.

This problem is most acute with respect to multiemployer plans. All too often, rules that were designed to address an abuse that does not exist in collectively bargained multiemployer plans, or that are unworkable in the multiemployer plan context because they are based on a single employer plan model, are imposed on multiemployer plans without any consideration of those plans' unique structure. As a result, multiemployer plans and their participating employers are often left facing a Congressional mandate to perform impossible tasks, based on information they cannot obtain, often to correct abuses that do not exist.

Let me first describe some of the unique characteristics of multiemployer plans. Then I would like to discuss a few specific types of provisions that are necessary to accommodate these unique characteristics.

I would also hope that you will keep in mind the fact that the shortest, easiest-to-read rules are not necessarily the simplest, most rational and least burdensome in terms of compliance. Sometimes, operational simplicity can only be accomplished through special rules designed to accommodate unique situations. Multiemployer plans, and often collectively bargained plans in general, present such a unique situation in many circumstances. Accordingly, although the inclusion of special rules to accommodate these plans will make the legislative language itself longer and more difficult to read, the result will be genuine simplification of plan compliance burdens.

II. THE UNIQUE NATURE OF MULTIEMPLOYER PLANS

Multiemployer plans are, by definition, maintained pursuant to collective bargaining agreements. The overwhelming majority of their participants are union-represented, rank-and-file workers. Typically, only a small proportion—if any—of these workers are highly compensated employees. The plans typically provide either flat dollar benefits or benefits equal to a flat dollar amount times years of service. Multiemployer plan pension benefits are rarely related to a participant's level of compensation. These plans therefore tend to discriminate, if at all, in favor of nonhighly compensated employees.

In addition, the arm's length nature of the bargaining process, coupled with the fact that employers may not recover surplus assets in multiemployer plans, provides effective disincentives to tax-motivated prefunding or other abuses. Employers have no incentive to contribute more than the minimum reasonably necessary to fund plan benefits. Excess contributions can never be returned and decisions as to their application will be made by independent trustees. The pooled funding in these plans, in effect, creates a cross-subsidy among contributing employers. Thus, by making excess contributions, an employer would be subsidizing its business competitors. On the other hand, employee representatives, through the collective bargaining process, typically negotiate a dollar per hour labor cost with employers. The hourly dollar amount of current wages is generally this total labor cost, reduced by the amount of plan contributions. As a practical matter, employees are therefore making these contributions out of their current hourly wages. This is a strong incentive to make certain that they are getting a good buy and that the amounts contributed are no greater than reasonably necessary to fund the benefits they will receive.

Another one of the things that makes multiemployer plan coverage unique is the independence of the plan from any particular contributing employer. The plan's trustees typically design and administer all aspects of the benefit program. They set the eligibility rules, determine benefit levels, etc. The plan may have hundreds of contributing employers. Some plans have contributing employers numbering in the thousands. A contributing employer typically does little more than send in its periodic contributions with whatever backup information is required to enable the plan to identify the employees to whom the contributions relate.

Employers, other than those on the boards of trustees, typically are not well informed about the details of the coverage provided under the multiemployer plans to which they contribute. Many of them may be contributing under agreements produced through collective bargaining in which the individual companies did not participate, because negotiations were handled on their behalf by employer associations.

Multiemployer plans do not have and ordinarily cannot get information about their contributing employers and their workforces necessary to apply complex nondiscrimination tests. The plans do not have information on the management structures of contributing employers or on the salaries and pay scales of employees, including employees who are not covered under the plan. In addition, they do not have information about leasing or affiliated service group arrangements in which contributing employers may be involved. They therefore cannot determine which, if any, covered or noncovered employees of those employers are highly compensated.

Contributing employers would be extremely resistant to providing this information to the plans, the boards of trustees of which are required by law to be made up 50 percent of union representatives and 50 percent of employer representatives who, in most cases, are highly placed in the management of competitors of contributing employers. Further, as a practical matter, it would not be feasible to compile and process this information for the hundreds of contributing employers that may be

participating in the multiemployer plan. Plans also do not have information about other plans maintained by contributing employers.

Another distinguishing characteristic of most multiemployer plans is the mobility of the employees they cover. Often, their participants will only work for a brief period for any one contributing employer, though they are working continuously in the industry during the year. For example, a construction worker may work for various contractors during a month, moving from one to another as he completes the specific job for which he was hired on each project. Many of these employees would never qualify for benefits under a plan maintained only by one employer. The multiemployer plan adds up the participants' short periods of service with each employer and gives them coverage based on the aggregate. Thus, these plans are the original models of pension portability. They have been providing effective pension portability for decades.

In addition, multiemployer plans have a fixed income. These plans are funded based on contribution rates fixed in collective bargaining agreements, which typically run for three years, five years or longer. These agreements typically require employers to contribute a set amount based on some measure of the activity of covered employees. The standard, for example, is a requirement of $X per hour worked by an employee covered by the bargaining agreement. These contributions are payable, typically, on all employees in the bargaining unit without regard to their coverage under the plan.

Thus, the total amount of an employer's contributions varies with the amount of covered work performed for that employer. Plan contributions tend to increase during periods during which business in that industry is booming and to decrease drastically during a downturn in the industry. Employers, however, contribute only what the collective bargaining agreements require. There is typically no mechanism for collecting additional amounts if it turns out that the plan actually needs more.

III. TYPES OF PROVISIONS NECESSARY TO ACCOMMODATE THE SPECIAL NEEDS OF MULTIEMPLOYER PLANS

A. Complex Rules Are Not Necessary to Maintain the Nondiscriminatory Nature of Multiemployer Plans

Multiemployer plans should not be subject to mechanical rules that are designed to correct abusive discrimination in favor of highly compensated employees. As discussed above, such rules are unnecessary for multiemployer plans, which discriminate in reverse, if at all. In addition, such rules may be incompatible with coverage patterns mandated by collective bargaining agreements. Further, as discussed above, multiemployer plans do not have and ordinarily cannot obtain, sufficient data about contributing employers' workforces to perform nondiscrimination tests.

I note that, in recognition of this, exemptions and special rules have been provided with respect to the minimum coverage and participation requirements. However, as discussed in more detail below, these are imperfect.

B. Funding Limitations Should Not Be Applied to Multiemployer Plans

Provisions that limit plan funding levels should not be applied to multiemployer plans. As discussed above, both contributing employers and employees have significant incentives not to overfund multiemployer plans. In addition, because of the long-term fixed nature of plan contributions, these plans may be unable to comply with such limits. Further, funding of multiemployer plans must necessarily be done on a more conservative basis than other plans because there is no way for the multiemployer plan to obtain additional funds from contributing employers in the event of a shortfall. Indeed, especially in the case of a declining industry, many contributing employers may have ceased to exist by the time their participants begin to receive benefits under the plan.

A recent example of this problem in the employee benefits area arose in connection with the welfare fund reserve limitations of Code sections 419, 419A and 512. I am pleased to note that special rules have been provided to relieve many of the problems that those rules presented for collectively bargained plans.

C. Lack of Identity Between Contributing Employers and the Plan

Another unique feature of multiemployer plans that is often overlooked in designing legislation is the fact that, as discussed above, there is no identity between contributing employers and the plan. In fact, these employers and the plan have little or no knowledge of, much less control over, each other. Thus, many legislative provisions designed with a single-employer plan model in mind, especially sanctions and penalties and provisions that assume the plan sponsor has full access to all em-

ployment-related information on the contributing employers' workforce, are extremely inequitable and unworkable in the multiemployer plan context.

The best recent example of this in the employee benefits area is the sanctions for violations of the health care continuation coverage requirements of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"). As initially enacted, the sanction for violating these COBRA requirements was the denial of an employer's tax deductions for contributions to all health plans maintained by that employer. However, many COBRA requirements were exclusively the obligation of and within the control of the plan. Contributing employers had no way of knowing about, much less monitoring, the plan's COBRA compliance. Even worse, this sanction was imposed on all employers participating in the plan, even if the violation was committed by only one unrelated employer. The excise tax rules that replaced the disallowance sanctions work better, although not perfectly. Plans are still exposed to tax sanctions based on the knowledge that contributing employers may have about those employers' COBRA violations.

D. The Need to Treat the Entire Multiemployer Plan in a Uniform Fashion

Recently there has been a trend towards providing necessary special rules and exceptions only with respect to employees covered under a multiemployer or collectively bargained plan pursuant to a collective bargaining agreement. This approach severely reduces, and sometimes completely destroys, the utility of the special rules.

Multiemployer plans often cover some individuals who are not covered pursuant to a collective bargaining agreement. They sometimes cover employees of the plan itself, the union representing plan participants and/or the employer association representing contributing employers. In addition, they sometimes continue to cover former bargaining unit employees who transfer to noncovered service or take independent work. Finally, they sometimes permit employers that cover their collectively bargained workforce to also cover a small number of noncollectively bargained employees. For example, a construction contractor that covers its construction workers pursuant to a collective bargaining agreement may also be permitted to cover its office staff.

It is often extremely difficult, if not impossible, to apply different rules to these two groups of participants. Further, typically, all or many of the same problems that existed with respect to the group to which the exemption or special rules apply continue to exist with respect to the other group. Recent examples include the minimum participation and coverage requirements. The required application of these rules to plan participants who are not covered pursuant to collective bargaining agreements is fraught with problems and could result in disqualification of the plans.

I also want to draw to your attention the fact that necessary extended effective dates have recently been applied frequently only to those multiemployer plan participants who are covered pursuant to collective bargaining agreements. It is generally not feasible to apply rules on this bifurcated basis. To take only one recent example, the COBRA health care provision effective dates were applied by Treasury in this fashion. It was simply not feasible for many multiemployer plans to incur the additional expense and administrative burdens of designing computer software and implementing procedures to comply with the COBRA rules twice for two different groups of employees. As a result, many multiemployer plans had to comply with the COBRA rules for all participants on the earliest date on which those rules applied to any participant.

I appreciate the opportunity to present these comments. I hope that you will keep these important principles in mind during your pension plan simplification deliberations and process.

If you have any questions, or if we can be of further help, please contact Vivian H. Berzinski of our professional staff at (202) 872-8610, 1200 New Hampshire Avenue, N.W., Washington, D.C. 20036.

Statement of the New York State Bar Association

Preamble

This is a report by pension specialists for nonspecialists, be they lawyers or laymen. While the subject of pensions and pension simplification is obviously very technical, the report which follows avoids discussion of the present law's technicalities except as needed to make the problems tangible for the reader. It is written to be readily understood by all persons concerned with its subject, because it is largely from nonspecialists that the impetus to simplify will come. Nevertheless; it will not

be lost on the reader that this call for simplification comes from the very category of lawyers most comfortable with the law's complexities.

Executive Summary

The legislative process by which the Federal regulation of pensions has developed in the almost 15 years since enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), and particularly in the last half decade, has produced a body of law that is both too complicated and too changing. The predictable consequence has been noncompliance and nonenforcement, as both the regulated private sector and the government regulators have been overwhelmed in the effort, but not without enormous costs having been expended by both in pursuit of a compliance that is all but impossible to achieve. The process must be halted lest the private pension system be destroyed, with devastating results for the retirement security of the Nation's workers and their families.

In the attached report, the Special Committee on Pension Simplification of the New York State Bar Association outlines the increasingly complex web of laws in which pensions have become enmeshed, and the accompanying need for almost continuous plan amendments due to repeated statutory changes. The report points out that these conditions, which have forced major changes in pension design and planning, have resulted in a growing dysfunctioning of the private pension system, as the law has become too complex for participants to understand, and for businesses to manage and for practitioners service.

The committee, in demonstrating the need for reform in the pension area, cites examples of situations where the rules are difficult even for experts to understand and apply; yet, the report notes, businesses face substantial penalties for erroneous interpretation of applicable regulations. The report points to the particularly adverse impact on small businesses caused by complex provisions aimed at preventing discrimination in favor of highly compensated employees. The committee urges the development of a national retirement income policy as a backdrop for law reform, so that the growing complexity caused by the present process will not continue to be repeated.

The report suggests ways to reverse this destructive process, the principal feature of which is the effectuation of drastic simplification of the laws through the instrumentality of an independent pension law revision commission, jointly appointed by the President and the Congress, with members chosen from government and representative segments of the public. The principal charges to this commission would be the encunciation of a national retirement income policy and the development of a pension revision act to replace the present laws; but, pending completion of that long-range task, the commission would be directed to make interim recommendations for repealing or alleviating rules that do not satisfy a burden-effective test.

To address the myriad problems which the present law—and the process by which it has evolved—have created, the committee proposes an integrated, three-pronged solution, consisting of: (1) the prompt enactment of relief legislation (including the lifting of noncompliance sanctions for a one-year period, a temporary moratorium on the enactment of pension-related legislation and on the promulgation of regulations, and the review and remediation of existing penalty provisions); (2) the establishment of an independent pension law revision commission to be charged with (i) enunciating a comprehensive, integrated national retirement income policy, (ii) recommending, for the near term, statutory improvements, and (iii) developing, for the long term, an omnibus pension revision act to replace the current pension system with one which is both simplified and rational; and (3) the authorization by Congress of an optional simplified retirement plan (principally for use by small companies), to become available forthwith, which would permit a pension plan to provide a threshold level of benefits for nonhighly compensated employees, coupled with expanded supplemental benefits (within permissible ranges beyond that threshold) for selected highly compensated employees. It is to be noted that all features of the proposal in the report are designed as interdependent components of a unified recommendation. Thus, the statutory moratorium, and delayed effective dates and suspended sanctions are only to be implemented in the context of establishing the law revision commission; and the alternative benefit plan election would complement this scheme, not serve as a substitute for it.

The report begins by identifying the need to rapidly overhaul the present system if the private pension system is not to pass the breaking point. A growing crisis of confidence among plan sponsors and their advisers, as well as plan participants themselves, is described; and the specific reasons are pointed to. Samples of rules without reason are cited. In order to put the problem in concrete terms, a specific case in point is given of a common problem whose difficulty of solution requires an

expenditure of professional effort—and consequent cost to the client—wholly disproportionate to the importance of the issue. The report then sets forth in detail the specific recommendation of the committee for achieving simplification and rationalization of the rules, and outlines the characteristics suggested for the optional simple plan alternative which employers would be authorized to adopt electively.

The report underscores, as a leitmotif of all future pension legislation, the goal of expanding pension coverage, even at the expense of the revenues, as distinguished from the present tendency to hold the retirement security institution hostage to budget deficits. Private pensions, the report points out, are one of the great resources of the Nation—more than just a safety net for workers' families—which the legislation of the past decade is greatly harming. The committee concludes that this destructive process must be reversed by a total overhaul of pension legislation, designed to accomplish meaningful simplification of the law, in order to assure preservation, let alone continued expansion, of private pensions.

I. INTRODUCTION

The private pension system, which had grown puissant in half a century, is reeling under a continuous succession of legislative onslaughts in the last half decade, necessitating a constant round of plan amendments and increasing costs of compliance, that is severely sapping its vitality. Disenchantment with the sponsorship of private pension plans is becoming rampant in the business community. These developments have compromised the dependability of pensions as a member of the "3-legged stool"—i.e., the Nation's tripod retirement system (along with private savings and Social Security). Hence, a crisis of major proportions has materialized in just a few years, as a result of an unending series of legislative and regulatory accretions.

ERISA is usually thought of as the major reform of the pension law of the current era. However, since the enactment of ERISA, in 1974, the pace of alteration and complication of the laws regulating pensions has actually escalated. In just the couple of years that our Special Committee on Pension Simplification has been in existence, we have had three major tax laws, one extensive technical corrections act, two pending technical corrections bills, and a spate of regulations, adding layers of complexity to an already overladen law.

In that same period, changes in the pension laws have brought about major changes in pension design and planning. Profit-sharing and other defined contribution plans are beginning to supplant fixed-benefit pensions as the plan of choice, not just for small businesses but for businesses of all size. Plan coverage requirements have had to be rewritten to comport with a thoroughgoing revision of the minimum participation rules. The requirements for social security integration have been drastically overhauled, necessitating the rethinking and reworking of integrated plans. So-called 401(k) plans have grown from essentially nonexistent to ubiquitous. "Safe harbor" plans for employee leasing companies are becoming almost extinct. Substantial benefit distributions are now taxed at a special punitive rate of tax that has begun to force the cessation of qualified pension plans and their replacement by all manner of nonqualified deferred compensation arrangements. The procedure for plan terminations has been radically recast, in some cases effectively precluding termination. Plan asset recapture programs, having first been chilled by a new 10 percent surtax, are now all but frozen stiff by an array of pending legislative threats. The list could go on and on.

The startling fact is that after ERISA, which had completely rewritten the pension law, every aspect of pension plans, from birth to death, extant in 1974 following its enactment has again been massively re-overhauled by Congress since then: qualification requirements, contribution limits and deductibility, funding standards, vesting, coverage, accrual of benefits, benefit limitations, benefit distributions, alternatives concerning forms of benefit, integration, cash-or-deferred options, employee contributions, matching contributions, loans, withdrawals, rollovers, terminations, etc. The cumulative effect of all this legislation and accompanying administrative rule-making is a roiling mass of pension law that has necessitated continuous plan amendments, and has become much too complicated for business to apply and for participants to comprehend without extremely costly professional advice—and even with such advice, since the law's many recent turnings have left most professionals far off course.

The qualified pension plan is increasingly attended by the unqualified pension professional. We can think of nothing that would strike more terror among pension professionals than a requirement that they pass a "closed book" proficiency examination testing comprehension of post-ERISA legislation. Were such a requirement to be established for government pension law specialists, I.R.S., D.O.L. and P.B.G.C. offices around the country would be decimated. This is not meant as an indictment of

people but of laws. In pensions, at least, the "government of laws" has gone too far by half. The result has been massive (but often inadvertent) noncompliance despite the expenditure of greatly increased administrative fees in order to achieve compliance, growing numbers of plan terminations, and widespread and increasing disenchantment with the pension benefit scheme of compensation. In short, we are seeing growing dysfunction of the private pension institution.

It is the process, as much as anything, which is to blame. Public input has been almost totally lacking, and no coherent national retirement policy has ever been enunciated. The sheer frenzied pace of legislative change in the years following ERISA—ten major pieces of legislation, each accompanied by the inevitable, in fact essential, regulations and rulings—has overtaxed the capacities of the public to make meaningful contributions to the development of legislation. In some cases—notably the introduction of the top-heavy-rules—the provision is grafted onto a major bill in Conference, without an antecedent in either the House or Senate bills, in patent violation of the Conference rules. In other cases, so-called "technical correction" bills become the vehicle for significant substantive changes in the law that all would readily acknowledge are not proper subject-matter for such legislation. In still other cases, a major change in the law surfaces unheralded, very late in the course of consideration of complex reform legislation, catching the pension community totally unprepared, and with no means to obtain its separate consideration apart from the bill to which it is attached. The minimum participation rule of the 1986 Tax Reform Act—overruling the seminal principle of "comparability" for testing discrimination—is a classic instance. The public has simply been overwhelmed, benumbed and, it must be said, often deceived by the process; and its professional advisers are not much better off.

At the outset of its labors in 1986 this Committee drew up a list of topics urgently needing simplification, which follows this Report as Appendix A. That list can now serve only as a memorial to the relative "simplicity" of the law just two years ago when compared to now, for such a list today, after recent legislation, would have to be expanded by at least 25%; and if we were to wait for enactment of the two separate technical corrections bills of 1988, H.R. 4333 and H.R. 4845 (adding 122 pages of new pension legislation alone), the list would grow another 10% to 15%. That is quite apart from the added complexity of recent regulations, e.g., 26 oversized pages of heavy-going bureaucratize prose to "explain" three page of statutory additions to the cash-or-deferred rules in 1986. (In some cases the ratio of agency explanation to codification has been even greater—14 pages of regulations for 14 lines of statute covering the once seemingly simple anti-cutback rule of Section 411(d)(6)[1]—leading one to inquire, is that explication or complication?)

In the face of this relentless layering upon layer of laws and rules, the task of our Simplification Committee dwarfs the efforts of Sisyphus. Moreover, the growing prolixity and intricacy of the pension law has created its own built-in-mechanism against simplification, since the very professionals best qualified to recommend simplifying changes are continually caught up in the task of mastering page after page of the latest complicating changes in order to discharge their first responsibilities to their own clients, leaving scant time or energy for the enormous public interest effort that a meaningful *pro bono* endeavor requires. What better evidence of this than 111 pages of questions and answers posed by representatives of the employee benefits community to the I.R.S., Department Of Labor, P.B.G.C. and S.E.C., at technical sessions in May 1988, identifying the current crop of concerns that are most troubling for experienced employee benefits practitioners?

There is, in our collective view, no longer any quick way to simplify the present law, any more than one could unscramble an egg. The present statute may now be past the point where it can be fixed, short of a fresh start beginning almost at the point of the bill that President Ford signed on Labor Day, 1974. On the other hand, some shoring up must be effected rapidly before completing such a radical procedure, lest the system fall of its own weight. This Report offers some proposals for at least beginning the shoring and follow-on processes. However, the reader must not be misled into expecting to find the key to so large a problem as simplification in these few pages. We have strived mainly just to point to the process that must be commenced; but our report does include a specific recommendation for prompt enactment of an elective plan alternative that could introduce instant simplicity into the system for those companies availing themselves of the option.

In very brief summary we are proposing:

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[1] If anything, the explanation in the regulations actually compounds the confusion, unless supplemented by an exegeses such as one coauthored by one of our committee members. See Siegel & Buckmann, "Accrued-Benefit Regulations," N.Y. Law Journal, August 8, 1988, p.3.

(1) legislation to be enacted forthwith

- temporarily lifting sanctions for nonobservance of the effective date provisions of recent legislation
- delaying the deadlines for various elections
- imposing a temporary moratorium on new pension laws
- requiring the issuance of regulations as a precondition to any pension legislation's becoming effective
- ameliorating the penalty provisions
- temporarily freezing the issuance of regulations

(2) establishment of a pension law revision commission specifically charged to enunciate a national retirement income policy, to temporarily roll-back significant portions of post-ERISA legislation, and to develop a new pension revision act replacing the present body of pension laws; and

(3) prompt enactment of an optional relief measure permitting the adoption of a very simple type of retirement plan with adequate but constrained incentives for highly compensated employees, which would be designed principally to simplify small plan compliance and to greatly broaden rank-and-file coverage, while also advancing the retirement needs of the Nation.

Under our proposal the foregoing are interdependent components of an integrated recommendation.

KURT F. PIPER,
March 8, 1990.

Senate Finance Subcommittee on Private Retirement Plans and oversight of the Internal Revenue Service,
Subcommittee Chairman David Pryor

RE: Hearing on Pension Plan Complexity

Dear Senators: Your goal in this hearing, the simplification of current rules governing private pension plans, is commendable. I would respectfully suggest that before any new rules are written, that some of the old rules be removed.

I have listed three examples of rules which greatly burden the qualified plans of small businesses. A great part of the complexity is not inherent in the law written by Congress, but arose from the burdensome manner in which the law is interpreted and administered by the Internal Revenue Service.

1. I.R.C. 412(m) Required Quarterly Contributions.

I.R.C. 412(m) is a noble attempt to improve -the funding of large, underfunded plans. The general problem is that the I.R.S. in Notice 89-52 makes small plans perform the same amount of work and calculations as large plans. The specific problem is not the calculation of the quarterly contribution but, rather, the requirement that the interest charge on missed quarterly contributions be accrued to the date of the actual contribution.

Few small plans will make the quarterly contributions out of fear of incurring the over contribution tax under I.R.C. 4972 due to attaining the new full funding limit (numbers 2 and 3 on my list to follow). Instead most small businesses will opt to pay the interest penalty to their plan.

The administrative and actuarial fees for calculating the interest charge can easily be more than the interest charge itself.

Small plans should be exempt from I.R.C. 412 (in).

2. I.R.C. 4972 10 Percent Tax on Non-deductible Contributions.

I.R.C. 4972 penalizes those plans which make large non-deductible contributions. However, it does not exempt small non-deductible contributions. Sometimes the fees for preparing the Form 5330 to pay the tax is larger than the tax itself. It also discourages employers from making the required quarterly contributions.

I.R.S. Revenue Procedure 89-35 sets forth a costly, complicated procedure to avoid the 4972 tax by requesting a ruling letter allowing the withdrawal of the excess contributions. The I.R.S. now admits that this procedure is too costly to be used by most small businesses and a new procedure is expected to be issued.

Unfortunately only the old procedure is available to small businesses at this time. They must choose between making quarterly contributions, which might be non-deductible due to the new full funding limit and pay the 4972 10% tax, or else fail to make the quarterly contributions and incur extra fees to have the interest charge calculated.

The 4972 tax should not apply to small amounts or should be easily returnable to the plan sponsor.

3. I.R.C. 412(1)(7) Current Liability for the Full Funding Limitation of I.R.C. 412(c)(7)(A)(i)(I), 150% of Current Liability.

The alternative full funding limitation in I.R.C. 412(c)(7)(A)(i)(I) is not bad law. I.R.S. 412(1) states that Current Liability generally includes all liabilities to participants and beneficiaries under the plan. The Conference Agreement to O.B.R.A.'87 modifies this by identifying such liabilities as those provided under code section 401(a)(2) determined "as if the plan terminated."

The problem is that when plan benefits are calculated using the twisted rules found in I.R.S. Notice 90-11, the resultant benefits can easily be less than even the benefits protected by I.R.C. 411(d)(6). It's quite possible that a plan could attain the full funding limit and yet be unable to satisfy the requirements for a Standard Termination under P.B.G.C. rules.

Not only do the I.R.S. 412(1)(7) rules require an obviously incorrect method of calculating plan benefits, but those benefits, according to the I.R.S., are to be calculated on an ongoing plan basis (according to the 1989 instructions to the Schedule B of Form 5500) rather than according to the instructions in the Conference Agreement, "as if the plan terminated."

The justification for the 412(1)(7) interpretation by the I.R.S. is that the extra tax revenue is needed due to the budget deficit. The I.R.S. does not seem to care about the resultant risk to the benefit security of plan participants and beneficiaries in under-funded plans.

Gentlemen, I guess that it is your job to care about the benefit security of plan participants and beneficiaries.

Since the I.R.S. seems incapable of administering the full funding limit in the public interest and incapable of obeying the law themselves by issuing regulations as required by August 1988, the O.B.R.A. '87 changes in the full funding limit should be repealed entirely.

I thank you for the opportunity to present my views on pension plan complexity.

Sincerely,

KURT F. PIPER, M.A.A.A., A.S.A., M.S.P.A.,
Senior Vice President,
Chief Actuary, Benefit Planning Division.

STATEMENT OF THE PROFIT SHARING COUNCIL OF AMERICA

Since 1947, the Profit Sharing Council of America (PSCA) has represented companies that sponsor profit-sharing and 401(k) plans. PSCA is a non-profit association dedicated to developing, collecting and communicating profit sharing information and to promoting the philosophy and practice of sharing profits with employees—the people who make profits possible.

PSCA represents approximately 1,200 companies that employ more than 1.75 million plan participants. Located throughout the United States, PSCA members are diverse businesses that range in size from family-owned fledgling enterprises to Fortune 100 companies. One member has shared profits for more than 100 years, while others only recently have instituted profit-sharing plans. PSCA's wide-ranging membership is bound by a common belief: that profit sharing is vital to success. All member companies depend on PSCA to advocate their interests concerning current legislative and regulatory proposals that would affect profit sharing and 401(k) plans. Because PSCA is comprised of defined contribution plan sponsors, this testimony is focused primarily on consequences to defined contribution plans.

PSCA strongly endorses efforts to simplify the regulation of retirement plans voluntarily provided by employers. Although voluntary employer-provided benefit plans are crucial to financial security in retirement, substantial numbers of workers are not covered by employer-provided plans—and the gap is not narrowing. The laws and regulations governing qualified plans are complex, confusing, unpredictable, unreliable and expensive to administer.

This situation affects plan participants as well as sponsors. It is difficult for workers to understand the plans of their current or prospective employers. They are often confused about how this formidable, complicated body of law affects them individually, especially when they receive distributions and have to make tax-related decisions.

The costs imposed on plans by this situation are of special concern to defined contribution plan sponsors because such costs often are charged against plan assets, reducing the retirement benefit to participants. Even when such charges are paid entirely by the plan sponsor, they reduce the company profitability from which contributions are paid.

For example, Section 1141 of the Tax Reform Act of 1986 required that final regulations be published by the Internal Revenue Service (IRS) by February 1, 1988 for eight of t.he provisions affecting qualified plans. Today, more than two years after the statutory deadline, the IRS has yet to issue final regulations for any of the eight provisions. For some of the provisions even proposed regulations have not been issued. It is obvious that the law is so complex that even the IRS is having trouble interpreting it. In such a situation it is unfair and unrealistic to expect compliance from employers and participants.

If more workers are to be covered by the voluntary retirement system, it is imperative that policymakers simplify the laws and regulations governing qualified plans. Congress must also stop increasing Federal revenue at the expense of retirement plan benefits. The first step is to eliminate complex and inconsistent laws and regulations. To this end, PSCA recommends that the following provisions be included in proposals to simplify the laws and regulations affecting qualified retirement plans.

ELIMINATE THE ADP TESTS FOR 401(K) PLANS AND THE ACP TEST FOR 401(M) PLANS

The 401(k) and 401(m) anti-discrimination requirements were enacted to ensure that higher-paid employees do not disproportionately benefit from certain qualified plans.. However, it is clear that these requirements mainly affect those participants with incomes just over $56,990 (indexed) who have had their pre-tax and after-tax contribution limits restricted even beyond the annual additions limitations under Section 415. For example, at a company where the lower-paid contribute 5 percent to a 401(k) plan, an employee earning $65,000 is restricted by the ADP test to a contribution of $4,550. All employees earning over $113,986 are able to contribute the maximum of $7,979 provided by law; as are lower-paid employees. These limitations have almost no effect on the highest paid because of the maximum contribution limits in Sections 415 and 402(g) and the limitation on the amount of base compensation under Section 401(a)(17).

Employers who provide profit-sharing plans which include voluntary pre-tax (401(k)) and post-tax contributions by participants must run six tests continually during the year. Even then they are not certain of compliance because three of the tests cannot be conclusively run until the year is completed.

Further, complicated and expensive testing for compliance with the Section 401(m) requirements has led to the elimination of plan provisions allowing after-tax contributions. This hurts lower-paid beneficiaries, who need access to their money and the convenience of payroll deduction to encourage their voluntary contributions and savings. Older employees especially take advantage of these plans to prepare financially for retirement.

Congress already has eliminated the 401(k) and 401(m) requirements for Federal employees; the law should be uniform for all. Such uniformity will: end the discriminatory treatment of non-government middle-management employees; encourage savings by lower-paid participants; and greatly simplify plan administration with little revenue loss to the government.

REPEAL THE SECTION 415 25-PERCENT LIMITATION FOR LOWER-PAID EMPLOYEES

Ensuring that lower-paid employees do not receive benefits in excess of 25 percent of taxable compensation is complex and expensive. Many companies must run complicated tests monthly to make sure they are in compliance, especially when employees are allowed to make voluntary contributions. The establishment of maximum contribution limitations has eliminated the need for the 25-percent limitation for lower-paid employees. For example, the same 401(k) dollar limitation applies to both highly-paid and lower-paid participants and prevents unlimited contributions. The requirements that the aggregate benefits of lower-paid employees not exceed 25 percent of compensation should be eliminated.

REPEAL MINIMUM DISTRIBUTIONS UNDER SECTION 401(A)(9)

Forcing minimum distributions at age 70-1/2 was initiated to prevent the wealthy from using qualified plans as an estate planning device. However, this practice generally was ended when the estate tax exclusion for distributions was repealed. Enforcing this requirement is expensive and complicated for both employers and participants and results in complicated tax situations for those affected. Often lower-

paid participants are forced to hire outside financial and legal advisors to avoid making costly mistakes.

The rules also limit the value of 10-year or 5-year averaging, thereby causing many older workers to opt to retire rather than continue working. This is contrary to prevailing policy encouraging continued participation in the workforce by older workers. It also makes no sense to require payment of a retirement benefit to an older worker who is still working. The minimum-distribution rules should be repealed for non-owner participants.

REPEAL SECTION 401(A)(26)

The Section 401(a)(26) minimum participation rules require every plan to benefit the lesser of 50 employees or 40 percent of all employees. It was passed to correct perceived deficiencies in Revenue Ruling 81-202, which Congress believed allowed some employers with defined benefit plans to discriminate in favor of a prohibited group by manipulating actuarial. assumptions or the differences in rates at which benefits accrue.

However, the proposed Section 401(a)(26) regulations are so broad that they apply the law to almost all but the most elementary plans. For example, Congress did not intend for the separate benefit structure to be applied to deferred profit-sharing and other defined contribution plans. Its application to profit-sharing plans prevents the use of particularized contribution formulas for separate divisions or subsidiaries under common control. Requiring an unprofitable subsidiary or division to make contributions, or requiring other entities to make contributions for such a division, diminishes the incentive value of profit sharing. Further, the application of the separate benefit structure to defined contribution plans as proposed in the regulations will not increase coverage or reduce discrimination in favor of the higher-paid.

Section 401(a)(26) and the proposed regulations implementing it go far beyond the limited problem they were originally designed to prevent. Section 401(a)(26) should be repealed and the problem should be solved in a more appropriate manner.

ELIMINATE TOP-HEAVY RULES UNDER SECTION 416

The changes to Section 415 made in the Tax Reform Act of 1986 limit participation by the higher-paid, making it unlikely that plans will fail the top-heavy test. Also, new faster vesting requirements diminish the penalty's usefulness in the event that a plan does fail. This test adds complication and expense to the administration of deferred profit-sharing and other defined contribution plans and discourages smaller companies from establishing such plans. The test should be eliminated.

EXTEND FIVE-YEAR AVERAGING

The Tax Reform Act of 1986 did not apply the 10-percent early distribution penalty to those retiring at age 55. However, employees who were born after 1936 are not allowed to use five-year averaging until they attain 59½. This is confusing to retirement-age participants. Many Americans work in physically demanding occupations where retiring at age 55 is a virtual requirement, not a luxury. The Code should be simplified and five-year averaging should be extended to all retirees age 55 and older.

ALLOW ALL DISTRIBUTIONS TO BE ROLLED OVER

Any distribution from a qualified plan should be eligible to be rolled over into an IRA. This would simplify distribution planning and encourage retention of funds originally contributed to retirement plans for retirement. It would also eliminate the disparity between the amount required to be distributed to be eligible for a rollover and, at the option of the recipient, the lesser amount which is permitted to be rolled over.

SIMPLIFY CONTROLLED GROUP REGULATION

The affiliated service group definitions in Section 414(m) and the IRS regulations implementing them are extremely complex. The complexity would be reduced if the terms used in the Code were more clearly defined.

Section 414(n) should be clarified so that it does not cover independent contractors where there is no third party leasing organization involved and the recipient of services does not control or direct the independent contractor or his employees. Also, the reference to Section 144(a)(3) under Section 414(n)(6) should be eliminated as it makes analysis under Section 414(n) extremely difficult.

Finally, Section 414(o) should be repealed. It has made it virtually impossible for small businesses and sole proprietors to determine eligibility for plan contributions when involved with another entity. The analysis required to determine plan contributions by this code section and its accompanying IRS regulations is beyond the ability of small business plan sponsors.

CONCLUSION

The Profit Sharing Council believes the suggested changes will greatly simplify the administration of qualified plans, especially defined-contribution plans, without significantly impacting the policy goals of qualified retirement plan law.

STATEMENT OF THE RATIONAL BENEFITS POLICY ALLIANCE

EMPLOYEE BENEFITS TAX SIMPLIFICATION PROPOSAL

Certain qualified retirement plan rules and welfare plan rules have become overly complex. The benefit to plan sponsors of plans subject to such overregulation often no longer outweighs the administrative, compliance and litigation costs of maintaining such plans, when the alternatives are considered.

Entire industries have sprung up to assist plan sponsors in testing for discrimination, top-heaviness and combined benefit limitations and to counsel plan sponsors and participants regarding alternative tax treatments and myriad other complex rules. Costs to plan sponsors have become burdensome and such monies should be better spent on the productive expansion of the businesses involved rather than in the unproductive payment of fees to lawyers, accountants, consultants and recordkeepers and in ever expanding plan administrative staff (which unproductive expenses lessen the competitiveness of domestic employers in the world marketplace).

It is axiomatic to state that the only monies (benefits) that may be paid out of a plan are the gross expenditures by the sponsor for the plan, plus net investment earnings thereon, minus plan maintenance costs. The costs of delivering a dollar of benefits have simply become too high.

It is respectfully suggested that the 401(a)(4) and 401(l) nondiscrimination and integration rules, the 401(a)(17) maximum compensation limitation, the 401(a)(26) and 410(b) participant coverage rules, the 411 five-year cliff vesting or three to seven year vesting rules, the 415 plan benefit and contribution limitations, the 412 funding rules and the 404 deduction limitations are sufficient to reasonably prevent perceived discriminatory abuses, and that other complex rules may be eliminated.

Accordingly, the following changes are proposed for consideration:

I. The following code sections and provisions would be repealed:

1. Section 401(k) would be repealed, eliminating all salary reduction arrangements under qualified retirement plans and the nondiscrimination testing associated therewith. Existing salary reductions would automatically become after-tax contributions (subject to the old 6% of pay/10% of pay safe harbors and the 415 contribution limitations).
2. Section 401(m) would be repealed, eliminating the employee contribution and matching contribution nondiscrimination tests.
3. Section 415(e) would be repealed, eliminated the combined plan benefit limits.
4. Section 416 would be repealed, eliminating the top-heavy rules.
5. The special taxation rules regarding distributions of net unrealized appreciation would be repealed, with net unrealized appreciation taxable unless rolled over to another qualified plan or IRA.
6. The special five-year averaging distribution rules would be repealed.
7. Section 125 would be repealed, eliminating flexible spending accounts and other cafeteria plans and nondiscrimination requirements and salary reductions related thereto. Existing salary reductions would automatically become taxable deductions.

II. The following compensating changes believed to be more fair and efficient would be enacted:

1. The IRA contribution limit would be increased to the lesser of $4,000 (subject to annual cost of living adjustments) or 100% of compensation, with the deduction being available only if an individual's compensation does not exceed the wage base.
2. The 415 annual addition limitation under a target benefit money purchase pension plan would be the lesser of $30,000 (subject to the current law cost-of-

living adjustments) or 25% of compensation for employees under age 50, and $60,000 (subject to cost-of-living adjustments) or 100% of compensation for employees aged 50 or older; provided that the enhanced limit for older employees would only be available under a plan which determined contributions on the basis of PBGC factors and assumptions for defined benefit plans that terminate either at the beginning or end of that year.

The foregoing would facilitate the accumulation of more meaningful retirement savings for non-highly compensated employees and certain older employees and also would allow plan sponsors to return to the provision of retirement and welfare benefits through traditional and simple plans that have worked well historically, without the current maze of conflicting overregulation and the unreasonable administrative costs thereof.

In addition, it is believed that the recommended changes would:

A. Foster the growth of traditional retirement plans and retirement savings through the creation of a more receptive legal environment by reducing administrative complexity and uncertainty.

B. Preserve the fair treatment of non-highly compensated employees provided by the 401(a)(4), 401(a)(17), 401(a)(26), 401(l), 410 and 411 rules which we believe are fully sufficient to enforce fair and nondiscriminatory treatment in qualified plans.

C. Preserve adequate limitations on benefits for highly compensated employees through the nondiscrimination rules in B above and the excess accumulation and excess distribution excise taxes, early distribution penalties, required minimum distributions, 415 separate plan limits, 412 reasonable funding requirements and 404 deduction limitations.

D. Stop the transfers of benefit funding responsibility from employers to employees occurring through employer utilization of salary reductions under 125 and 401(k), which provisions can fairly be categorized as failed experiments gone awry.

E. Recognize both the relative unattractiveness to a plan sponsor of defined benefit plans (resulting from the legislative changes during the past 16 years) and the inherent limitations in the ability of defined contribution plans to provide adequate benefits for nonhighly compensated older workers, by enhancing the ability of target benefit money purchase pension plans to deliver adequate retirement benefits to older workers.

It is hoped that the above would tend toward a positive revenue impact, especially if studies take into account the enhanced net income of each plan sponsor due to reduced administrative expenses in maintaining plans.

Retirement Programs Corporation
625 Plainfield Road, Suite 120
Willowbrook, Illinois 60521
(708) 887-8444

April 6, 1990

Ms. Laura Wilcox,
Hearing Administrator, Senate Finance Committee
SD-205
Washington, DC 20510

Re: Sen. Pryor's Private Pension Plan Simplification Hearings

Dear Ms. Wilcox:

Congratulations to Senator David Pryor for holding his hearings and recognizing the disastrous effect that the government's costly and complex pension rules are having on this country's private pension system. As a thirteen year veteran of the pension profession and owner of my own pension consulting/ administration firm for the past seven years, I have watched with increasing dismay as the federal government has steadily eroded and subverted the viability of this nation's private pension system.

As each new onerous law and its associated exceedingly complex IRS regulations emerge from Washington, I have personally witnessed the rising anger and frustration of many small business owners as they are forced to incur the increasing expense and bureaucratic headaches involved with testing, administrating, redesigning and amending their plans. What troubles me the most, however, is that as these laws become more foolish, many businesses are simply terminating their plans or not adopting them to begin with. They are fed up with the complexities and expense involved with operating what they thought would be relatively simple plans that they and their employees could use to save for their retirement.

My personal observation is that recent legislation designed to prevent perceived abuse and discrimination in pension benefits and coverage is unnecessarily complicated. To many of us pension professionals, it seems that those who write the laws and regulations are trying too hard to prevent every conceivable type of abuse. They fail to recognize that the more convoluted the rules, the less likely a small business owner will establish a plan for his employees.

In these times of low savings rates, uncertain viability of the social security system, and an increasingly aging population, it is essential that the government encourage employer's to sponsor retirement plans for themselves and their employees. Inanely complex rules and their corresponding compliance costs only serve to discourage employers from maintaining or establishing retirement plans.

For your consideration, below I have presented some simple, common sense recommendations. While only a start, they can go a long way toward simplifying the private pension system and reducing some of the costs and disincentives now facing American businessmen, and still ensure that plans operate equitably on behalf of all employees.

A) For 401(k) plans, **eliminate the nonsensical ADP and ACP testing** and compliance requirements. The $7,979 statutory ceiling effectively eliminates any "outlandish" discrimination that could result from very highly paid employees deferring large amounts of their compensation into a CODA. Our experience has shown that the small businessman cannot justify the expense and time involved in performing these so called "discrimination tests" and the headaches involved with having to refund "excess contributions". Many businessman decide that the cost of analyzing and testing their plans cannot justify the benefits of having one.

Understanding that the working public may not be well served by a non-match 401(k) plan where the highly compensated can put in whatever they want up to the maximum, I suggest the following **safe harbor specifications:**

If an employer, as part of the 401(k) plan, offers a minimum 100% vested matching contribution of 25 cents for every dollar contributed by the employee up to the first 5% of compensation that the employee defers, for example, that plan would be exempt from the ADP and ACP testing requirements. Plans that don't offer at least this minimum would have to satisfy the testing requirements. Thus providing sponsors, who want to have an administratively simple plan, a way to achieve their goal.

B) **Eliminate the top heavy rules of IRC Section 416.** The new maximum seven year graded vesting schedule and integration rules have basically eliminated the need for these rules. At the very least, the portion of the 401(k) proposed regulations effecting top-heavy 401(k) plans should be fixed. Assuming a non-match 401(k) plan, these proposed rules outlandishly decree that because a key employee defers a portion of his salary into a 401(k) plan, the employer must make a 3% of compensation contribution for all non-key employees regardless of whether or not the non-key employees are deferring any of their salary into the plan. What this is saying is that if a small top-heavy employer has a CODA in their plan, then they are required to also have a 3% of compensation money purchase plan! To the pension community this smacks of mandatory pension requirements and is discriminatory against the small businessman. This surely cannot be what Congress intended when it passed TRA '86.

C) **Eliminate the quarterly funding requirement for defined benefit plans that are not subject to the PBGC's variable rate premium.** The laudable purpose of this OBRA '87 provision was to try and prevent plans from running into funding problems by falling too far behind on their contributions. If a plan is not hitting the PBGC's variable rate premium, then it is not in any funding trouble. The extra administrative charges and cash flow constraints that are being placed on small defined benefit plan sponsors because of this rule are unnecessary.

D) When **proposing legislation** to enhance the pension system or to prevent perceived abuse, **use a simple common sense approach and don't get hung up on trying to prevent every conceivable abuse.** By using general non-discrimination rules and allowing the Service to use a facts and circumstances test to disqualify and punish grossly discriminatory plans, there is enough deterrent to prevent plans from slipping back into the abusive pre-ERISA days.

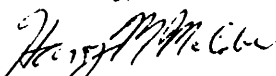
E) Consider pension bills separate from other revenue bills. The pension system, by its nature, is a revenue loser. But this fact alone should not determine pension policy. A weakened private pension system resulting in millions of poor and financially unprepared retirees will ultimately cost this country far more in welfare and social security payments than the tax revenues forsaken on account of current pension contributions.

F) Do not enact any provision for mandatory joint trustees of private pension funds. This type of legislation would trigger massive small plan terminations.

G) When considering pension legislation, *consult experts* like the Profit Sharing Council of America and the American Society of Pension Actuaries. Too often, pension policy and rules are shaped by ill-informed legislative staffers and IRS technocrats who have very little knowledge as to how the real business world works and reacts to new laws and rules. Experts like the PSCA and ASPA should be involved early in the process and not after a bill or rule is passed, when it is too late.

In closing, let me say that *it is very important that Americans be given the opportunity to adequately prepare financially for their retirement. A viable private pension system, not the **federal government**, is the best vehicle for this goal.* Plans sponsored by private businesses are the best tool we have for adequately funding our worker's retirement. Since most people don't have the means or the wherewithal to plan for themselves, the government must encourage business owners to set up and maintain plans. The most effective encouragement that the government can utilize is the offering of generous tax breaks (deductions and/or credits) and simple, easy to administer rules.

Sincerely,



Harry M. McCabe, President
Retirement Programs Corporation

HMM:pf

cc: Ed Mihalski, Minority Chief of Staff (5)
Paul Simon, Senator - Illinois
Alan Dixon, Senator - Illinois
David L. Wray, President - PSCA

TULSA PENSION ATTORNEYS
1000 ONEOK Plaza
Tulsa, Oklahoma 74103

March 27, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
SD-205
Washington, D.C. 20510

Dear Ms. Wilcox:

This statement is submitted to you by the Tulsa Pension Attorneys to present our views with respect to simplification of the current rules governing private pension plans which we understand was the subject of a hearing on March 23, 1990, before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service.

The undersigned Tulsa Pension Attorneys is an ad hoc organization of attorneys who specialize in the practice of federal income tax law related to qualified pension, profit-sharing and stock bonus plans.

Our clients have expressed to us great dissatisfaction with the continuing increase in the complexity of the law in this area, and the mounting expense of maintaining plans.

They are extremely troubled and perplexed by the seemingly continuous change in requirements for plan qualification, and in the lessening of tax benefits for plan participation.

In simplest terms, no matter how well intended the wave of legislative changes may be, it is operating to defeat the purpose of plan qualification, which is to provide a tax-favored mechanism to encourage retirement savings. A more skeptical, perhaps simpler analysis of the added complexity of plan qualification legislated in the 1980s, is that federal revenues have been needed, and qualified plans as a most significant "tax expenditure" have become an attractive and favorite target.

In either case, we believe there is an apparent growing disinclination by employers to establish and/or continue to sponsor qualified pension, profit-sharing and stock bonus plans for employees' retirement due to the complexity and cost of compliance with frequent changes in standards.

In particular, we would cite as examples of excessive and restrictive legislation and regulations, the provisions of the Tax Reform Act of 1986 pertaining to minimum participation requirements, and permitted disparity in benefits under plans integrated with Social Security. Those are examples of the type of changes which extended to unreasonable lengths the concept that qualified plans should not be discriminatory in favor of highly compensated employees. As a result, pension planning is unduly complex.

Much like the ill-fated and ill advised rules of Section 89, which Congress repealed, the minimum participation and permitted disparity requirements now impose excessive and undue regulatory requirements on plan sponsors, which are particularly burdensome to small employers attempting to provide attractive compensation and employee benefits to their employees in an increasingly competitive business environment.

Those and similar rules appear to have been conceived by overly technical determinations by Congressional and Treasury staffs of what is necessary for plan qualification, without due consideration to the practical effect on employers attempting to provide reasonable and fairly apportioned retirement benefits to employees. Such complexity effectively frustrates a fundamental Congressional goal of encouraging and protecting privately funded retirement benefits which has been a part of the federal income tax policy and law for more than fifty years.

We respectfully submit that Congress needs to formulate, establish and maintain a simple, more uniform and more consistently applied tax policy as to retirement savings. Relatively simple rules should be established and be generally left unchanged over time to encourage a long-term commitment by employers and employees to the creation of retirement savings.

Very truly yours,

TULSA PENSION ATTORNEYS

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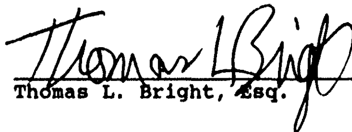

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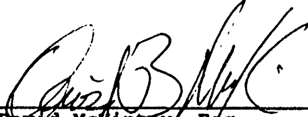
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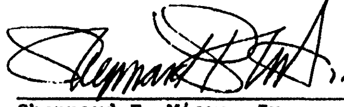
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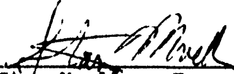
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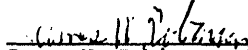
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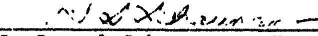
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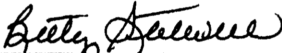
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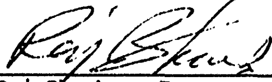
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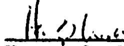
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April 20, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
205 Senator Dirksen Office Building
Washington, DC 20510

Dear Ms. Wilcox:

I understand that Subcommittee Chairman David Prior (Democrat - Arkansas) plans to introduce pension simplification legislation at sometime in the future. I know that I and many others from the corporate community would welcome simplification in many areas, which include but are not limited to

- Elimination of the Average Deferral Percentage and Average Deferral Contribution nondiscrimination tests for 401(k) plans

- Simplifying the minimum participation rules

- Simplifying the definition of highly compensated employees

Unless congress does something to ease the pressures of private pension plans they most certainly may be in jeopardy.

Sincerely yours,

Eileen Cross
Manager - Employee Benefits

EC/jc

Statement of the U.S. Chamber of Commerce

The U.S. Chamber of Commerce appreciates this opportunity to express its views on an issue of crucial importance for the preservation of the nation's voluntary private retirement system.

BACKGROUND

Over the past decade, Congress continually has revised and amended the tax laws governing private retirement plans, requiring corresponding design and operational changes in existing plans. This piecemeal legislation, often driven not by a desire to develop a coherent retirement policy but by the need to find new revenues, has been a source of increasing frustration to plan sponsors. The layering of tax laws has confused even specialized practitioners, as well as small business owners. The latter respond to the legal complexities and the corresponding operating restrictions not only by failing to adopt new plans but also, in many cases, by abandoning plans that they have had for years.

When one considers the increasing costs of assuring compliance with constant legislative changes, coupled with the frequent inability under current law to fund plans in a logical manner, it is hardly surprising that small and mid-sized businesses may choose either to drop their retirement plans or refrain from establishing them. It should be noted that large employers face problems as well; often, of late, they find that they have no sooner reprogrammed their computers to comply with a regulatory change than the Internal Revenue Service (IRS) revises its newly released regulations and the whole process must begin again.

There is legitimate concern that this pattern of legislative and regulatory tinkering has an adverse effect on retirement savings. A member poll by the American Academy of Actuaries, released in 1989, found a consensus that no more than half of the baby-boom generation will be able to retire with adequate income. Reasons cited by the actuaries include a shrinking base of workers to support Social Security benefits, ever-rising health care costs, and inadequate tax incentives to encourage employer-provided pension plans and personal savings.

Concern about the Social Security system's ability to provide benefits to the next generation of retirees, especially since its so-called reserves are used to finance current spending, has been highlighted in this legislative session. This concern can only be exacerbated when viewed in conjunction with the pressures inhibiting employers from providing meaningful retirement benefits. One way out of this dilemma would be to develop public policy that not only encourages employers to provide retirement income to their employees but also makes it easy to do so. At the same time, individuals should be encouraged to save for their own retirements, in part through employer-sponsored saving plans, such as 401(k) plans.

THE NEED FOR SIMPLIFICATION

Employers' objection to the geometric increase in administrative complexity is not simply a matter of distaste for spending more money and more time to satisfy criteria that often seem of dubious merit. The penalty for failure to comply, even unwittingly, with the most minute specification of voluminous IRS regulations is as drastic as that for the most blatant and deliberate violation of legislative intent: plan disqualification, with all its attendant tax and employee-relations consequences. There seemingly is no sense of proportion at work here, and employers may judge it safer not to set up a plan in the first place. This is particularly true in small firms without the resources to keep a tax attorney or certified public accountant on retainer.

To reverse a trend toward elimination of employer-provided retirement benefits, Congress is charged with a task involving not only the simplification of existing laws governing qualified retirement plans but also the exercise of restraint when retirement plan savings become the target of revenue-raising measures. The Chamber is grateful to the Subcommittee for its decision to look into these matters and to offer plan sponsors some hope of relief. This Subcommittee is well-placed to take the lead and to deflect the recent tendency to draft pension legislation with a focus on preventing any conceivable abuse rather than to promoting retirement plan coverage. The Chamber believes that increasing employers' ability and incentive to fund private retirement plans will have a positive effect on the national economy as well as on the population's retirement security.

The sensible first step would be to strip away some of the inconsistencies and needless complexities in the qualified plan area. The Chamber urges that such unraveling be undertaken with strict attention to minimizing compliance costs. Follow-

ing are some Chamber recommendations for improving the private pension system through tax simplification.[1]

SPECIFIC RECOMMENDATIONS

1. Simplify the definition of highly compensated employee

The definition of highly compensated employee should be simplified by replacing the $75,000 rule, the $50,000 top paid group rule, and the officer earning 50 percent of the defined benefit limit rule with a single rule making any employee who earns over $75,000 (indexed) annually a highly compensated employee. There is little need to include five-percent owners in the definition of highly compensated employees when the dollar threshold for defining a highly compensated employee is so low. If a person's compensation does not exceed a certain level, it should be irrelevant that that person is also a shareholder or owner of a business.

The rule should allow the plan administrator to decide whether to use the plan year, tax year or calendar year as the determination period and to elect whether to use prior year compensation or current year compensation (with compensation annualized for employees hired during the year). This will permit employers to use their existing data bases and systems while still maintaining the integrity of compliance goals.

2. Simplify the Rules on Aggregation of Leased Employees Under Code Section 414(n)

As presently written, the scope and complexity of these rules go far beyond what is necessary to curb any conceivable abuse. Leased employees in a bona fide employment relationship with a leasing company should not be subject to general qualification rules with respect to the client company. Only those employed under potentially abusive situations should be aggregated under the rule, with direction from Congress to the IRS on what types of potential abuse should be targeted.

3. Simplify Rules on Minimum Distributions Under Code Section 401(a)(9)

The minimum distribution rules originally were promulgated in order to prevent the wealthy from using qualified plans as an estate planning device. This risk generally was removed when the estate tax exclusion for distributions was repealed. In any case, the rules are unnecessary for the majority of plan participants, who will use their benefits for retirement purposes regardless of whether minimum distributions are required by law.

The Chamber considers these rules a suitable candidate for repeal. Failing this, they might be modified to apply only to participants with total account balances over a specified threshold. The Chamber in this case would support the Association of Private Pension and Welfare Plans' suggestion of $750,000, representing a benefit of $50,000 per year for 15 years.

4. Simplify the Distribution Rules of Code Section 402

As written, Code Section 402 represents an incomprehensible maze of rules covering all forms of distributions: qualified total distributions, partial distributions, lump sum distributions and periodic distributions. It is often difficult to determine whether a particular distribution may receive favorable averaging treatment, or be rolled over to another qualified plan or Individual Retirement Account. Research on a question involving a distribution under Code Section 402 may result in legal fees exceeding the size of the account balance. A restructuring of Code Section 402 is called for with elimination of unnecessary distinctions between the treatment of types of distributions. It should be noted that current restrictions on partial rollovers add unnecessary complexity and limit portability.

5. Eliminate Top Heavy Rules Under Code Section 416

The top-heavy provisions provide for accelerated vesting, minimum benefit accrual and a limit of $200,000 on the amount of compensation that can be taken into account under a qualified plan if more than 60 percent of the benefits under the plan are payable to key employees. These provisions must be included in all plans, even those of large employers who can never conceivably become top-heavy. Because of changes enacted under the 1986 Tax Reform Act, including the new coverage and participation rules; vesting standards; strengthened integration requirements; and

[1] These suggestions are largely consistent with, and in some cases derived from, those set forth in two excellent papers, *Gridlock: Pension Law in Crisis and the Road to Simplification*, published by the Association of Private Pension and Welfare Plans, and *Employee Benefits: Statutory Simplification*, by David J. Kautter of Ernst & Young.

new limits under Sections 401(a)(17), 402(g), and 415, the top-heavy rules are redundant and should be eliminated.

6. Eliminate Excise Tax on Excess Distributions

The excise tax originally was intended to replace the complex combined plans limitations of Section 415(e) with a simpler and more equitable scheme for limiting retirement income. However, as finally enacted, the excise tax provisions do not replace the combined plans limitations but are applied in addition to them. Because Code Section 415(e) was not repealed, the excise tax should be eliminated. The rationale for maintaining such taxes, the prohibition against excessive accumulations, is outweighed by the complexity of the provisions. Moreover, since the excise tax is imposed on the dollar value of retirement distributions, it acts as a penalty on investment success. Also, the enactment under the 1986 Act of other limitations, i.e., the defined benefit limit is now phased in over ten years of participation rather than years of service, and compensation taken into account under a plan is limited to $200,000, provides little policy justification for the maintenance of the excise tax.

7. Repeal Code Section 401(m).

New Code Section 401(m) subjects matching contributions and after-tax employee contributions to testing similar to the average deferral percentage test of 401(k). In addition, new tests exist to limit the combined amounts that can be contributed to an employer's plan(s) under both 401(k) and 401(m). The addition of these new tests significantly complicates the operation of many plans.

If Code Section 401(m) is repealed, matching contributions still will be subject to nondiscrimination principles in Code Section 401(a)(4) and the dollar limitation of Code Section 415. The statute could provide that if matching contributions are available at the same rate for all employees, these contributions would be deemed nondiscriminatory. This should be more than sufficient to ensure that any abuse in this area is curtailed.

8. Modify the Full Funding Limitation

Code Section 412(c)(7) was amended by the Omnibus Budget Reconciliation Act of 1987 to redefine the full funding limitation as 150 percent of termination liability. Contributions in excess of this limitation are not deductible and are subject to a 10 percent excise tax. The calculation of this limitation requires a separate actuarial valuation each year.

The Chamber believes that the new funding rules are both complex and overly restrictive. "Termination liability" is often less than what actually is required to close out a plan, and the limit is applied to ongoing plans which are not terminating. The effect of the current full funding limitation is that a plan's actual funding will always lag behind the funding need for real benefits at retirement where such benefits are based on final average pay, and level funding over the life of a plan is impossible.

Because the effects of the full funding limitation are only beginning to be felt, their full ramifications are not yet clear. The Chamber recommends that the Subcommittee study the broad issue of retirement plan funding processes with a focus on liberalizing the current strict rules.

9. Repeal or Modify Section 401(a)(26)

The Section 401(a)(26) minimum participation rules, which require every plan to benefit the lesser of 50 employees or 40 percent of an employer's employees, were initially aimed at preventing arrangements whereby one or more highly compensated employees would be covered by defined benefit plans while the rank and file employees were covered by defined contribution plans. This arrangement generally provided the greatest contributions and benefits for both rank and file and highly compensated employees. Congress believed that, while prior law condoned such arrangements if they satisfied the comparability tests of Revenue Ruling 81-202, in practice, the Revenue Ruling could not prevent some employers from discriminating in favor of the prohibited group by the manipulation of actuarial assumptions or the differences in rates at which benefits accrue. In addition, Congress believed that the enactment of Section 401(a)(26) would promote simplification by eliminating, in many cases, the reliance on complex comparability rules. Nothing could be further from the truth.

The reach of the proposed regulations is so broad that all plans except the most elementary will be subjected to this Code section. For example, the regulations prohibit small employers from tailoring truly nondiscriminatory benefit packages to respond to the idiosyncrasies inherent in particular groups of employees unless such plans satisfy the "40/50" rule. Moreover, Section 401(a)(26) provides no exceptions

for plans where the only employees eligible for the benefit are non-highly compensated. In addition, all employees will be required to divide even a single nondiscriminatory plan into "separate benefit structures" and to rate every variation in terms of benefits as a "separate plan" under the rules. This is the antithesis of simplification.

It is clear that under the proposed regulations, the complexities are magnified and the goals obscured. To remedy this situation, at the very least, the proposed regulations should be withdrawn and rewritten with a focus toward the original purpose, and the Code Section should be limited to defined benefit plans.

However, since the IRS will soon be responding to the Congressional directive to rework Revenue Ruling 81-202 so as to make it more difficult to discriminate using "comparable" plans that satisfy the Code Section 410(b) requirements, the best course of action is the complete repeal of Section 401(a)(26). Once the IRS publishes new comparability rules that achieve the desired anti-discrimination goal, there will be no reason for a provision like Section 401(a)(26).

CONCLUSION

The Chamber appreciates this opportunity to offer its primary recommendations on improvements in pension law and stands ready to work with the Subcommittee members and their staffs to create a climate in which employers truly can satisfy their desire to provide meaningful employee benefits at an affordable cost.

VISTA CHEMICAL CO.,
Houston, TX, April 25, 1990.

MS. LAURA WILCOX,
Hearing Administrator,
Senate Finance Committee,
Senate Dirksen Office Building,
Washington, DC.

Dear Ms. Wilcox: I am responsible for the administration of two qualified benefit plans at my company. We have a 401(k) type plan as well as a traditional defined benefit pension plan.

I am writing to ask you to please consider the recommendations regarding pension law simplification that were proposed in a letter from Frederick W. Rumack of Buck Consultants. In particular, the recommendations simplifying the definition of highly-compensated employees and eliminating the ADP and ACP testing of 401(k) plans would be a welcome change for plan administrators as well as participants.

Each year we determine which employees are highly-compensated and inform the "new" members that they must reduce the amount they are contributing to our plan. I then have to explain to people that just because they worked a lot of overtime or were transferred by the company and received some non-deductible moving allowances, they will still be penalized by the regulations.

The current definition of highly-compensated tends to reach too low. I don't feel the intent of the regulations was to prohibit hourly workers or low level supervisors from contributing to these plans. But in practice, that is what occurs. A uniform level of $75,000 (indexed) as proposed in H.R. 4508 seems a reasonable solution.

Regarding the ADP and ACP discrimination tests, we have found that there are some people that simply *will not save* for their future regardless of the incentives. We currently have a 2 for 1 company matching feature for any employee who will contribute 3% of their base salary on either a pre- or post-tax basis. And there are *still* employees who choose not to participate. Should employees that wish to save for their future (even if they are "highly-compensated") be penalized by those that won't?

Regarding our pension plan, a few months ago I would have asked you to consider the recommendation to allow offset plans based on the Social Security Primary Insurance Amount to continue, however we recently amended our pension plan formula to eliminate that type of offset. The amendment cost our company a great deal of money, most of which went to consultants in the form of fees, not to plan participants as increased benefits.

Our management is getting to the point that any more changes required by legislation may result in a plan termination instead. This would serve no one, particularly the lower paid employees.

Therefore, I sincerely urge you to carefully consider pension law simplification. It is the best thing that can be done for plan participants as well as plan administrators.

Sincerely,

CHARLES C. MEIENBERG, *Supervisor, Qualified Plans.*

Statement of Professor Edward A. Zelinsky

Benjamin N. Cardozo School of Law
Yeshiva University
New York, New York

Much discussion about the simplification of the tax law casts the problem of complexity as technical in nature, divorced (or divorcable) from the substantive policies Congress has placed in the Internal Revenue Code. From this perspective, the much bemoaned complexity of the tax law reflects a failure of implementation, an unwillingness or inability to draft and adopt appropriately simple statutes and regulations to effect the policies selected by Congress. We can, from this vantange, simplify the Code if we are more sensitive to the costs of complexity in drafting legislation and regulations or if we restrain the hyperactive technicians who implement Congress' substantive tax policies in an overly complicated fashion. Such sensitivity and restraint do not require a reevaluation of the underlying premises upon which current law is based.

In this vein, one commentator has recently suggested that the initial steps toward simplifying the Code ought be the reduction of the legislative and administrative staffs addressing tax issues:

> "(1) The tax-writing staffs of Congress and the Treasury should be reduced. This action would be partly symbolic and partly substantive. It may, in fact, be the only way to reduce the volume of legislation and to force the legislature to focus on the jugular rather than the capillaries...
>
> "(2) The regulation-writing staffs of the Service and the Treasury should be even more sharply reduced, and for the same reason. We should get away from the assumption that every statutory provision must spawn a regulatory provision, and particularly a long one."[1]

The technical approach to complexity in the tax law has much to commend itself. This approach suggests, rather comfortingly, that we can simplify the tax law without reassessing or abandoning the substantive policies currently embodied in the Code. Defining complexity as a technical matter orients the search for simplication towards the professional performance of the mandarins of the tax system. If the technicians draft simpler laws and regulations, we are promised, it should be possible to streamline the tax law without confronting difficult choices as to the underlying policies reflected in the Code.

There is, no doubt, an important element of truth in the technical explanation for the current complexity of the tax law. A greater sense of restraint, an increased sensitivity to the costs of complexity would be welcome and could produce some gains in simplifying the Code and the regulations.

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[1] Henderson, "Controlling Hyperlexis -- The Most Important 'Law And...'", 43 The Tax Lawyer 177 (1989) at 198.

Ultimately, however, the current complexity of the tax law cannot be isolated from the substantive policies Congress has embodied in the Code. Much, if not most, of the complexity in the present tax law stems from the reasonable and rigorous implementation of the policies Congress has adopted with respect to the public fisc. We cannot achieve serious simplification until we are prepared to reassess the substantive tax policies which have given rise to our current, complicated state of affairs.

The statutes and regulations governing qualified pension and profit sharing plans illustrate well the connection between complexity in the tax law and the substantive policies adopted by Congress. Present law has been built on the premise that the Code's treatment of qualified plans constitutes a tax subsidy, a departure from the normatively correct treatment of pension and profit sharing arrangements under a proper income tax system. From this premise, it reasonably follows that the perceived subsidy of qualified plans ought be restrained and channeled to achieve the presumed purpose of the subsidy; the encouragement of private pension and profit sharing plans benefiting rank-and-file workers.

The rigorous implementation of these notions has added considerably to the complexity of the tax law vis-a-vis pension and profit sharing arrangements.

Consider, for example, the complicated provisions of the Code mandating the aggregation of employers for qualified plan purposes. In 1974, Congress adopted sections 414(b) and 414(c), relatively simple provisions which require that, for pension and profit sharing purposes, commonly-owned corporations, trades and businesses be treated as a single employer. This rule was intended to prevent the artificial division of a single enterprise into multiple legal entities. Such multiple entities were perceived as abusive as each, if respected for tax purposes, could maintain its own qualified plan. Thus, in the absence of rules like sections 414(b) and 414(c), an employee could receive many tax-subsidized pension or profit sharing contributions from what is essentially a single employer artificially divided into separate juridical entities.

Alternatively, the artificial division of a single enterprise into multiple entities could result in the relegation of rank-and-file employees to employers without qualified plans. Simultaneously, the highly-compensated employees of the enterprise, nominally working for a separate entity, could be covered by pension and profit sharing plans and thus enjoy the resulting tax subsidy.

Sections 414(b) and 414(c) define common ownership in a mechanical fashion, borrowing concepts, well-known to the tax bar, from the consolidated return provisions of the Code.[2] Sections 414(b) and 414(c) require that, for qualified plan purposes, separate entities, under certain conditions of common ownership, be treated as a single employer. This treatment was intended to deter the manipulation of the qualified plan subsidy through multiple entities by disregarding such entities' separate juridical existences for pension and profit sharing purposes.

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[2] See section 1563 of the Internal Revenue Code, incorporated by reference into sections 414(b) and 414(c). Except as indicated, all references are to the Internal Revenue Code of 1986, as amended to date.

In Garland, M.D., F.A.C.S., P.A. v. Commissioner,[3] the United States Tax Court condoned, for qualified plan purposes, a multiple employer arrangement designed to fall outside the boundaries established in sections 414(b) and 414(c) for aggregating employers into a single entity. Dr. Garland had created a professional corporation which employed only him. This corporation, in turn, was a fifty percent (50%) partner, with a second doctor, of a medical partnership. This partnership employed all of the other persons associated with Dr. Garland in the provision of medical services. The evident purpose of this arrangement was to segregate Dr. Garland by himself into one employer, his professional corporation, while placing all the rank-and-file personnel in a separate entity, the partnership.[4]

Dr. Garland's professional corporation maintained a qualified plan, in effect just for him, while the partnership did not maintain a plan for the rank-and-file employees.

The Tax Court, applying the mechanical ownership rules of sections 414(b) and 414(c), concluded that Dr. Garland's professional corporation and the medical partnership were not to be treated as a single employer. Those sections require a partner and its partnership to be aggregated if the partner owns more than fifty percent of the partnership. Since Dr. Garland's corporation owned exactly fifty percent of the partnership, the court noted, the corporate partner and the partnership were to be recognized as separate entities.[5] And since the rank-and-file employees were employed by the separate partnership, their exclusion from pension coverage did not jeopardize the tax status of the corporation's plan covering only Dr. Garland.

The Garland decision catalyzed a dramatic expansion of the Code's rules treating, for qualified plan purposes, juridically separate entities as a single employer. Section 414(m), responding directly to the Garland decision, introduced into the Code the new concept of an "affiliated service group." Under these provisions, certain corporations, trades and businesses not described in sections 414(b) and 414(c) are, under a separate rule, nevertheless treated as a single employer because they are closely related to one another in the performance of services. Congress subsequently augmented the affiliated service group rules with provisions designed to prevent, for qualified plan purposes, businesses from segregating their management personnel into separate employer entities.[6] These rules introduce into the Code the concept of an organization providing "management functions" for a single other entity.

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[3] 73 T.C. 5 (1979). The result in Garland had been presaged in an earlier decision of the Tax Court, Thomas Kiddie, M.D., Inc. v. Commissioner, 69 T.C. 1055 (1978).

[4] Prior to the adoption of the Employee Retirement Income Security Act of 1974, the employees of the partnership had been covered by the qualified plan. Hence, the removal of those employees from qualified plan coverage was a deliberate act.

[5] See Garland, supra, note 3 at 11 (footnote 8).

[6] See section 414(m)(5). For one such case, see Achiro v. Commissioner, 77 T.C. 881 (1981).

The protectors of the qualified plan subsidy also responded to the Garland problem through the somewhat oxymoronic concept of the "leased employee," i.e., someone nominally employed by an independent entity but permanently assigned to another corporation, trade or business. Section 414(n) generally requires that such leased employees be treated as true employees for the purposes of the pension and profit sharing plans of the entities to which the leased employees are permanently assigned. This means that such leased employees must usually participate in the qualified plans of the corporation, trade or business to which they are permanently assigned.

Finally, confronted with the innumerable permutations of this problem, Congress granted the Treasury broad regulatory authority to address future arrangements perceived to be abusive.[7] The Treasury has used this authority to propose regulations which are not a model of simplicity.[8]

The post-Garland additions to the tax law have added considerable complexity to an area, the regulation of qualified plans, many had thought was already overly complicated. There is, however, no reason to view the complexity of sections 414(m), 414(n) and 414(o) and their regulations as a failure of technical skill or desire. Indeed, those who drafted these provisions have generally implemented the underlying policy as well as could be expected.

Sections 414(m), 414(n) and 414(o) cannot be dismissed as the product of tax technicians run amok. Rather, these provisions faithfully implement the substantive policy of Congress, to restrict and channel the perceived tax expenditure for qualified plans in the face of the possibilities for the manipulation of legally separate entities a la Dr. Garland.

For one who believes strongly in that policy, the complexity generated by sections 414(m), 414(n) and 414(o) is a regrettable but necessary cost of channeling and restricting the qualified plan subsidy to protect rank-and-file employees and the federal fisc. For others, such as myself, who do not believe in that policy, it matters little that sections 414(m), 414(n) and 414(o) are complicated: these provisions ought be repealed because they are wrong substantively.[9] The complexity of sections 414(m),

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[7] See section 414(o).

[8] See Proposed Regulation section 1.414(o)-(1) which introduces into the tax law the concepts of the "leased owner" and the "leased manager."

[9] I adhere to the decidedly minority view that the qualified plan provisions of the Code ought not be characterized as creating a tax expenditure. Rather, I view these provisions as consistent with our normative vision of an income tax considering such criteria as administrability and measurability. See, e.g., Zelinsky, "The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo," 66 N. Car. L. Rev. 315 (1988). There is, of course, no need to channel or restrict the qualified plan tax subsidy through legislation like section 414(m) if no such subsidy exists. Those favoring consumption, rather than income, as the base for taxation would also be inclined to permit unlimited contributions to qualified plans since, under a consumption tax, saving is to be encouraged and excluded from the tax base. See, generally, Pechman (ed.), What Should Be Taxed:

414(n) and 414(o) is of decisive import only for the fence-sitters, those unsure whether the underlying policy of these provisions is correct or those favoring that policy but not strongly. For them, and only for them, will the complexity of sections 414(m), 414(n) and 414(o) be a decisive factor in determining if these provisions ought remain in the Code.

The post-Garland additions are merely one example of the link between complexity in the tax law and the substantive policy of restricting the perceived subsidy for qualified plans. A similar story, for example, can be told about the complicated Code provisions regulating the distributions received by employees and their beneficiaries from pension and profit sharing arrangements.[10] These complex measures do not represent a failure of draftsmanship or technical skill. They do implement a policy which seeks to channel and restrict the presumed qualified plan subsidy. If we jettison that policy (as I think we should), we could eliminate these provisions from the Code also.

The connection between substantive tax policy and complexity is not restricted to the qualified plan arena. The much-maligned section 2036(c) implements faithfully the underlying policy animating this addition to the Code: to subject to estate and gift taxation various intergenerational transactions previously outside the transfer tax base.[11] While section 2036(c) can probably be improved technically, I do not think that is really the crux of the controversy about this measure. Implementing the vision which underlies section 2036(c) will be complex under the best of circumstances.

My analysis suggests that the search for tax simplification will be both less productive and less important than some expect. Insofar as the search for simplification is defined in technical terms, the results are likely to be limited. If the attack on complexity is broadened to a review of the substantive rules complicating the tax law, there will be understandable resistance to simplification from those defending particular policies as worth the complexity they cause.

And frequently those defenders of the substantive status quo will be correct: some necessary policies in a complex economy require complex tax laws.

We can do some things to assist decisionmakers balance the imperatives of particular substantive policies with the complexity those policies will cause. In particular, it would be useful to identify systematically those types of policies which tend to generate the most complexity. We can also identify those constituencies of the tax system with respect to which our concern for simplification is greatest. These considerations will

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Income or Expenditure? The Brookings Institution: Washington, D.C. (1980).

[10] See sections 72(t), 401(a)(9) and 4974.

[11] Defenders of Section 2036(c) frequently cite the difficulty of policing the valuation of intrafamily transfers. However, the committee reports accompanying Section 2036(c) articulate a desire to extend the substantive reach of the estate tax. See House Report No. 100-391(I), 1987 U. S. Code, Cong. and Adm. News, Vol. 4 at 2313-659. ("The committee believes that keeping a preferred stock interest in an enterprise while giving away the common stock resembles a retained life estate, and should be treated as such.")

not be determinative when decisionmakers have strong views as to the substantive desirability of a particular rule. In such situations, complexity will usually be dismissed as the unpleasant but unavoidable cost of implementing correct policy choices.

However, if the decision as to a proposed measure is close, the scales might be tipped by the likelihood the measure will generate considerable complexity in the future or by the fact that those affected by such complexity will be the participants in the tax system least able to cope with such complexity.

The history of the qualified plan provisions suggests a particular kind of policy likely to complicate the tax law measurably, i.e. a policy which depends upon the introduction of totally new statutory concepts rather than the incremental use of existing ideas. Sections 414(b) and 414(c) introduced less complexity than the post-Garland provisions because, inter alia, sections 414(b) and 414(c) incorporated and built upon the pre-existing common ownership rules of the consolidated return provisions. Sections 414(m), 414(n) and 414(o), by contrast, have introduced into the Code a plethora of new and complexity-generating concepts ("affiliated service group," "leased employee", "management functions"). When tax proposals require the creation of totally new concepts of this sort, those concerned about complexity should be more alert than when existing notions of the tax law are being expanded incrementally.

Another type of policy likely to generate inordinate complexity is the compromise policy.[12] A statute amalgamating two different rules is likely to be more complicated than a statute embodying a single approach to a tax issue. Again, this consideration will be determinative only for the fence-sitters, those unsure whether to pursue a compromise rather than adopt either alternative wholeheartedly. The partisans of the competing positions will typically view the complexity generated by compromise as an acceptable price for the partial adoption of their respective positions.

I would cite as a prime example of compromise-driven complexity section 402 governing the taxation of distributions from qualified plans. Discernible in section 402 are several distinct, largely incompatible approaches to the taxation of pension and profit sharing distributions: taxing such distributions as ordinary income,[13] permitting the tax-free transfer of such distributions to individual retirement accounts and other qualified plans,[14] taxing certain pension and profit sharing distributions pursuant to a special averaging formula.[15] The amalgamation of these contrasting approaches in section 402 has resulted in a maze of highly technical rules specifying the conditions under which tax-free rollovers and special averaging treatment will be permitted. Transition provisions[16] preserve pre-1986 versions of these rules for some plan distributees.

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[12] I am indebted to my colleague, Professor Edwin Cohen, for making this observation to me.

[13] See section 402(a)(1).

[14] See sections 402(a)(5), 402(a)(6) and 402(a)(7).

[15] See section 402(e).

[16] See section 1122(h) of the Tax Reform Act of 1986 as amended by section 1011A(b) of the Technical and Miscellaneous Revenue Act of 1988.

In contrast to section 402, my own policy preferences as to the taxation of plan distributions could be implemented quite simply. I see no reason to provide averaging treatment for pension and profit sharing payments when no averaging rule is available for other forms of income. I similarly see no basis, in light of the sharply lower rates which currently apply to ordinary income, for preserving pre-1986 formulas for some plan distributees or in deferring taxation on the distribution of appreciated employer securities. I also, as a matter of tax policy, opppose the rollover provisions of the Code. If tax-free rollovers are to be permitted, I would grant such treatment for any distribution from a qualified plan regardless of the amount of such distribution or the event occasioning the distribution.

I could thus reduce section 402 to a simple cross reference to section 72 and ordinary income treatment for all plan distributions. If rollover provisions are necessary, I would merely provide that any distribution transferred within sixty days should qualify. I would therefore eliminate from section 402 such concepts as the lump sum distribution,[17] the qualified total distribution[18] and special averaging. [19]

These are, however, judgments with which many would disagree. Compromising their views and mine would ultimately result in a statute which looks very much like section 402 as it exists today.

In short, section 402 is a measure which, in its present form, nobody really wants. However, the technicians cannot be blamed for the morass that is section 402. Rather, section 402 reflects the interplay of conflicting policies. To paraphrase Oscar Wilde, compromise is rarely pure and never simple.

Finally, I would observe that the significance of complexity depends critically upon the identity of those affected by it. I am not troubled, for example, about the complexity of the corporate reorganization provisions of the Code insofar as those provisions affect publicly-held corporations. In contrast, I am more troubled by the convoluted nature of our current rules governing the taxation of qualified plan distributions. Section 402, and its overly complicated rules governing rollovers and lump sum distributions, affect a great many unsophisticated taxpayers. It is worrisome when taxpayers of relatively modest means are subjected to such a complicated tax regime.

In summary, if tax simplication is defined in technical terms, eschewing a review of substantive policy, the resulting gains will be limited. Modestly conceived efforts at reform will produce modest results. Only by challenging and abandoning the underlying premises currently embodied in the Code can the tax law be appreciably simplified.

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[17] See section 402(e)(4).

[18] See section 402(a)(5)(E)(i).

[19] See section 402(e).

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