SUMMARY OF H.R. 4200; RETIREMENT INCOME SECURITY FOR EMPLOYEES ACT; AS PASSED BY THE SENATE

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY

THE STAFF

OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

OCTOBER 9, 1973

U.S. GOVERNMENT PRINTING OFFICE

22-099 WASHINGTON : 1972 JCS-31-73

CONTENTS

I. REVENUE EFFECT

There are several different kinds of revenue effects which can be expected to arise from H.R. 4200, the Retirement Income Security for Employees Act, as passed by the Senate. These are summarized in table 1. First, three provisions designed to equalize the tax treatment of pensions have an impact on tax deductions. These are the provisions raising the maximum deductible amount that the self-employed can set aside annually for their retirement, making provision for a retirement savings deduction for those not now covered under any retirement provisions, and a provision which limits the maximum retirement benefit and the maximum deductible contribution on behalf of corporate employees.

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

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

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

TABLE 1.—*Estimated annual revenue effect of the Retirement Income Security for Employees Act as passed by the Senate—at 1973 levels of income and employment*

[Millions]

I. Provisions designed to equalize tax treatment under pension plans:	
Increase in maximum annual deductible contribution by the self-employed under H.R. 10 plans to the greater of $750 (but not in excess of earned income) or 15 percent of earned income (up to $7,500)[1]	−$175
Allowing individuals not covered by pension plans to deduct annually up to the greater of $1,000 (but not in excess of earned income) or 15 percent of earned income (up to $1,500) for contributions to personal retirement plans, except that where employers also contribute the overall ceiling is $1,000 (long-run effect)[1]	−355
Limiting to $100,000 the maximum annual compensation for purposes of calculating the deductible contribution on behalf of corporate employees and limiting to 75 percent of the first $100,000 of compensation the maximum annual retirement benefit[2]	+40
Total, provisions designed to equalize tax treatment under pension plans	−490

See footnotes at end of table, p. 2.

TABLE 1.—*Estimated annual revenue effect of the Retirement Income Security for Employees Act as passed by the Senate—at 1973 levels of income and employment*—Continued

[Millions]

II. Revised tax treatment of lump-sum distributions from qualified plans (long-run effect)[3]	+35
III. Revenue effect of new taxes:	
Audit fee tax of $1 a year for each employee covered by plan [4] (to finance IRS administration of provisions relating to pension plans and exempt organizations)	+30
Tax to finance plan termination insurance ($1 per plan participant)[5]	+30
Gross revenue collections	+60
Revenue loss due to tax deductions taken by employers:	
For audit fee tax [4]	−14.4
For tax to finance plan termination insurance [5]	−14.4
Total offset of new taxes against income tax collections	−28.8
Net revenue effect of new taxes	+31.2
IV. Revenue effect of minimum vesting provision:[6]	
Case 1: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute a substitute for cash wages	−130
Case 2: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute an addition to cash wages	−265
Case 3: Assuming that benefit levels of pension plans are adjusted downward to absorb the additional employer contributions to pension plans resulting from the minimum vesting requirement	0

[1] Effective for taxable years beginning after 1973.
[2] Effective for plan years beginning after 1973 for plans adopted after July 24, 1973, and effective for plan years beginning after 1975 for plans in existence on July 24, 1973.
[3] Takes effect Jan. 1, 1974.
[4] Effective for calendar years beginning after 1973.
[5] Effective for plan years and taxable years beginning after 1973; where employers elect to have no liability for losses a higher rate will be set by the trustees of the Guaranty Corporation.
[6] The minimum vesting provision is effective for plan years beginning after 1975 for plans in existence on the date of enactment; for plans adopted after the date of enactment the vesting requirement applies to plan years beginning after the enactment date.

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

Provisions designed to equalize tax treatment of retirement plans.—It is estimated that the provision increasing the maximum annual deductible pension contribution by self-employed persons on their own behalf to the greater of $750 (but not in excess of earned income) or 15 percent of earned income (up to $7,500) will result in an annual revenue loss of $175 million. The provision allowing individuals not covered by pension plans to deduct annually up to the greater of $1,000 (but not in excess of earned income) or 15 percent of earned income (up to $1,500) for contributions to personal retirement plans is expected to involve a revenue loss amounting to $225 million for 1974 and rising to $355 million for 1977 (at 1973 income levels). On the other hand, limiting to $100,000 the maximum annual compensation for purposes of calculating the deductible contribution on behalf of corporate employees and limiting to 75 percent of the first $100,000 of compensation the maximum annual retirement benefit is expected to

increase revenue by $40 million a year at 1973 income levels. Altogether, when fully effective, these three provisions involve an estimated annual net revenue loss of $490 million.

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

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

The second new tax is imposed on employers with qualified plans, except money purchase, stock bonus, and profit-sharing plans, and is to be used to finance plan termination insurance ($1 per plan participant, except that where employers elect to have no liability for losses a higher rate will be set by the trustees of the Guaranty Corporation). This tax, which is effective for plan years and taxable years beginning after 1973, is expected to raise an estimated $30 million annually.

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

These deductions against income tax reduce the revenue from the new taxes from $60 million to about $31 million.

Revenue effect of minimum vesting and funding provisions.—The new minimum vesting standard, which generally becomes effective for plan years beginning after 1975, will also involve an indirect loss of revenue, ranging from zero to an estimated $265 million a year (at 1973 income levels).

The minimum vesting requirement involves little or no revenue loss to the extent that the benefit levels of plans are adjusted to absorb the increased employer costs resulting from the requirement. This is because, in that event, the requirement would have no effect on the deductions taken for contributions to plans or on the taxable income of covered employees. If the additional amounts required to be contributed to pension plans as a result of the vesting standard are a substitute for cash wages, rather than a net addition to cash wages, the annual revenue loss is estimated at $130 million. This could occur, for example, if the additional employer payments into the pension plan are taken into consideration in setting future wage increases. In this

event, the revenue loss results from the fact that the covered employees are permitted to postpone payment of tax on the employer contributions involved, instead of being required to pay tax currently, as would be the case had they received an equivalent amount of wages. Some part of this postponed $130 million of taxes presumably will be recovered in the future in tax payments on the benefits paid out by the plan.

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

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

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

II. PARTICIPATION AND COVERAGE

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

1. PLAN PARTICIPATION—AGE AND SERVICE REQUIREMENTS

Present law

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

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

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

[1] As described below (2. Plans Where a Collective Bargaining Unit is involved; Other Antidiscrimination Provisions), a qualified plan must meet certain coverage standards. Several of the alternative standards require certain percentages of employees, or of eligible employees, to be covered by the plan, but in such cases the employer is permitted to exclude employees who fail to meet the plan's service requirements, not exceeding five years of service. If the coverage standards are met, conditions other than age or service conditions may still be imposed, except in the case of owner-employee plans. The Senate bill would not change this rule.

[2] An owner-employee is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec 403(c)(3)).

The Senate bill (H.R. 4200)

The Senate bill provides that a plan which is qualified under the Code is not to require, as a condition of participation, more than one year of service, or an age greater than 30 (whichever occurs later).[3] It was felt that this rule will significantly increase coverage under private pension plans, without imposing an undue cost on employers. In addition, the bill contains a "look back" rule, which provides that once an employee becomes eligible to participate in a pension plan, his years of service with the employer (on and after the effective date of the plan) before becoming a participant, up to a maximum of 5 years, are to be credited toward his required years for minimum vesting (sec. 221(a) of the bill). Additional preparticipation service, beyond 5 years, is to be credited to the employee for any years for which (although the employee technically may not have been a participant) the employee contributed to the plan or the employer contributed on the employee's behalf. The bill does not provide any authority to exclude from the plan those employees hired within any specified number of years of normal retirement age.

For purposes of these rules, an employee is considered to have performed a year of service if he was employed for more than 5 months during the year, for at least 80 hours each month.[4] The "year" of service may be a calendar, plan, or fiscal year, whichever is applied on a consistent basis under the plan.

Service with a predecessor of the employer is to be counted for purposes of the eligibility requirements to the extent provided in Treasury regulations. In the case of a multiemployer plan, service with any employer who was a member of the plan when the service was performed is to be counted toward an individual's participation requirement (see sec. 705 of the bill).

The provisions of present law with respect to coverage under an owner-employee (H.R. 10) plan are not changed by the Senate bill. Present law already requires relatively early participation (after 3 years of service) and 100-percent immediate vesting in the case of owner-employee plans. It was concluded that the retention of these provisions of present law was needed to protect employees in such cases.

Generally, these provisions apply to plan years beginning after the date of enactment. However, to allow time for amendment, in the case of a plan already in existence on the date of enactment, the provisions apply to plan years beginning after December 31, 1975 (or, if later, plan years beginning after the expiration of a preexisting collective bargaining agreement or after December 31, 1980, whichever is earlier).

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

Present law

Under present law (sec. 401(a)(3)), a qualified retirement plan must cover either (1) a specified percentage of all employees (generally 70 percent of all employees, or 80 percent of those eligible to benefit

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

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

under the plan if at least 70 percent of all employees are eligible) [5] or (2) such employees as qualify under a classification which is found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. (A plan is not *per se* discriminatory for purposes of these rules merely because it is limited to salaried or clerical employees.)

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

The Senate bill (H.R. 4200)

The Senate bill provides that collective bargaining employees may be excluded for purposes of applying the coverage test of the tax laws where there is evidence that retirement benefits have been the subject of good faith bargaining between the union employees and the employer in the negotiations relating to the most recent contract. Thus, if pension plan coverage had been discussed with the representatives of the union employees and no pension coverage was provided, either because the union employees were covered under a union plan (which might or might not offer comparable benefits to those provided under the employer plan), or because the employee representatives opted for higher salaries, or other benefits, in lieu of pension plan coverage, or for some other valid reason, then it would be permissible to exclude those union employees from the plan, or provide them with a lesser or different level of benefits without prejudice to future coverage if the subject is raised and agreed to in subsequent negotiations.

In addition, with respect to the coverage and antidiscrimination requirements, the bills provide for the exclusion of those employees who are nonresident aliens with no United States income from the employment in question. Also, for purposes of these requirements, the bills provide that employees of all corporations who are members of a "controlled group of corporations" (within the meaning of sec. 1563(a)) are to be treated as members of the same corporation (to prevent avoidance of the coverage and antidiscrimination requirements through the establishment of a management company or otherwise through the use of 2 or more corporations).

III. VESTING

(Secs. 221 and 261 of the Senate bill and secs. 401, 411, 413, 4973, and 6690 of the Code)

Present law

Plans which qualify under the Internal Revenue Code are now required to provide vested (i.e., nonforfeitable) rights to participating employees when they attain the normal or stated retirement age. Employees must also be granted vested rights if the plan terminates or the employer discontinues his contributions.

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

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

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

The Senate bill (H.R. 4200)

The Senate bill provides that a qualified retirement plan (whether trusteed or insured) would be required to give each participant vested rights to at least 25 percent of his accrued benefit from employer contributions after 5 years of service, plus 5 percentage points a year for each of the next 5 years of service and 10 percentage points a year for each year of service thereafter. This means that there must be 100 percent vesting after 15 years of service. (Also, under the bill, each participant would have to be fully and immediately vested in his accrued benefit derived from his own contributions.) Also, under a "look back" provision, once an employee becomes eligible to participate in a pension plan, his years of service with an employer before becoming a participant, up to a maximum of 5 years, are to be credited toward his required years for minimum vesting (if the pension plan was in existence during those years). Thus, an employee who began his service at age 25, and became a participant at age 30, would be 100 percent vested in his accrued benefits at age 40, after 15 years of service.

Generally, the vesting requirements of the bill apply to all accrued benefits, including those which accrued before the effective date of the provision, in order to afford protection to older employees who will already have the bulk of their working years (and benefits accrued during their lifetimes) behind them on the date when the act becomes effective. Years of service prior to the effective date are also to be counted for purposes of determining the extent to which the employee is entitled to vesting.

To allow some flexibility in the general vesting rule, the Senate bill provides that any plan which, on the date of enactment, provides for 100 percent vesting of employer contributions by the end of the tenth year of the employee's service with the employer under the plan may continue to use this vesting schedule. Also, a class year plan may meet the vesting requirements under the bill if the plan provides for 100 percent vesting of the employer contributions within 5 years after the end of the plan year for which the contributions were made.

The term "year of service" for purposes of these rules is to be defined under regulations prescribed by the Department of Treasury (after consultation with the Department of Labor) for years ending prior to January 1, 1982. After that time "year of service" is to be

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

defined as any year where the employee has more than 5 months of service with at least 80 hours of work each month.

Under the Senate bill, no rights to accrued benefits, once vested, can be assigned or alienated under a qualified plan, and such rights cannot be forfeited (except that benefits attributable to employer contributions may be forfeited in the event of death, or if the employee withdraws his own mandatory contributions to the plan).

To help enforce the vesting requirements, the bill also provides for the imposition of an excise tax on the employer in cases where the employer is not complying with the vesting requirements in practice, even though the plan contains a vesting schedule which is consistent with the requirements of the bill. Initially, the tax would equal 5 percent of the accumulated vesting deficiency and could go to 100 percent of this amount if the offense were not corrected. Also, the Secretary of the Treasury is authorized to bring actions for equitable relief to restrain plans from failing to comply with the vesting requirements in practice (sec. 262 of the bill).

In addition, the bill contains a provision which would authorize highly mobile employees, such as engineers, to trade off high benefits which might be available under one pension plan of their employer for the right to participate in another plan with lower benefits but very rapid vesting. Also, under the bill, the Secretary of Labor is authorized to develop recommendations for modifications of Federal procurement regulations to insure that highly mobile professional, scientific, technical and other personnel in occupations employed under Federal contracts will be protected against forfeitures of their retirement benefits.

Generally, these provisions are to apply to plan years beginning after the date of enactment. In the case of a plan already in existence, to allow time for amendment of the plan, the provisions will apply in plan years beginning after December 31, 1975. However, if the Secretary of Labor should find that implementation of the vesting requirements will impose "substantial economic hardship" on the plan, he will certify this fact to the Secretary of Treasury and the effective date may be postponed for a period of up to 6 years as recommended by the Secretary of Labor. The provisions will apply to Government plans in plan years beginning after December 31, 1980.

IV. FUNDING

(Sec. 241 of the Senate bill and secs. 4971 and 4972 of the Code)

Present law

Under present tax law, contributions to a qualified pension plan must be sufficient to pay the liabilities created currently (i.e., the normal pension costs) plus the interest due on unfunded accrued pension liabilities (past service costs) (regs. § 1.401-6(c)(2)(ii)).[1] This is to keep the amount of unfunded pension liabilities from growing larger, but does not require any contributions to be made to amortize the principal amount of the unfunded liabilities.

Pension plan costs [2] generally are estimates and are based on ac-

[1] The minimum funding requirement of present law applies only to pension and not to profit-sharing or stock bonus plans.

[2] In determining costs, an employer must take into account factors such as the basis on which benefits are computed, expected mortality, interest, employee turnover, and changes in compensation levels.

tuarial calculations. Consequently, all actuarial methods, factors, and assumptions used must, taken together, be reasonable and appropriate in the individual employer's situation (Regs. § 1.404(a)–3(b)). When applying for a determination letter from the Internal Revenue Service that a plan is qualified, the actuarial methods, factors, and assumptions used generally must be reported to the Service, along with other information to permit verification of the reasonableness of the actuarial methods used. Changes in actuarial assumptions and methods must be reported annually to the Service.

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

Actual experience may turn out to be different from anticipated experience, resulting in experience loss or experience gain. Depending on the circumstances, the contributions needed to make up experience losses may be deducted currently or may be added to past service costs and deducted only on an amortized basis.[3] Similarly, depending on the circumstances, experience gains may reduce the plan cost currently or reduce costs under one of the spreading methods used to determine the amounts deductible.[4]

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

The Senate bill (H.R. 4200)

H.R. 4200 would establish new minimum funding requirements for qualified pension, profit-sharing, and stock bonus plans designed to give assurance that these plans will accumulate sufficient assets within a reasonable time to pay benefits to covered employees when they retire. These rules are to apply to any pension, profit-sharing, or stock bonus plan which, after December 31, 1975, has qualified (or has been determined to qualify by the Internal Revenue Service) under sec. 404(a)(2) or sec. 401(a) of the Code. These minimum funding requirements are to continue to apply to such plans and trusts even though they later lose their qualification.

Generally, under these requirements the minimum amount that an employer must annually pay under a defined benefit pension plan includes the normal cost of the plan (as under current law) for currently accruing liabilities, plus amortization of past service costs, experience losses, etc. The minimum amortization payments required by the bill are calculated on a level payment basis—including interest and principal—over various stated periods of time and take into account the accrued liabilities whether or not vested. Generally, initial past service costs (and past service costs established by substantial plan amendments), both vested and unvested, must be amortized over no

[3] Under the "10 percent" deduction limit (sec. 404(a)(1)(C) of the Code), if the deficiency occurs using the same assumptions as previously, the additional contributions may be deducted currently. If the deficit results from a loss in asset values or revaluation of liabilities using more conservative assumptions the deficit may be added to past service cost. Rev. Rul. 57–550, 1957–2 C.B. 266.

[4] See Rev. Rul. 59–153, 1959–1 C.B. 89, discussing a pension plan using the "entry age normal method," where adjustment for gains is generally made by deducting the amount of gains arising in any year from the next year's deductible limit under sec. 404(a)(1)(C). See also Rev. Rul. 65–310, 1965–2, C.B. 145, discussing a plan using the "frozen initial liability method," where adjustments for gains are spread automatically as a part of current and future normal costs.

more than 30 years, and experience losses generally must be amortized over no more than 15 years. (Decreases in cost from substantial plan amendments also generally are to be amortized over 30 years, and experience gains are to be amortized over 15 years.) In calculating experience gains and losses, values of fund assets may be determined on a current basis or, if used consistently, on the basis of a moving average over not more than 5 years.

If an employer would otherwise incur substantial business hardship for a plan year, the Internal Revenue Service may waive that year's required payment of normal costs, and amounts needed to amortize past service costs and experience losses; the amount waived must be amortized over no more than 10 years, and no more than 5 waivers may be granted for any 10 consecutive years.

For money purchase pension, profit-sharing, and stock bonus plans, the minimum amount that an employer must annually contribute to the plan is the amount that must be contributed for the year under the plan formula (or other system used by the plan to determine the contribution level). For purposes of this rule, a collectively bargained plan which provides an agreed level of benefits and a specified level of contributions during the contract period is not to be considered a money purchase (or other type of defined contribution) plan. This type of plan is subject to the funding provisions of the bill, and contributions must be made which are adequate to fund the agreed benefit on the basis required under the bill.[5]

The Senate bill provides essentially the same rules for multiemployer plans as for other plans, except that 40 years is given to amortize past service costs and the initial unfunded liability, and any such 40-year period may be extended by the Secretary of Labor for up to an additional 10 years in cases where he determines that otherwise there would be substantial hardship for 10 percent or more of the contributing employers involved.

Because of the importance of actuarial determinations, the Senate bill requires the enrollment of actuaries before they may practice as such before the Internal Revenue Service, and requires periodic reports by actuaries.

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

The bill would impose an excise tax on the employer if he fails to fund the plan at the minimum required level (but only if a waiver has not been obtained). The tax initially is to be 5 percent of the accumulated funding deficiency at the end of the plan year. The 5 percent tax is to be imposed for each plan year in which the funding deficiency has not been corrected. Additionally, in any case in which the 5 percent tax is imposed and the accumulated funding deficiency is not corrected within the correction period allowed after notice by the Internal Revenue Service, a 100 percent tax is imposed on the accumulated funding deficiency. In accord with present law respecting the excise taxes with regard to private foundations, neither the 5 percent nor the 100 percent taxes are to be deductible.

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

The funding provisions are to apply to plan years beginning after the date of enactment, for plans established after that date. These provisions are to go into effect for plan years beginning after December 31, 1975, for plans in existence on the date of enactment, however in cases of substantial economic hardship (as determined and certified by the Secretary of Labor) this may be extended to years beginning after 1981.

V. OTHER PROVISIONS ASSOCIATED WITH VESTING AND FUNDING

(Secs. 261, 262, 281, and 282 of the Senate bill and secs. 401 and 404 of the Code)

1. RIGHT TO ELECT A SURVIVOR ANNUITY

Under present law, there is no requirement that a qualified retirement plan must offer the option of a survivor annuity. This can result in a hardship where an individual primarily dependent on his pension as a source of retirement income is unable to make adequate provision for his spouse's retirement years, should he predecease her.

To deal with this situation, the Senate bill requires that a joint and survivor annuity must be offered with respect to any benefit under a qualified retirement plan which is payable as an annuity. The benefit is to be paid as a joint and survivor annuity (with the survivor annuity being not less than half the annuity payable to the participant), unless the participant elects not to receive it in this form, within 2 years of normal retirement age, after receiving a written explanation concerning the terms of the annuity. The survivor annuity must be at least half of the amount payable to the participant during the joint lives of the participant and his spouse.

This provision generally applies to plan years beginning after the date of enactment. However, in the case of a plan in existence on the date of enactment, the provision applies to plan years beginning after December 31, 1975.

2. PROHIBITION AGAINST MAINTAINING NONQUALIFIED PLANS

Present law

Generally, if an employer maintains a funded plan which does not meet the requirements for qualification under the Internal Revenue Code, no deduction is allowed for contributions to the plan by the employer until the rights of the employees on whose behalf the contributions are made are no longer subject to a substantial risk of forfeiture or are actually paid. At that time, a deduction generally is allowed the employer, but the employee then must take the contributions into his income. Also the earnings on these contributions are not tax exempt.

Unfunded plans are the most common type of nonqualified plans and are typically found in a small business where the employer simply continues a part of the employee's salary after retirement. Unfunded plans are normally referred to as "pay as you go" plans, because they are not funded and the employer pays benefits out to his retired

employees on a "pay as you go" basis. They receive no special tax benefits. Payments generally are deductible when made.

In comparison with the nonqualified plan, under the qualified plan the employer may deduct contributions to the plan when they are made, the earnings on the contributions are tax exempt, and the employees generally do not have to take the contributions into income until benefits are actually distributed to them. Thus, while there are substantial tax advantages to maintaining a qualified pension plan under present law, the maintenance of a nonqualified plan is not prohibited.

The Senate bill (H.R. 4200)

The Senate bill contains a provision which would prohibit any employer (in interstate commerce) from establishing a retirement plan (other than a profit-sharing plan) which does not meet the qualification requirements of the Internal Revenue Code. The Secretary of Treasury is to enforce this prohibition by obtaining an injunction against the continued maintenance of such nonqualified plans. In addition, no deduction will be allowed for a contribution by an employer under any such plan, even if the employee is required to take the amount of the contribution into income. Certain exceptions are provided in the case of plans maintained by governmental units, churches, fraternal societies, plans maintained to comply with workman's compensation laws, plans maintained outside the United States for noncitizens, and deferred compensation arrangements. In general, the bill distinguishes between pay as you go pension plans, which would be prohibited, and deferred compensation arrangements for officers and 5-percent shareholders, which would not. Generally, a plan could be maintained as a deferred compensation arrangement if it (1) was not in writing, (2) provided a benefit which is required to be paid in full within 5 years after it accrues, (3) is solely for officers or employees who are 5 percent stockholders in the corporation, or (4) does not provide a determinable retirement benefit.

Generally, these provisions would be effective for taxable years beginning after December 31, 1975.

3. PROTECTION OF PENSION RIGHTS UNDER GOVERNMENT PLANS

Plans of the Federal Government, and State and local governments, are not subject to the funding requirements of the bill because the Senate believed that taxing power of a governmental unit should generally be adequate to ensure that funds will be available to pay the pensions which have been promised by governmental units. However, in some cases, questions have been raised, in view of the size of the future pension payment commitments, as to whether this may represent too heavy a future tax burden. In view of this, the Secretary of the Treasury is authorized and directed to make a study of the funding of government plans, which takes account of the minimum funding standards under the bill, and the taxing power of the governmental unit, and make recommendations as to whether it would be advisable to require such plans to comply with the funding requirements applicable to private pension plans, or some other funding standard, as recommended by the Secretary. The Secretary is to file his report with the Ways and Means Committee and the Senate Finance Committee by December 31, 1976.

4. PROTECTION OF THE PENSION RIGHTS OF HIGHLY MOBILE EMPLOYEES THROUGH USE OF THE FEDERAL PROCUREMENT REGULATIONS

Many employees, such as engineers, who are employed in industries engaged to a substantial extent in the performance of Federal contracts, have an unusually high rate of mobility which is imposed to a considerable extent as a result of terminations or modifications of Federal contracts, grants, or procurement policies. As a result of this unusual mobility, these employees are particularly susceptible to the loss of their pension rights due to changes in their employment status before they can become vested.

To meet this situation, the Senate bill authorizes the Secretary of Labor to develop, in consultation with professional societies, business organizations, and other Federal agencies, recommendations for modifications of Federal procurement regulations to ensure, to the maximum possible extent, that professional, scientific, technical and other personnel employed under Federal contracts shall be protected against loss of their pensions resulting from job transfers or loss of employment. Such recommendations are to be published in the Federal Register within six months after enactment and are to be adopted by each Federal department and agency unless the head of such department or agency has substantial grounds for determining that the recommendations should not be applied in the case of his department.

VI. PORTABILITY

(Secs. 301 through 310 of H.R. 4200 and secs. 402 and 403 of the Code)

Present law

Under present administrative practice, when an employee changes jobs an amount representing his vested benefits in his former employer's qualified retirement plan may, in certain circumstances, be transferred to the retirement plan of his new employer without the employee being taxed on the transfer. For this to be done, both his former and new employers must agree to the transfer, the transfer must be possible under the terms of both the plans and trusts involved, and the Internal Revenue Service's administrative requirements as to the method of transfer must be met. However, transfers of employee interests between qualified plans upon changes in employment do not appear to be usual.

The Senate bill (H.R. 4200)

The Senate bill includes several provisions that deal with portability. First, the bill establishes a voluntary central portability fund for the use of employees who leave an employer with vested retirement plan benefits. Second, the bill allows an employee to receive a complete distribution from his former employer's qualified plan and recontribute this amount within 60 days of receipt to the qualified plan of a new employer, or to the central portability fund or an individual retirement account, without being taxed on the distribution. Third, the bill provides that the Social Security Administration is to keep records of plans which an employee leaves with vested retirement benefits so that, upon retirement, he will know whom to consult to obtain his retirement benefits. These features of the bill are discussed below.

22-099—73——3

The bill establishes a voluntary central portability fund to enable an employee who changes jobs to consolidate all of his vested retirement benefits under one program (sec. 301 et seq. of the bill). Employers with tax-qualified plans may register (and withdraw registration) with the central fund on a voluntary basis. When an employee leaves an employer who is registered with the central fund, he may direct the employer's qualified plan to pay the value of his entire vested benefits to the central fund. The central fund is to establish an account for each employee on whose behalf it receives funds. The central fund will invest its assets and its income will be allocated to the participants' accounts. Funds may be invested in U.S. government obligations or interest-bearing accounts (or certificates of deposit) of banks, savings and loan associations, and credit unions which are members of a Federal insurance system (*e.g.*, Federal Deposit Insurance Corporation).

This income will not be taxed until it is distributed to the participants or their beneficiaries, and transfers between the central fund and qualified plans will be tax-free.

On a participant's retirement (no earlier than age 59½ and no later than age 70½) the central fund will pay him the value of his account or, at his request, will distribute an annuity contract to him. If a participant is disabled, payment may be made at that time, or if he dies prior to retirement or disability payment will be made to his beneficiaries. Alternatively, if a participant is hired by an employer who is a member of the central fund, the participant may direct (with this employer's concurrence) the central fund to transfer the value of his account to the new employer's qualified plan, to purchase actuarially equivalent retirement benefits in this plan. This transfer would be tax-free.

The central fund is to be operated by the Pension Benefit Guaranty Corporation (the Corporation is also in charge of the insurance program, as indicated below). Its administrative expenses in carrying on the portability program are to be provided for by appropriations. The Corporation is to establish the rules which govern the fund's operation, including its relations with individual participants and employers.

The bill also provides that an employee may receive, tax-free, a complete distribution of his interest from a qualified retirement plan if he reinvests (within 60 days after receipt) the full amount of the assets received in another qualified plan, in an individual retirement account (described subsequently), or in the central portability fund (sec. 309 of the bill). However, amounts equal to the employee's own voluntary nondeductible contributions to the plan need not be reinvested. This tax-free roll-over is available only with respect to complete distributions from a plan that occur within 12 months after termination of employment.

Employees who frequently change employment may have difficult problems in locating their former employers and the retirement plans in which they have vested benefits. To deal with this problem, the bill provides that each retirement plan must file an annual statement regarding individuals who have terminated employment and have a right to a deferred vested benefit in the plan (sec. 151 et seq. of the bill) and must also provide each such individual with a certificate of his rights. The Social Security Administration is to maintain records of the retirement plans in which individuals have vested benefits

and is to provide this information to plan participants and beneficiaries on request and also upon their application for Social Security benefits, whether or not by request.

The provisions regarding the central portability fund and the tax-free roll-over are effective upon enactment of the bill. The Social Security registration provisions are to be effective for plan years ending after 1973.

VI. PLAN TERMINATION INSURANCE

(Secs. 401 through 491 of the Senate bill and secs. 162, 401, and 4981 of the Code)

The purpose of plan termination insurance is to provide a guarantee that participants will receive their full vested benefits (at least up to some specified income level) upon the termination of a plan. With the strengthening of funding requirements, the losses of vested benefits from the termination of a plan should significantly decrease. Nevertheless, since even the new funding requirements do not provide for the immediated funding of all unfunded vested liabilities and since the market value of plan assets can vary widely from year to year, the new funding rules give no guarantee that the termination of a plan may not result in the loss of a participant's benefits. These terminations may occur because of a closing or sale of a business, a merger, or because an employer decides to stop funding a plan in order to cut costs.

Present law

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

The Senate bill (H.R. 4200)

A governmental corporation called the Pension Benefit Guaranty Corporation is established within the Department of Labor to provide plan termination insurance through administration of the Pension Benefit Guaranty Fund (Sec. 401 *et seq.* of the bill). The Corporation is to be directed by a board of directors consisting of the Secretaries of Labor, of the Treasury, and of Commerce, with the Secretary of Labor as chairman of the board.

The insurance program would be basically funded through premiums (imposed as taxes to lessen collection costs) imposed upon employers at an initial flat rate of $1 per plan participant. For plan years ending after 1976, however, the premium rate would be set by the Corporation according to the cost experience of the program. Because of the lesser possibility of termination in cases of multiemployer plans, a separate premium rate schedule could then be used for participants in multiemployer plans. These subsequent premium rates must be approved by Congress.

In addition to the amounts paid through the premium taxes, up to $100 million may be borrowed by the Corporation from the Secretary of the Treasury to avoid unexpected financial difficulties.

In order to be "qualified" for tax benefits in the sense of the Internal Revenue Code, defined benefit plans must provide plan termination insurance coverage for their participants through payment of the (excise tax) premiums. Defined contribution plans, such as money

purchase, stock bonus, and profit-sharing plans would be excluded from the program because their benefits are defined in terms of amounts of employer contributions, and not in terms of promised, insurable, defined benefits to be paid to participants. Plans for governmental employees also are excluded because the power to tax is considered an adequate substitute for the insurance. In addition, plans of tax-exempt churches (or organizations or conventions of such churches) are exempted. However, these churches may elect to have their plans covered, and a church plan is not exempt from the coverage if it is only for employees of an unrelated trade or business, or if the plan is a mulitemployer plan and one of the employers in the plan is not a church. Finally, plans for employees of tax-exempt fraternal societies are excluded if no contributions to the plan are made by the employer.

Coverage of a plan participant is limited to the lesser of 50 percent of the participant's average monthly gross income during his highest-paid five consecutive year period as a plan participant or $750 monthly (adjusted for changes in the Social Security contributions and benefits base). This coverage limitation includes any distributions from the terminating plan. All vested benefits that were created (whether resulting from the creation of a new pension plan or from the amendment of an existing plan) at least three years prior to the plan termination are to be insured. (This period is five years for plans in which employers elect to avoid liability for insurance losses by paying higher premiums, as discussed infra.) Whether the benefits were accrued or became vested before, or after, the enactment of the bill would be irrelevant. Coverage includes both retirement benefits and ancillary benefits (such as death or disability benefits) vested under one or several plans, but the amount that may be paid to any participant from the Fund, regardless of the number of plans in which the employee participated, cannot exceed the $750 per month limitation (adjusted to reflect changes in the Social Security contributions and benefits base).

Benefits of self-employed persons are also covered by the Fund, but their insurance payments are to be reduced by their proportionate share of any funding deficiency at the time the plan terminates.

In order to discourage the unrealistic creation of employee benefits, and the shifting of liabilities to the Corporation by employers who have the means to fund those liabilities, employers are liable to the extent of 30 percent of their net worth for the Corporation's payments upon terminations of their plans, but employers may elect to avoid this liability by paying an additional premium in an amount to be determined, from time to time, by the Corporation. By paying this additional amount for five years, employers would escape liability for subsequent terminations of their plans, if they do not remain in the same general line of business or become parties to reorganizations during the three years following the terminations.

If an employer ceases to exist by reason only of a change in identity, form, or place of organization, or in instances of liquidations or reorganizations, the successor corporation would remain liable for the Guaranty Corporation's loss.

In order to prevent possible abuses of the insurance system, the bill provides a mandatory system of allocation of plan assets applicable in cases of insured terminations. This is accomplished by setting aside first all voluntary contributions by employees, then allocating to

participants all mandatory contributions (contributions required by the plan or required to obtain employer contribution benefits), then allocating to participants the amounts necessity to continue benefits that had been paid already for at least three years prior to the termination of the plan, but at the level that existed three years prior to the termination. Finally, any remaining plan assets would be allocated to participants to the extent of their other guaranteed benefits.

To avoid abuse of the insurance program by paying benefits in anticipation of a plan termination, certain large lump-sum distributions made within three years prior to termination and periodic payments that began within that time could be partially recaptured by the Corporation, except that no recapture could be made for benefits paid on account of disability or after the death of the participant and this rule in individual hardship cases.

Special provisions are made, in the case of multiemployer plans, for employers who withdraw from operation of the plans, where these employers have been contributing 10 percent or more of the plan's contributions. These employers could be required to pay into escrow their share of any potential employer liability, or to post a bond, upon their withdrawal from the plan. If the plan terminated within five years the payment or the bond (to the extent needed) would be turned over to the insurance Corporation, otherwise it would be returned to the employer. Other employers who have withdrawn can also be required, if feasible, to contribute their share of any loss if the termination occurs within five years of their withdrawal.

Alternatively, the Corporation could allocate the funds of a multiemployer plan into two or more funds and treat as a terminated plan those funds allocated to workers no longer covered by the plan, whenever it determines that employer withdrawals have endangered the rights of the employee-participants. The Corporation could waive both of these possibilities if it is satisfied that the members of the multiemployer group have entered into reciprocal indemnification agreements that insure that liabilities will be paid in the event of plan failure.

VIII. REPORTING AND DISCLOSURE

(Secs. 501 through 507 of the Senate bill)

Present law; reporting to government agencies

Every employer who maintains a funded retirement plan must file returns annually with the Internal Revenue Service, regardless of whether the plan is qualified or whether a deduction is claimed for the current year (regs. § 1.404(a)–2(a)). The employer's return generally must include information on the type of plan, plan coverage, participation requirements, vesting, benefits, funding, and actuarial methods and assumptions. Employer returns also must include a statement of all plan assets and liabilities and a statement of receipts and disbursements, including benefits paid.

A return disclosing whether the trust engaged in transactions which may have been "prohibited," (and a statement describing the transactions) must be filed annually with the Internal Revenue Service by the trustee of a qualified retirement trust. (Prohibited transactions include self-dealings between the trust and interested parties, and are described in the section on Fiduciary Standards.)

The Welfare and Pension Plans Disclosure Act (29 U.S.C. § 301 *et. seq.*) also provides for reporting of welfare and retirement plan transactions. Under this Act, most private employers (except certain tax-exempt organizations) engaged in interstate commerce or in an industry or activity affecting commerce who have welfare or retirement plans covering more than 25 participants must filed a description of the plan with the Secretary of Labor when the plan is established or amended (29 U.S.C. §§ 303, 305). This report describes the plan coverage, plan administrators, plan benefits, and includes basic plan documents.

Further, if a covered plan includes at least 100 participants, an annual report must be filed with the Labor Department providing information on plan participants, funding, benefits, actuarial assumptions and methods, assets and liabilities, receipts and disbursements, and transactions between the plan and interested parties. The financial data required by the Labor Department in its annual report is more detailed than that required by the Internal Revenue Service; therefore, the annual report filed with the Labor Department is accepted by the Service as satisfying its financial reporting requirement.

Present law: disclosure to employees

Under Treasury regulations, employees must be informed of the establishment of a qualified retirement plan and its basic provisions (regs. § 1.401–1(a)(2)). This may be done by furnishing each employee with a copy of the plan, but where this is not feasible substitute methods may be used. Satisfactory substitutes must describe the essential features of the plan, and may be in the form of a booklet given to the employees or a notice posted on the company's bulletin board. Substitutes must state that the complete plan may be inspected at a designated place and times on the company's premises.

Under the Welfare and Pension Plans Disclosure Act, the plan description and annual reports filed with the Labor Department must be available for examination by participants and beneficiaries in the principal office of the plan. Additionally, upon written request, a copy of the plan description and summaries of the annual reports must be mailed to participants and beneficiaries (29 U.S.C. § 307).

The Senate bill (H.R. 4200)

The Welfare and Pension Plans Disclosure Act is amended by the bill to require that additional information be provided in the plan descriptions and annual reports filed with the Labor Department (secs. 502 and 503 of the bill). Furthermore, annual reports generally would be required for private funded employee benefit plans of any size maintained by an employer or employee organization affecting interstate commerce and coverage would be extended to most tax-exempt organizations (secs. 502 and 503 of the bill). Annual reports also would include the opinion of an independent auditor based on an annual audit (sec. 502 of the bill).

However, under the bill the Department of Labor could provide exemptions from these reporting requirements. It is anticipated that this authority to grant exemptions would be used on a relatively broad basis in the case of small plans. For example, it is anticipated that they might well be exempted from the filing requirements but nevertheless be required to have the same type of information gen-

erally available to their employees and also available in the case of an audit by Labor Department personnel. In addition, even where exemption is not granted, the Department of Labor is authorized to prescribe simplified reporting requirements for small plans.

Annual reports would include additional information of all investments, and include separate detailed schedules for transactions involving securities, other investment assets, and certain loans and leases (sec. 502 of the bill). Additionally, detailed reporting would be required for all transactions involving interested parties. Detailed actuarial information also would be required, in order to allow evaluation of the funding of the plan.

In addition to current requirements on disclosure to employees, plan administrators would have to furnish (or make available) to each new participant a summary of the plan's important provisions, including an explanation of plan benefits and the circumstances which would disqualify a person from receiving benefits (sec. 503 of the bill). Every three years a revised summary of the plan's provisions would be furnished (or made available) to participants. (Plan descriptions would be required to be written in a manner calculated to be understood by the average participant.) Participants also would be entitled to obtain copies of all the underlying plan documents. When a participant terminates service with a vested pension right, he would be given a certificate setting forth the benefits to which he is entitled (sec. 151 of the bill). Any participant or beneficiary may also request and receive a statement of benefit rights and benefit credits accrued.

In addition, the Internal Revenue Code would be amended to provide that applications for qualification of employee benefit plans (except for plans covering less than 26 persons) and annual returns filed with regard to these plans would be available to the public (sec. 706(k) of the bill).

The disclosure and reporting provisions are to be effective January 1, 1974.

IX. FIDUCIARY STANDARDS

(Secs. 511 through 522 of the Senate bill and sec. 4974 of the Code)

Present law

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

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

"Prohibited transactions" include the lending of funds to certain interested persons without receipt of adequate security and a reasonable rate of interest. Other prohibited transactions with disqualified

persons include payment of excessive salaries, providing the trust's services on a preferential basis, substantial purchases or sales of property for other than adequate consideration, and engaging in any other transaction which results in a substantial diversion of trust assets.[1] If the trust engages in any prohibited transaction, it will lose its tax-exempt status for at least one year.

The Senate bill (H.R. 4200)

Both the Welfare and Pension Plans Disclosure Act and the Internal Revenue Code are to be amended to provide new standards of conduct for fiduciaries of employee benefit plans (secs. 511 and 522 of the bill). The Secretary of Labor is to have primary responsibility for administering the general fiduciary standards (such as the "prudent man" rule described below) and for administering the investment standards governing these plans.

The Secretary of Labor and the Internal Revenue Service both would administer the fiduciary standards that prohibit certain specific transactions ("prohibited transactions"). The Secretary of Labor would have primary responsibility to administer the prohibited transaction provisions with regard to fiduciaries, and the Service would have primary responsibility with regard to parties in interest.

The Secretary of Labor would administer the fiduciary provisions by bringing civil actions to surcharge a fiduciary (and civil actions could also be brought by participants and beneficiaries). The Service would impose an excise tax on parties in interest who participated in a prohibited transaction. This excise tax would replace the prohibited transaction provisions now in the Internal Revenue Code.

The fiduciary standards provided under the bill are outlined below. The fiduciary standards of the bill generally would supersede State standards of fiduciary conduct (sec. 699 of the bill).

A fiduciary would be required to act as a "prudent man acting in a like capacity and familiar with such matters * * * in the conduct of an enterprise of a like character and with like aims" (sec. 511 of the bill). This "prudent man" rule would govern investing and other conduct such as custody of assets, protecting plan assets from loss or damage, etc. In addition, fiduciaries would be required to act in accordance with plan documents and for the exclusive benefit of participants and beneficiaries.

Investments by fiduciaries of plan assets would be governed by the prudent man rule and also, in the case of securities of the employer, by specific rules. Pension plans could have no more than 7 percent of plan assets in employer securities. Profit-sharing, stock bonus, thrift and savings, and similar plans would not be subject to this limitation if the plan documents so provided. Also, leasebacks of real property (and related personal property) to employers would be treated the same as holding employer securities (sec. 511 of the bill). Plans would be allowed ten years to divest themselves of excess securities (and leases) now held. In addition, without the approval of the Secretary of Labor a plan generally could not invest in assets outside the jurisdiction of U.S. district courts (sec. 511 of the bill). All of the provisions discussed up to this point would be enforced by the Department of Labor, through civil actions.

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

Certain additional transactions involving plan assets and parties in interest would be specifically prohibited, under both the civil action and tax provisions. These include leases, purchases and sales,[2] extension of credit and furnishing of goods and services between plans and parties in interest. Prohibited transactions also would include use of plan assets by or for the benefit of parties in interest, dealings with plan assets in the interests of fiduciaries or parties in interest, and receipt by fiduciaries or parties in interest of consideration from other parties in connection with transactions involving plans. Additionally, fiduciaries would be prohibited from representing or acting for other parties with regard to the plan. Generally, the prohibition of these transactions would in the case of fiduciaries be enforced by the Department of Labor (and by participants and beneficiaries) by civil actions. The prohibition of these transactions in sofaras parties in interest are concerned is to be enforced by the Internal Revenue Service by the imposition of excise taxes.

Exemptions could be provided from the prohibited transactions. The Secretary of Labor and Secretary of Treasury jointly could exempt classes of transactions or individual transactions from these prohibitions. Any such exemption would be after published notice to interested parties (and the opportunity to intervene), and could only be granted on joint findings that the exception is administratively feasible, is in the interests of all plans involved, and protects the rights of all participants and beneficiaries of these plans.

The bill also exempts specific transactions, generally allowing nondiscriminatory loans by plans to participants if the loans are adequately secured and at a reasonable interest rate, and allowing plans to pay reasonable compensation to fiduciaries for services to the plan. Additionally, it would not be a prohibited transaction to pay reasonable compensation to parties in interest for office space or for other services necessary to operate the plan, nor would it be prohibited for an individual to serve as an officer, employee, etc., of a party in interest. The bill also allows receipt by fiduciaries or parties in interest of benefits as participants or beneficiaries in a plan. These exceptions from the prohibited transaction rules would apply equally to the civil action and tax provisions.

To prevent undue hardship, transition rules are provided for situations where plans are now engaging in activities which do not violate current law but would be prohibited under the bill. Ten-year transition periods would be available for the lease or joint use of property and for loans between a plan and party in interest under an existing contract. Additionally, where property is now under lease or joint use and qualifies for the ten-year transition rule, it could be sold at arm's-length terms to a party in interest.

Persons convicted of specified crimes would be prohibited from serving employee benefit plans for five years after conviction or end of imprisonment (unless the U.S. Board of Parole waives the prohibition). Violation of this provision would be a crime subject to a $10,000 penalty and one year imprisonment. Removal of trustees would be through the Department of Labor and enforcement of the criminal penalties would be through the Department of Justice.

[2] Transfer of mortgaged property in some cases would be treated as a sale or exchange.

In the case of the provisions to be administered by civil actions brought by the Secretary of Labor (or participants and beneficiaries), fiduciaries (and certain parties in interest) who violate the fiduciary standards would be liable to the plan for its losses or for the profits they made as a result of the breach of fiduciary duty in which they participated. Joint fiduciaries generally would have the duty to prevent a breach by other fiduciaries, or could avoid liability for surcharge by appropriate objection and notice to the Secretary of Labor. Exculpatory agreements also would be prohibited.

Parties in interest who participate in taxable prohibited transactions would be subject to a 5 percent excise tax on the amount involved in a transaction for each taxable year (or part of a year) that the transaction was not corrected. Additionally, if the transaction was not timely corrected after notice, a party in interest who participated in it would be subject to a 100 percent excise tax on the amount involved. These taxes generally follow the format of the excise tax on self-dealing with private foundations, enacted as part of the Tax Reform Act of 1969.

These taxes would be nondeductible and payment would not relieve parties in interest from their duty to the plan of correcting the transaction.

Generally, all employee benefit plans established by employers or employee organizations engaged in or affecting interstate commerce would be subject to the Welfare and Pension Plans Disclosure Act. However, the Welfare and Pension Plans Disclosure Act would not apply to government plans, workmen's compensation or unemployment compensation or disability insurance plans, certain religious organization plans, and plans maintained outside the U.S. primarily for the benefit of employees who are not citizens of the U.S. (sec. 502 of the bill). Generally, all tax-qualified plans would be subject to the excise tax on prohibited transactions (sec. 522 of the bill). However, government plans and certain church plans would not be subject to the excise tax.

The prohibited transaction provisions are to go into effect on January 1, 1975. The other fiduciary standard rules are to go into effect January 1, 1974 (sec. 512 and 522 of the bill).

X. ENFORCEMENT

(Secs. 101, 102, 601, 641, and 691 through 699B of the Senate bill and secs. 4975, 7476, 7477, and 7802 of the Code)

Present law

Plans which meet the requirements of the Internal Revenue Code (e.g., exclusively for benefit of employees, nondiscriminatory in regard to coverage and benefits, limit on contributions for self-employed persons under H.R. 10 plans) receive special tax treatment to foster their growth. It is not necessary, in order to receive this special tax treatement, that a prior determination be obtained from the Internal Revenue Service. However, to assist employers in their development of plans or plan amendments, the Internal Revenue Service issues determination letters that proposed plans or amendments qualify for the special tax treatment. As a practical matter, since taxpayers generally wish to be assured in advance that their plans or amendments will

qualify, they obtain prior determinations from the Internal Revenue Service. Such a determination is with respect to the qualification of the plan (sec. 401 of the code) and tax-exempt status of the related trust (sec. 501 of the code).

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

Standards are set forth under which the national office is to determine whether it will entertain a request for consideration of a case. One situation where a request will be entertained is where the contemplated district office action is in conflict with a determination made in a similar case in the same or another district. The procedure provides for a conference in the national office, if it is requested by the applicant. In addition, determination letters issued by the district director are subject to post review procedure in the national office.

The Internal Revenue Service, besides granting prior determinations, also administers the tax provisions of the Internal Revenue Code relating to the continued qualification of pension and profit-sharing plans. If a plan does not comply with the requirements of the Internal Revenue Code, these special tax benefits are lost. Thus, to a considerable extent, the provisions of the Code in this area are self-enforcing (i.e., those in charge of a plan have an interest in seeing to it that the plan continues to comply with the antidiscrimination requirements, that the plan does not engage in prohibited self-dealing transactions, and that it otherwise acts in such a manner to preserve the complex of tax benefits to both the employer and the participants and their beneficiaries).

In addition, the Department of Labor administers the Welfare and Pension Plan Disclosure Act of 1958 (P.L. 85–832, as amended by P.L. 87–420), discussed above, under Reporting and Disclosure.

The Senate bill (H.R. 4200)

The bill is designed to provide additional opportunities for redress in case of disagreement with a decision of the Internal Revenue Service on retirement plan matters. Both employees and employers will be allowed to appeal determination letters issued by the Internal Revenue Service to the United States Tax Court after exhausting their remedies under the Internal Revenue Service's administrative procedures. Employees as well as employers are to be allowed to participate in the Service's administrative proceedings. If either the employer or the employee exercises his right of appeal and requests the Tax Court to issue a declaratory judgment, the other party is to have the right to intervene in the proceedings.

All interested parties to the controversy are to have an opportunity to participate in the administrative determination of the matter and to have an opportunity to contest the Internal Revenue Service's determination of the matter.

A second enforcement procedure under the bill requires an arbitration procedure to be provided in each employee benefit plan, for settlement of claims under the plans. The Department of Labor will

prescribe regulations for the type of arbitration provisions which are to be included in the plans.

The bill establishes within the Internal Revenue Service a new office, headed by an Assistant Commissioner, to be known as the Office of Employee Plans and Exempt Organizations. This office is to have the supervision and direction of the basic activities of the Internal Revenue Service in connection with pension, etc., plans (governed by secs. 401 through 414 of the code) and tax exempt organizations (exempt from tax under sec. 501(a) of the code).

As discussed above (in Fiduciary Standards), the Secretary of Labor is to have primary responsibility in administering standards of conduct with respect to fiduciaries by bringing civil actions to enjoin or remedy a breach of conduct. The bill also provides that plan participants and beneficiaries may bring civil actions to redress breaches of fiduciary duties. The Internal Revenue Service is to have primary responsibility for enforcing restraints on specified prohibited transactions with respect to parties in interest, through an excise tax. Further, the bill provides for an excise tax on violations of the funding standards and on violations of the vesting standards.

The bill also provides for the imposition of a $1 audit-fee-excise tax on the employer for each plan participant in a qualified employee plan to provide for Internal Revenue Service costs of administering the retirement plan provisions. For purposes of administration and collection of this tax, the employment tax provisions of the tax law are to be applicable. However, this tax is to be deductible as a trade or business expense. The tax is with respect to participants of plans which are qualified under the tax laws and does not apply to agencies or instrumentalities of the United States, a State, or political subdivision.

The bill, in general, preempts State laws that "relate to the subject matter regulated by this Act or the Welfare and Pension Plans Disclosure Act * * * ." However, general State regulatory (dealing with insurance, banking) and criminal laws would continue to apply.

The bill makes it illegal to discriminate against any participant or beneficiary for exercising any right to which he is entitled under the bill.

XI. EMPLOYEE SAVINGS FOR RETIREMENT

(Secs. 701 and 706 of the Senate bill and secs. 72, 219, 408, 409 and 4960 of the Code)

Present law

Generally, an employee is not allowed a deduction for amounts which he contributes from his own funds to a retirement plan. There is no provision for an employee to establish his own retirement plan with tax-free dollars. Also, while an employer's qualified plan may allow employees to contribute their own funds to the plan;[1] no deduction is allowed for these contributions (except to the extent that tax excludable contributions made in connection with salary reduction plans, described below, may be viewed as employee contributions). However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.[2]

In the case of a salary reduction plan, however, in the past employees have been permitted to exclude from income amounts contributed by

[1] Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation. I.R.S. Publication 778, p. 14 (Feb. 1972).

[2] At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person; no deduction was allowed for half of the contribution (the half regarded as "contributed by" the self-employed person). This limitation (sec. 404(a)(10)) was repealed for taxable years after December 31, 1967.

their employers to a pension or profit-sharing plan, even where the source of these amounts is the employees' agreement to take salary reductions or forego salary increases. If the plan met certain nondiscrimination requirements, the Internal Revenue Service in the past had taken the position in a few private rulings that, under certain circumstances, the amount of the salary reduction would be treated as an employer contribution to a qualified pension plan, not taxable to the employee (until benefits were received from the plan). The maximum amount that could be so treated generally was 6 percent of compensation.[3]

On December 6, 1972, the Service issued proposed regulations (37 Fed. Reg. 25938) which would change this result in the case of qualified pension plans by providing that amounts contributed by an employer to such a plan in return for a reduction in the employee's total compensation, or in lieu of an increase in such compensation, will be considered to have been contributed by the employee and consequently will be taxable income to the employee.[4] Public hearings have been held on these proposed regulations but regulations in final form have not yet been issued.

The Senate bill (H.R. 4200)

In general.—Under the Senate bill, any individual who was not covered during a year as an active participant in a qualified retirement plan, or a government plan (whether or not qualified), or a section 403(b) annuity plan,[5] is to be permitted a deduction of $1,000 a year from earned income, or (if greater) 15 percent of earned income up to $1,500, for contributions to a personal retirement account. The bill provides that the deduction in this case is to be from gross income, and as a result can be taken even by those taxpayers who also take the standard deduction. Earnings on these contributions would also be tax free (until actually distributed to the employee as benefits from the account).

In the case of a married couple, each spouse may establish his or her separate retirement savings account and the $1,000 (or 15 percent-$1,500) limitation is to be applied separately to the earned income of each spouse. For this purpose, earned income is to be determined without regard to State community property laws.

Under the bill, the employee can establish his own retirement savings account, or the retirement savings can be made through the medium of contributions by an employer (either in the form of additional compensation provided by the employer or a salary reduction plan) if there is no qualified, government, or section 403(b) plan in which the employee in question is an active participant.

Where individual retirement accounts are set up by the employer, the aggregate tax excludable contributions and tax deductible contributions by the employee (which are to be accounted for separately

[3] In the case of employees of tax-exempt charitable, educational, religious, etc., organizations and employees of public educational institutions, a specific statutory provision provides for employer contributions of up to 20 percent of compensation, times years of service, reduced by amounts previously contributed by the employer for annuity contracts on a tax excluded basis to the employee (sec. 403(b)). The regulations under the statute allow the employer contributions to be made under these salary reduction plans. Antidiscrimination provisions that apply generally to qualified plans do not apply to those tax sheltered annuities. The Senate bill does not affect the tax treatment of these contributions.

[4] The proposed regulations would not affect the tax treatment of contributions to certain qualified profit sharing plans, where the contributed amounts are distributable only after a period of deferment: however it was indicated that there would be reconsideration of the rulings permitting exclusion of such profit sharing contributions. (Rev. Rul. 56-497, 1956-2 C.B. 284: Rev. Rul. 63-180, 1963-2 D.B. 189: Rev. Rul. 68-89, 1968-1 C.B. 402.)

[5] If contributions were made on behalf of an individual under a plan during the taxable year, he would generally be considered an active participant for that year.

in the records of the account) are not to exceed $1,000 per year.[6] Of course, all benefits under the salary reduction plan are to be immediately vested, since the contributions, in effect, either represent compensation to the employee or come from his own funds.

Requirements for an individual retirement account.—If an individual wishes to establish an individual retirement account, the trustee of the account would have to maintain, under the provisions of a written governing instrument, a separate accounting of the individual's contributions, the earnings on them, and the distributions made either to the individual involved or to his beneficiaries. The balance in the account could, for example, be invested in insurance annuity contracts, in a common trust fund managed by a bank, in a savings account with a savings and loan institution or a credit union, or in stock of a mutual fund. However, in any case, the funds must be held by a bank or other person who establishes to the satisfaction of the Service that the manner in which it will hold the balance in the account is consistent with the intention of the new provision. The funds might be held in a trust, a custodial account, an annuity contract, or any similar arrangement approved by the Secretary of the Treasury.

The bill also contains a number of other provisions designed to ensure that the accounts will be used for retirement savings, many of which are similar to requirements which are already in the law with respect to H.R. 10 plans.

For example, the written governing instrument is to provide that no contributions in excess of the deductible limit can be made to the plan. Any excess contributions inadvertently made would have to be refunded to the individual with interest within 6 months after notice of the excess contribution was sent by the Internal Revenue Service. If the excess contributions were not repaid, the account would be disqualified for that year and all succeeding taxable years. In this case, the individual would also be required to take into income the assets of the account (valued as of the first day of the taxable year in which the account became disqualified), reduced by any contributions in the account for the current year (for which deductions are denied).

In addition to the rules on excess contributions, the written instrument is also required to provide that no distributions can be made to the individual prior to age 59½, except in the event of death or disability. On the other hand, under the bill, the plan is required to begin distributions not later than the year during which the individual attains the age of 70½, and distributions then have to be made at least on a ratable basis over the remaining lifetime (or period of life expectancy) of the individual, or of the individual and his spouse. After age 70½, an excise tax of 10 percent a year is imposed on the proportion of the individual's account that represents the amount that should have been (but was not) distributed. Also, under the bill, no tax deductible contributions could be made to the account during or after the taxable year during which the individual attains the age of 70½.

If the individual establsihing the account dies before his entire interest in the account has been distributed to him, the governing instrument is generally to require that the undistributed assets be

[6] Any amount deductible or excludable under these provisions is not to be considered to be part of the employee's investment in the contract for purposes of computing the taxable part of the distribution, since all of the contributions would be made, in effect, with tax-free dollars. If contributions in excess of these limits are made, the employer is not to receive a deduction for the excess contribution, and all excess would have to be repaid to the employer.

distributed, or be applied to the purchase of an annuity for his beneficiaries, within 5 years after his death. However, this rule does not apply if distributions began prior to his death, and the account was to be completely distributed over a period not exceeding the life expectancy of the individual and his spouse (measured as of the time when distributions from the account began).

In addition, if the assets of the account are invested in an insurance contract, the governing instrument must provide that any refunds of premiums are to be held by the insurance company and applied toward the payment of future premiums or the purchase of additional benefits within the current taxable year or the next succeeding year.

Premature distributions.—Premature distributions frustrate the intention of saving for retirement, and the bill, to prevent this from happening, imposes a penalty tax. If a premature distribution from the account is made before the individual attains the age of 59½, the distribution is subjected to a penalty tax of 30 percent of the amount of the taxable distribution.[7] This is in addition to any other income taxes payable on this distribution, and would not be offset by any tax credits. Also, this tax would not be treated as reducing the individual's tax liability under the minimum tax provisions (sec. 56).

The penalty tax is not to apply in the event of distribution due to death or disability.

To permit flexibility with respect to the investment of an individual retirement account, the bill provides that money or property may be distributed from an individual retirement account, without payment of tax, if the same amount is reinvested by the individual within 60 days in another qualifying individual retirement account.

Taxation of beneficiaries.—Generally, the proceeds of an individual retirement account are to be taxable to the individual when distributed. Since the contributions to the account will be made with tax free dollars, the employee's basis in the account will be zero.

The amounts distributed to the individual are not to be eligible for capital gains treatment, and the special averaging rules applicable to lump sum distributions (under sec. 72) are not to be available. However, the individual would be permitted to use the general averaging rules (sec. 1301).

If any individual borrows money, pledging his interest in the retirement account as security, the portion pledged as security is to be treated as a distribution from the retirement account to the individual. Any contribution to an individual retirement account, or any income of the account, applied to the purchase of current life insurance protection under any retirement income, endowment, or other life insurance contract also will constitute income to the individual.

For purposes of the estate and gift taxes the amounts in individual retirement accounts are not to be excluded from tax (secs. 2039(c) and 2517).

Other rules.—Under present law, if an asset of an individual is transferred pursuant to a divorce settlement, the individual is deemed to realize gain on the difference between his basis in the asset and its fair market value at the time of the transfer (if the asset has appreciated). Under the bill, if an individual retirement account is transferred

[7] The distribution would not, however, be subject to the penalty provided under section 72(m)(5) for premature distributions to owner-employees.

to the individual's spouse pursuant to a divorce decree, or settlement agreement, this transfer is not to be taxable under the bill.

Qualified retirement bonds.—In addition to the various types of investment described above in which an individual retirement account can be placed, the bill also provides that these amounts may be invested annually in retirement bonds to be issued by the Government. The bonds are to be issued under the Second Liberty Bond Act and provide for the accumulation of interest until the time of redemption. In conformity with the general provisions for individual retirement accounts, the bill provides that the bonds generally can be cashed only after the individual has reached the age of 59½ years, or if he becomes disabled or dies before that age.[8]

Consistent with the general rules for individual retirement accounts, the bill provides that the bonds are to cease to bear interest when the individual reaches age 70½. In addition, during that year the individual is also required to take any of these bonds he is still holding into income, even if he does not cash them in.

Also the bill provides that bonds are to cease to bear interest not later than five years after the death of the individual in whose name the bonds have been issued.

The bonds are to be issued in the name of the individual who purchases them for his retirement and are not to be transferrable, under any circumstances, except to his executor in the event of his death (or to a trustee for his benefit in the event he became incompetent to manage his own affairs). For example, the bonds could not be pledged for the payment of debts, and could not be assigned to a trustee in bankruptcy. Also, the bonds could not be awarded to the individual's spouse as the result of a divorce settlement.

When the bonds are redeemed, the full proceeds of the bonds, including any interest earned on them, is to be treated as ordinary income to the individual, whose basis in the bonds would be zero. However, if the individual chose to do so, he could treat this income under the general averaging provisions of the tax law (sec. 1301 et seq.).

Salary reduction and cash or deferred profit-sharing plans.—As discussed above, until recently, the Internal Revenue Service had taken the position that amounts contributed to a qualified retirement plan on a salary-reduction basis could, under certain conditions be considered as tax excludable employer contributions to the plan. Under the bill, this treatment is continued with respect to contributions to a qualified pension or profit-sharing plan made prior to January 1, 1974. Thereafter, as is already true under present law in the case of employee contributions under the Federal Civil Service Retirement Plan or similar government plans, contributions which are really employee contributions (whether required to be made or made at the individual option of the employee in return for a reduction in his compensation, or in lieu of an increase in such compensation) are to be treated as such and will no longer be excludable from income by the employee. The only modification in this rule is that where an individual is not covered by a qualified plan, a government plan, or a sec. 403(b) annuity plan, employer contributions of up to $1,000 per annum can be made to an individual retirement account under a salary reduction arrange-

[8] Such a bond could be redeemed within 12 months after issuance, but no interest is payable if it is redeemed in that period.

ment. Income earned on amounts contributed under a salary reduction plan prior to 1974 would for the future remain tax exempt as also would the earnings of these amounts.

Section 403(b) annuity plans.—Under present law, the proceeds of a section 403(b) annuity plan, for the benefit of teachers or employees of tax-exempt organizations, may be invested only in insurance contracts. The Senate bill provides that the assets of these accounts may also be invested in mutual funds, under appropriate custodial restrictions.

Effective date.—These provisions will apply with respect to taxable years beginning after December 31, 1973.

XII. LIMITATION ON CONTRIBUTIONS

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

Present law

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

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

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

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

In the case of pension plans, the amount of the contribution that is deductible is not to exceed 5 percent of the compensation to employees covered under the plan, plus the amount of the contribution in excess of 5 percent of compensation to the extent necessary to fund normal pension costs and remaining past service costs of all employees under

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

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

the plan as a level amount or as a level percent of compensation. In the alternative, the taxpayer may compute the limit on his deductible contributions by limiting his deduction to his normal cost for the plan plus 10 percent of the past service cost of the plan (sec. 404(a)). In practice, these limitations have very little effect in limiting contributions to regular corporate pension plans.

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

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

Professional corporations.—Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. Consequently, their contributions to retirement plans were limited by the rules governing self-employed persons. In recent years, however, all States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate employees. The Treasury Department, in the so-called Kintner regulations, held that professional corporations were not taxable as corporations. A number of court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

The Senate bill (H.R. 4200)

H.R. 10 plans.—The Senate bill increases the maximum deductible contribution on behalf of self-employed persons to the lesser of $7,500 or 15 percent of earned income. (A similar, although not identical, rule is applied in the case of defined benefit pension plans.) However, no more than the first $100,000 of earned income may be taken into account in applying the percentage limits. The $100,000 ceiling on the earned income rate base means that a self-employed person with more than $100,000 income will have to contribute at a rate of at least 7½ percent on behalf of his employees if he wishes to take the full $7,500 deduction on his own behalf (in order to comply with the antidiscrimination requirements.)[3] The Senate bill also contains a

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

minimum as to the amount self-employed individuals may set aside each year as a deductible contribution to a pension plan even though it exceeds the otherwise applicable percentage limitation. Each year a self-employed individual may set aside as a deductible contribution up to $750 out of his earned income even though this exceeds 15 percent of his earned income.

Also, the Senate bill contains a formula which would allow the self-employed, in effect, to translate the 15 percent–$7,500 limitation on contributions, to which they would otherwise be subject, into limitations on benefits which they could receive under a defined benefit plan.

Under the formula, the basic benefit for the employee (in terms of a straight life annuity commencing at the later of age 65 or 5 years from the time the participant's current period of participation began, with no ancillary benefits) is not to exceed the amount of the employee's compensation which is covered under the plan (up to a maximum of $50,000)[4] times the percentage shown on the following table.

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

The percentages in early years are higher to reflect the fact that contributions made during these time periods earn interest for a longer period prior to retirement than contributions made in later years.

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

The benefit would be computed as follows:

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

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

In addition, the Senate bill contains a provision generally limiting the annual benefits which can be paid out under defined benefit plans to 100 percent of the participant's average compensation from the employer during his highest 3 consecutive years of earnings adjusted for changes in the cost of living.

[4] For purposes of the antidiscrimination rules, the maximum amount of compensation which is to be taken into account is $100,000.

Another provision of the Senate bill would allow self-employed individuals, in effect, to pool their contribution limitations. In effect, a plan could provide that the senior partners in a law firm could accrue more than their share of retirement benefits, if the more junior partners accrued less than their share, the benefits do not result in prohibited discrimination, and the overall contribution limits were met. In such a case, however, the 75-percent—$100,000 limit on corporate plan benefits (described below) would also apply.

Contributions by self-employed persons (and other cash basis taxpayers) would be deductible, under the Senate bill, if they were made at any time up to the point when the Federal income tax return for the year in question is due (whereas, under present law, the contributions must be made by the end of the taxable year). Also, the Senate bill would permit owner-employees to withdraw their voluntary contribution to a self-employed plan prior to retirement, without penalty, whereas, under present law, this may not be done by owner-employees (although it may be done by other participants).

Corporate plans.—The Senate bill imposes limitations on the contributions which may be made or the benefits which may be paid under qualified corporate plans for all employees.[5]

Under the Senate provisions, in the case of a defined benefit plan, no deduction is allowable for contributions in excess of those necessary to fund (from employer contributions and the earnings thereform), a basic benefit in the form of a straight-life annuity commencing at age 65 (with no ancillory benefits), in excess of 75 percent of the participant's average high-three year compensation from the employer, not in excess of the first $100,000 per year. In other words, the basic pension benefit from employer contributions cannot exceed $75,000 per year. (To the extent that employee contributions are made the $75,000 limit could be exceeded.) This benefit would have to be funded over at least a 10-year period and in the case of employees who participated in the plan for less than 10 years, the maximum permissible benefit would be scaled down proportionately.

In the case of a defined contribution plan (a money purchase pension, profitsharing, or stock bonus plan), the corporation would be permitted to make deductible contributions sufficient to fund for the employee a pension on this same 75 percent of average high-three year pay basis. For example, if an employee had an average high three years salary of $50,000, this figure would be multiplied by 75 percent ($37,500) to determine the maximum amount of pension the employee would be entitled to receive. The amount of contributions needed to fund this size pension would then be computed. First, the amount of the pension would be multiplied by a conversion factor of 10 (in the case of a basic benefit commencing at age 65) to determine the total funding which will be needed to provide the pension at age 65 ($375,-

[5] The bill as reported by the Senate Finance Committee would, in general, have made certain corporations, those having "proprietary employees," subject to essentially the same rules and limitations on contributions which are imposed under the tax law on H.R. 10 plans. In general, a "proprietary employee" would be any individual owning at least 2 percent of the voting stock or total stock in the corporation, where all proprietary employees who are active participants, as a class, had at least 25 percent of the value of the accrued benefits under the plan. The philosophy of this provision was that corporate plans which came within this description resembled self-employed plans more closely in essential respects than other types of corporate plans, thus justifying a distinction in the type of tax treatment to be afforded. On the Senate floor, however, these distinctions between different types of corporate plans were eliminated, and instead, a provision was adopted imposing certain limitations on all corporate plans.

000). Second, from this amount ($375,000) will be subtracted any amounts already contributed by the employer on behalf of the employee (together with the past earnings on these contributions and the assumed interest which will be earned in future years on these contributions before the employee's retirement). The difference between these two amounts is called the "unfunded limitation balance" and (subject to certain other limitations imposed under present law) the employer may deduct contributions which, together with 6-percent earnings on these contributions, will be sufficient to build up to a $375,000 balance by the time the employee reaches normal retirement age.

If the corporation has both a defined benefit plan and a defined contribution plan, the maximum benefit payable under the defined benefit plan would have to be reduced in proportion to the amount of the benefit which was funded through the defined contribution plan.

Subchapter S corporations.—Under present law (sec. 1379 of the Code), as described above, shareholder employees of subchapter S corporations are subject to contribution limitations which are very similar to the limitations imposed on self-employed individuals. Under the Senate bill, these provisions would be repealed, and subchapter S corporations would be subject to the same limitations as other corporations.

Money purchase plans.—The Senate bill contains a provision that tax excludable contributions to a money purchase plan cannot exceed 20 percent of the employee's compensation. Any additional contributions on behalf of the employee must be included in income by him.

Any amount included in gross income under this provision would be considered as part of the employee's investment in the contract for purposes of computing the taxable amount of a distribution from the plan to the employee. However, these contributions would be considered to be made by the employer for purposes of qualification of the plan. If the employee's rights under the plan should terminate before tax excludable payments under the plan equaled the amounts included in gross income under this provision, a tax deduction would be allowed equal to the unrecovered contributions.

Custodial accounts.—Under present law, a custodial account may be treated as a qualified trust, but only if the custodian is a bank, and the investments are made solely in the stock of regulated investment companies, or solely in annuity, endowment, or life insurance contracts (and certain other conditions are met) (sec. 401(f)). The Senate bill would allow the custodian of the account to be someone other than a bank; however, the custodian would have to establish, to the satisfaction of the Internal Revenue Service, that it would manage the assets of the account in a manner consistent with the intention of the tax law. Also, the Senate bill would provide that someone other than the trustee or custodian, including the employer, can have authority to control the investments of the plan account, either by directing the investment policy of the plan, or by exercising a veto power.

Effective date.—Generally, these provisions will take effect in years beginning after December 31, 1973.

XIII. LUMP-SUM DISTRIBUTIONS

(Sec. 703 of the Senate bill and secs. 72, 402, and 403 of the Code)

Present law

Retirement benefits generally are taxed under the annuity rules (sec. 72) as ordinary income when the amounts are distributed, to the extent they do not represent a recovery of the amounts contributed by the employee. However, an exception to this general rule under the law in effect before the Tax Reform Act of 1969 provided that if an employee's total accrued benefits were distributed or paid from a qualified plan within one taxable year on account of death or other separation from service (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than as ordinary income.

The capital gains treatment accorded these lump-sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than other compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of $50,000, particularly in view of the fact that a number of lump-sum distributions of over $800,000 have been made.

To correct this problem, the Tax Reform Act of 1969 provided that part of a lump-sum distribution received from a qualified employee's trust within one taxable year on account of death or other separation from service (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. The ordinary income treatment applies to the taxable portion of the distribution (i.e., the total distribution less the employee's contribution) which exceeds the sum of (a) the benefits accrued during plan years beginning before 1970, and (b) the portion of the benefits accrued thereafter which does not consist of employer contributions (sec. 402(a)(5) and 403(a)(2)(c)).

The 1969 Act provided a special limitation in the form of a seven-year "forward" averaging formula which applies to the portion of the lump-sum distribution treated as ordinary income. An employee (or beneficiary) is eligible for the special 7-year forward averaging provision if the distribution is made on account of death or other separation from service (or death after separation from service) [1] and, in the case of receipt by an employee, if he has been a participant in the plan for 5 or more taxable years before the taxable year in which the distribution is made.

The Senate bill (H.R. 4200)

The Senate bill substitutes for the computational procedure provided under the 1969 Act a new procedure designed to simplify the calculations required to determine the tax while preserving revenues at at least as high a level as they would be under the proposed regulations.

Under the Senate bill the portion of the distribution attributable to post-1973 value, in excess of the employee's own contributions, is to be taxed as ordinary income, but the tax is to be determined separately from any other income which he may have and is to be eligible for 15-

[1] Self-employed taxpayers, on the other hand, continue to be eligible for their special 5-year forward averaging only on lump-sum distributions received on account of death, disability as defined in sec. 72(m)(7) of the Code, or if received after age 59½ and, in the case of receipt by an employee, after at least 5 years of participation.

year averaging. The portion of the contribution attributable to pre-1974 value is to receive capital gains treatment and is to be included with the taxpayer's other income in determining his tax liability for the year of the distribution.

In computing the ordinary income element on the post-1973 value, a special minimum distribution allowance is to be provided to give assurance that the tax on relatively small lump-sum distributions will not be appreciably more than under present law. This allowance is half of the distribution up to $20,000. Above that level, it is phased out on a $1.00 for $5.00 basis with the result that it is entirely eliminated for distributions of $70,000 or more.

In determining the proportion of a distribution attributable to pre-1974 value (and, therefore, eligible for capital gains treatment) and the portion attributable to post-1973 treatment (and therefore treated as ordinary income but with 15-year averaging), the bill provides that the allocation is to be made on the basis of the amount of time in which the employee was covered by the plan before 1974 and after 1973.

In order to treat all distributees the same, all computations of tax on the 15-year averaging ordinary income portion are to be made on the basis of the tax schedule for unmarried individuals.[2] For this purpose, community property laws are to be ignored, and as a result, a distributee in a community property State is to compute his tax on the basis of the entire amount of the distribution.

The bill provides that where the distributee accrued part of the value of his lump-sum distribution as a regular corporate employee and part as a self-employed individual, the 5-year averaging available for self-employed individuals is to be used for the entire distribution if the number of years while he was covered as a self-employed individual exceeds 50 percent of the total time he was a participant in the plan. Otherwise, the 15-year averaging rule is to apply to the entire amount.

To protect against possible tax avoidance possibilities the bill provides that distributions made during the previous five years are to be included in the 15-year averaging computation for purposes of determining the tax on the last distribution. When the total tax is determined, however, the amount of tax liability on any earlier distributions is to be subtracted and the tax on the final distribution is to be the remainder. All distributions made within the prior five years to the same distributee are to be subject to this 5-year lookback rule.[3]

The computation of the ordinary income element in the lump-sum distribution is to take into account any annuity purchased for the distributee in the year of distribution (or in the prior five years where the lookback provision applies). The value included for purposes of the annuity is its cash surrender value. Although the value of the annuity is included for purposes of determining the tax on the remainder, its value is not taxed as a part of the lump-sum distribution.

No changes are made with respect to the basic tax treatment of distributions of employer securities.

---

[2] Distributees in computing the tax on their other income (including the capital gain element of the distribution) may use any appropriate tax schedule. They may also use, when appropriate, the regular 5-year averaging method for the tax on this other income.

[3] For this purpose, the five years is to be measured from the time the distribution is reported to the Insurance Corporation for purposes of the plan termination insurance provisions described above.