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New Pension Laws: Problems or Solutions?

By Sarah C. Dawkins and Nancy G. Boyd

Introduction

The Pension Reform Act of 1987 amended the Internal Revenue Code of 1986 and Title I of the Employee Retirement Income Security Act (ERISA) of 1974 with regard to pension integration, participation, and requirements for vesting. The Financial Accounting Standards Board (FASB) has also been active in determining how pensions should be treated. The FASB has released Statement of Financial Accounting Standards No 87 which took effect in 1989. (This topic is covered in another article in this issue.)The new tax law will have far-reaching effects in the business world as it will affect all accrued pension benefits existing in the year 1989 and thereafter.

Background

The Tax Reform Act of 1986 changed certain stipulations involving pensions. The most important change was to shorten the vesting period - the time required for employees to be on the job before they are entitled to pension benefits - from 10 years to 5 years. This was viewed as a way to provide greater retirement security.

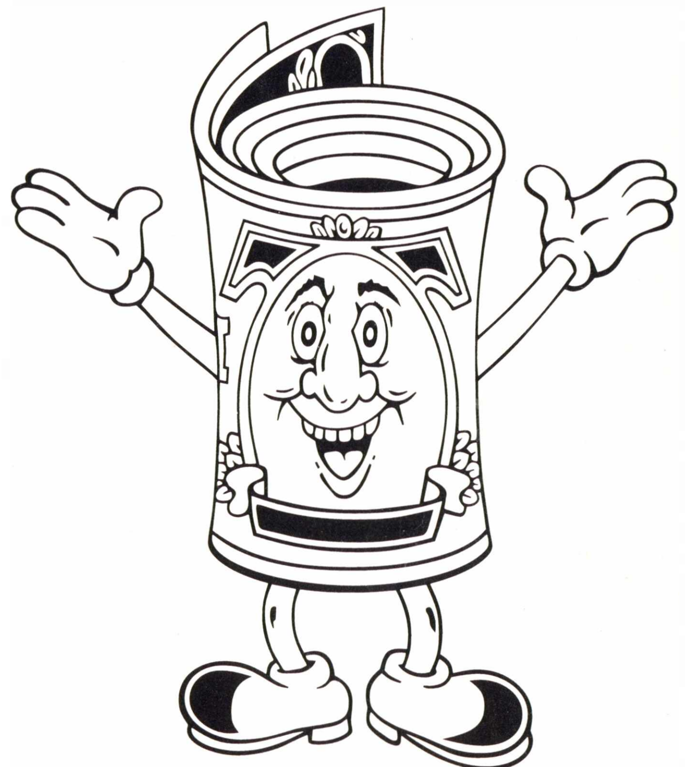
Starting in 1987, any early withdrawals from all types of retirement plans are subject to a 10% penalty.

In 1974, ERISA had set forth three alternative schedules for the vesting of employees' accrued benefits. One alternative gave a graduated step vesting that started with 25 percent vesting after five years of service and increased at 5 to 10 percent thereafter, so that employees' accrued benefits would be 100 percent vested after 15 years. Another schedule allowed 100 percent vesting of accrued benefits after ten years of service, and the third alternative is referred to as the "rule of 45." This alternative accrued benefits of an employee with 5 or more years of service and provided for 50 percent vesting when the sum of a person's age and service equal 45, with 10 percent additional vesting for each year of service.

The 1986 Tax Reform Act changed the time required for vesting under the second alternative from 10 to 5 years. Previously, under the ERISA's second option, unless an employee stayed on the same job for 10 years, the employee was not vested in the pension plan. The person would have nothing to look forward to in terms of pension benefits. Under the new law, if an employee is on the job when the new vesting rules go into effect, the employee gets full credit for the number of years already worked [Tax Reform, p. 14].

In addition, after 1986, employers can offer employees two options with regard to compensation. The first option is to receive all compensation in cash. The second option is for the employee to contribute up to a maximum of $7,000 of compensation to a simplified employee pension. The $7,000 limit applies to all elective deferrals by an individual under all cash or deferred arrangements in the individual's tax year. Any monies put into the simplified employee pension are not taxed until withdrawn after age 59½. If withdrawn before that time, there is a 10% penalty.

The Tax Reform Act of 1986 also brought changes in the area of who qualifies for the pension plan. Prior to the



Because lump-sum payments and cashouts reduce retirement benefits, Congress is investigating ways to make pensions portable.

law, employers could ignore making contributions for employees who earned low wages, as long as the contribution plan was coordinated with Social Security. Under the Tax Reform Act of 1986, the employer is specifically prohibited from discriminating in favor of employees who are highly paid, or shareholders, or officers. Now, if a plan exists, all employees will receive some retirement benefits provided by the employer in addition to the benefits received under Social Security.

The Tax Reform Act of 1986 changed the penalty associated with withdrawals from a retirement plan. Prior regulations permitted withdrawals and only regulated that these withdrawals would be taxable. However, no penalty was imposed if the use of the funds was for personal reasons. Starting in 1987, any early withdrawals from all types of retirement plans are subject to a 10% penalty. Exceptions to the 10% penalty are when there are rollovers from IRA's and other plans, life annuities, early retirement, or certain cases of hardship.

The latest bill concerning pensions, the Pension Reform Act of 1987, has opened up the issue of pensions even more than was done by the Tax Reform Act of 1986. As a result of the Pension Reform Act of 1987, several bills have been introduced that address the issue of portability of pensions.

Pending Legislation

In the past, when an employee quit a job, the employee could receive a lump-sum payment for the vested pension amount. The result was, more often than not, a case where the employee spent the money rather than re-investing it in a pension-type retirement plan. Consequently, when that employee is ready to retire, the amount of funds available for retirement will have been reduced by the amount of money received in the lump-sum payments [Geisel, p. 1]. Currently, 81% of defined contribution retirement plans pay out a lump sum when an employee terminates his employment. In addition, 39% of the plans have a provision for a cashout of the plan [Bodnar, p. 9]. The future stream of retirement benefits to supplement social security benefits is interrupted anytime a lump-sum payment or cashout is allowed.

Because lump-sum payments and cashouts reduce retirement benefits, Congress is investigating ways to make pensions portable. One such bill establishes guidelines for employees who leave one job and go to another before retirement age. The bill proposes that an employee would transfer accumulated pension funds to the next employer's defined contribution plan or to an Individual Retirement Account. In either case, the funds would remain invested until retirement age. Another option would be for the employee to leave the funds in the pension plan of the former employer. Basically, the bill prohibits any lump-sum distributions before retirement from a pension plan except in cases of death, disability, medical care expenses, or to invest in a plan for employee stock ownership [Geisel, p. 37].

Another recent pension bill, the Pension Portability Act of 1987, proposes to have employees transfer pension plan distributions to outside accounts under the control of asset managers, banks, and insurance companies. Companies would offer workers various plans that would be administered by asset managers who would deal with reporting requirements and red tape. Under this proposal, all sizes of companies would benefit, especially smaller companies who could provide retirement benefits without the large expense of administrative costs [Perlman, p. 10].

One problem for employers under the proposed bills is information dissemination.

Current Problems

Many companies have opted to cash out their pension plans rather than continue to administer them. A company can opt to terminate a plan that requires that the plan assets be used for the exclusive benefit of the plan participant and beneficiaries. In this way, a company can eliminate the problems of dealing with the pension plan and at the same time recapture plan assets that were not available as long as the plan remained in force. This has been a growing problem in the area of pensions. Terminations of 1,100 defined benefit pension plans have occurred since 1980, and almost 1.5 million participants are no longer covered. Meanwhile, the termination of these 1,100 plans has provided the companies with $12 billion in surplus assets. When a plan is terminated, the company is required to provide for benefits accumulated up to that point by everyone who is covered by the plan. The plan stops and the pension benefits accumulated to date provide the employee with a fixed pension rather than one that can continue to grow and be adjusted for higher salary bases and cost-of-living increases [Hodge, p. 50].

Employers will be responsible for taking care of the transfer of funds from their plan to another employer's plan when an employee changes jobs.

The Pension Assets Protection Act of 1987 has been introduced into Congress. Its aim is to prohibit the recapture of excess pension assets from terminated defined benefit pension plans. The act would do away with the loop-hole that now exists for corporations who want to get their hands on excess assets and in the process, eliminate pension plans for their employees [Perlman, p. 11].

Pros and Cons

The main argument for the bill to prohibit lump-sum payments prior to retirement is that it ensures a more

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secure retirement future for employees in that the stream of pension savings is not interrupted or destroyed. When a worker retires, there is money available to help meet needs. To provide employees with greater security for the future is the biggest argument in favor of the new pension bills.

One problem for employers under the proposed bills is information dissemination. In 1974, the Employee Retirement Income Security Act (ERISA) required employers to tell their employees about their benefit status. However, the Department of Labor has never established rules that ensure this information is passed on to employees. In a study conducted by the General Accounting Office, 82% of the workers questioned were in error about when they qualified for their retirement benefits. In addition, one-half of the summary sheets supplied to workers about their pension plans contained incorrect data [When, p. 1]. If this problem of mis-information on pensions has existed since 9174, the explanation of the new pension options to employees may never be accomplished unless some penalty is imposed.

In addition to disseminating correct information, employers will be responsible for taking care of the transfer of funds from their plan to another employer's plan when an employee changes jobs. The amount of red tape involved in accomplishing this goal is seen by employers as an unreasonable burden to assume in an area where there is already confusion.

Employers are not the only opponents of the pending legislation. There are pension experts who are opposed to the new pension bills and the requirements to transfer lump-sum payments to other pension plans. These individuals feel that employees may not contribute to pension plans if withdrawals cannot be made before retirement. The general feeling is that the overall employee savings rate will be reduced [Geisel, p. 37].

Future Trends

As a result of the recent advent of numerous pension bills in the Congress, the area of pension fund investment is being explored for new opportunities. If the portability features requiring employees to transfer their accrued pension benefits from one employer to another, rather than spending them, is enacted into law, a larger amount of pension funds will be available for investment than ever before.

One of the areas that is already being explored as an arena for investment of pension funds is investment firms which are minority owned. Public pension plans are being considered to see if they have affirmative action plans. These plans mean committing funds to minority owned investment firms. Although there are not many, they are growing in number. To get pension fund business, minority firms are teaming up with larger, more established money management firms. Pension plans which have invested funds in minority investment firms include the Florida state pension plan and the District of Columbia's Retirement Board. Once these firms gain experience, pension funds will be looking more closely at them as an avenue for investment of their increasing balances [Crossen, p. 27].

Over the past several years, pension coverage of employees has been decreasing because many employers have come to see pension plans as a cost rather than a benefit, or as a source of additional capital in times of financial stress.

Summary

Pension plans are a fringe benefit of employment. The new pension laws being proposed in Congress are aimed at protecting this employee benefit. Over the past several years, pension coverage of employees has been decreasing because many employers have come to see pension plans as a cost rather than a benefit, or as a source of additional capital in times of financial stress. In order to provide the employee with a more secure retirement future, the new laws seek to protect pension benefits, not only from dilution by employers, but also from dilution by employees themselves who change jobs periodically without providing for continued pension coverage. Requiring lump-sum pension payments to be transferred to the new employer will ensure the employee of a stable retirement fund to supplement social security when the employee is ready to retire.

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