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Norman: Private Pensions: A Study of Vesting, Fudning, and Integration

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PRIVATE PENSIONS: A STUDY OF VESTING, FUNDING, AND INTEGRATION*

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INTRODUCTION

A major storm is developing in the field of private pensions. Problems that have been accumulating with the rapid growth of the private retirement systems have been brought to public attention by several notable plan failures, abuses of plan management by both union and employer trustees, and the searching analysis given the private pension system by the President's Committee on Corporate Pension Funds, completed in January 1965.[1] Congressional hearings, administrative review, and private comment foretell of sweeping legislative revision of the private pension system. The purpose of this study will be to examine vesting, funding, and integration with Social Security in the light of these current trends toward regulation of private retirement.

A number of causes have contributed to the creation of a system of private retirement. Public policy has encouraged pension plans and protected them through tax laws, labor relations statutes, standards of fiduciary obligations of trustees, and more recently, through specifically designed legislation requiring public disclosure of various aspects of retirement and welfare plans.[2]

This study will emphasize the significance of tax law in the growth and regulation of the private retirement system. Tax legislation and administrative regulation have furnished the primary tools for governmental control over private pensions, as well as providing the incentive for expansion of the system by making it possible to provide these benefits at substantially lower cost.[3] The article will focus on pension plans, as distinguished from profit-sharing and stock-option plans and nonqualified deferred compensation

*A Table of Headings and Subheadings is appended at the end of this article.

**A.B. 1952, Rutgers University; J.D. 1955, LL.M. 1968, University of Miami; Member of The Florida Bar, The American Bar Association, and the Broward County Bar Association.

1. PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS (Jan. 29, 1965) [hereinafter cited as CABINET COMMITTEE REPORT].

2. *Id.* at vi-vii.

3. *Id.*

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arrangements. In order to illustrate the significance of proposed reforms for existing pension legislation, it is desirable to trace the development of the private retirement system.

Development of Private Retirement

The first private pension plan was established in the United States in 1875 by the American Express Company.[4] By 1940, retirement plans had grown to cover four million people.[5] During and since World War II pensions have become a major economic institution. Direct wage increases were limited under the wage stabilization policy in force during the war, and workers became more interested in pensions and other fringe benefits. Employers, who were subject to high rates of corporate and excess profits taxes, regarded such benefits as a relatively inexpensive way of holding their workers and attracting new personnel.[6]

There are many factors that have been responsible for the growth of the private retirement system and, while it would be difficult to choose a primary one, the following are considered to be among the leading causes:

(1) an increase in life expectancy from forty-seven years at the turn of the century to over seventy in the 1960's coupled with a decrease in working expectancy and a consequent increase in the number of years of nonworking old age;[7]

(2) movement of population from rural to urban areas and from agriculture to industry;

(3) the need for security brought about by the economic upheaval of the depression of the 1930's, which swept away the life savings of millions, leading to the establishment of the Old Age and Survivors Insurance program (OASI);[8]

(4) a desire on the part of workers for a higher standard of living continuing through retirement;

(5) the desire of employers to increase productivity and reduce turnover among employees;[9]

(6) inability of the average individual to provide post-retirement income by personal savings and investment, caused by progressive rates of taxation;

(7) the realization that group action could accomplish the goal of retirement security while the individual could not;[10] and

4. D. ROTHMAN, ESTABLISHING AND ADMINISTERING PENSION AND PROFIT-SHARING PLANS AND TRUST FUNDS 1 (1967).

5. P. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 6 (1959).

6. Holland, *Some Characteristics of Private Pension Plans*, 2 TAX REVISION COMPENDIUM 1301 (1959).

7. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 293 (1967).

8. D. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS 31 (1964).

9. *Id.* at 21-23.

10. Goldworn, *Pension Plans: Their Background, Current Trends, and an Agenda for Inquiry*, 25 OHIO ST. L.J. 234, 235 (1964).

(8) the tax and other inducements offered by the federal government.

The beginning of a favorable federal tax policy toward private retirement is found in the Revenue Act of 1921,[11] which provided an exemption from current taxation of income from a trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees. Without specific legislation, reasonable payments as pensions to retired employees or contributions to a trust for retirement purposes were deductible as an ordinary and necessary business expense if, together with other payments, they constituted reasonable compensation. The 1921 Act removing the income from profit-sharing or stock-bonus trusts was not accorded the same status by legislation until the Revenue Act of 1926,[12] although administratively pension trusts were treated in a like manner after 1921.[13] Income was taxed to the employees when distributed or made available.

Deductions for past service contributions were not authorized by the Revenue Act of 1921. Employers adopted the practice of carrying balance sheet reserves against their pension obligations, and credits to these reserves were not deductible to the employer. Increases in size and number of these reserves led to the enactment of a provision in the Revenue Act of 1928,[14] permitting a deduction for reasonable contributions to a trust in excess of current funding liabilities. Apportionment of contributions to fund past service credits was required over a. ten-year period in equal amounts. The ten-year restriction did not apply to plans funded through group annuities. Two "loopholes" permitted pension plans to lend themselves to tax avoidance schemes after 1928. A pension trust could qualify for favorable tax treatment if it was created for the exclusive benefit of some or all of the employees. This permitted plans established for the owners, officers, and key employees with current deductions available to the corporation and deferral of taxation to the participants. Secondly, a pension trust was not required to be irrevocable. This allowed an employer to make substantial contributions during high earning years and deductions against income tax and then recapture of the funds in poor years by revocation of the trust. Participants lost their pension expectations and the Government lost tax revenue through these devices.[15]

Such abuses led to the enactment of the "nondiversion rule" in the Revenue Act of 1938,[16] which required that it be impossible to divert any part of such trust funds to purposes other than the exclusive benefits of the employees at any time prior to the satisfaction of all liabilities. In short, an irrevocable trust was required. However, it was still possible to create a plan for only a few favored employees.

11. 42 Stat. 227 (1921).
12. 44 Stat. 9 (1926).
13. D. McGill, *supra* note 8, at 24.
14. 45 Stat. 791 (1928).
15. D. McGill, *supra* note 8, at 25.
16. 52 Stat. 447 (1938).

World War II brought a sharp increase in corporate income and excess profits taxes, together with wage stabilization policies and higher individual income taxes. Pension plans increased rapidly, and Congress responded with significant legislation in the Internal Revenue Code of 1942,[17] which became the forerunner of the present provisions in the Internal Revenue Code of 1954.[18] Capital gains treatment was afforded lump-sum distributions and more stringent requirements were imposed for qualification. Discrimination in favor of highly compensated employees was prohibited, irrevocable dedication of funds for retirement purposes was required, a limitation was placed upon annual contributions, and wider employee coverage was assured.

Organized labor became a vigorous proponent of the private pension system following a decision of the Supreme Court that a pension plan was a bargainable issue in *Inland Steel Co. v. NLRB*[19] in 1949. This accelerated the growth of private retirement, which began to cover large segments of the working force.

The growth of private pension plans and their funds after 1940 is set forth in Tables 1 and 2, covering industrial and governmental plans, respectively. Coverage under industrial plans has grown five-fold in less than a quarter of a century, and contributions have increased to twenty times their 1940 level. The number of beneficiaries and benefits has also grown, but, evidencing the youth of the pension structure, falls below coverage and contributions. Earnings and assets have increased considerably, demonstrating the development of private pensions from a small financial factor to a major institution in the market. Similar growth can be observed in governmental plans.

TABLE 1

Growth of Private Industrial Pension and Profit-Sharing Plans in the United States, 1940-1963[20]

	1940	1945	1950	1955	1960	1963
Covered workers (millions)	4.1	6.4	9.8	15.4	21.2	23.8
Contributions ($ billions)	0.3	1.0	2.1	3.8	5.5	6.2
Beneficiaries (millions)	0.2	0.3	0.5	1.0	1.8	2.5
Fund earnings ($ billions)	0.1	0.2	0.3	0.7	1.7	2.7
Fund assets ($ billions)	2.4	5.4	12.0	27.4	52.0	69.9
Annual change in fnnds ($ billions)	0.4	0.8	1.9	3.7	5.4	6.4

17. Int. Rev. Code of 1942, §162A.

18. INT. REV. CODE of 1954, §§401-04.

19. Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949). Profit-sharing plans were included in 1953 in NLRB v. Black-Clawson Co., 210 F.2d 523 (6th Cir. 1954).

20. D. HOLLAND, PRIVATE PENSION FUNDS: PROJECTED GROWTH 2 (1966).

TABLE 2
Growth of State and Local Government Employee Pension Plans, 1940-1962[21]

	1940	1945	1950	1955	1960	1965	1966
Covered workers (millions)	1.4	1.8	2.6	3.5	4.5	5.8	6.1
Contributions ($ billions)	0.3	0.4	0.9	1.7	2.9	4.2	4.7
Beneficiaries (millions)	0.2	0.2	0.3	0.4	0.7	0.9	1.0
Benefit payments ($ billions)	0.1	0.2	0.3	0.6	1.0	1.7	1.9
Fund assets ($ billions)	1.6	2.5	5.2	10.6	19.7	33.6	37.1

Phenominal growth continues in private pensions. Statistics released by the Institute of Life Insurance for 1965-1966, shown in Tables 3 and 4, indicating coverage and assets, emphasize the present size of public and private retirement.

TABLE 3
Persons covered by All Types of Pensions, 1965-1966 (in thousands)[22]

	Total		Retirees	
	1966	1965	1966	1965
All types of plans	38,619	37,320	4,443	4,163
Private	27,940	27,060	2,690	2,490
Insured	7,040	6,710	790	740
Noninsured (estimate)	20,900	20,350	1,900	1,750
Government administered	10,679	10,170	1,753	1,673

TABLE 4
Assets of All Types of Pensions, 1965-1966 (in billions)[23]

	1966	1965
All types of plans	$ 139.5	$ 126.5
Private	85.4	77.1
Insured	27.3	25.2
Noninsured	58.1	51.9
Government administered	54.1	49.4

In his message to Congress in February 1967, President Johnson called for additional control over private pensions. The President noted that more than 40 million workers were then covered by private pensions administering assets of $90 billion. The very size of the private retirement system was given as a reason to establish additional safeguards insuring its administration in the public interest.[24]

21. *Id.* at 3, as revised, INSTITUTE OF LIFE INSURANCE, PRIVATE AND PUBLIC PENSION PLANS IN THE UNITED STATES 16-17 (1967) and unpublished data.

22. Institute of Life Insurance, in 21 P-H PENSION & PROFIT-SHARING REP. No. 53, at 4 (Jan. 1967).

23. *Id.*

24. 113 CONG. REC. H 1407 (daily ed. Feb. 16, 1967).

Public Interest in Private Retirement

The American public is vitally interested in the private retirement system. Pension plans provide economic security for millions of workers and their families; they are a substantial factor in the national savings stream and money market; they affect labor mobility, incentives, and employment; and they are subsidized by favorable federal tax laws.[25]

In addition to the influence of federal taxation, the government's interest has grown apace with other aspects of private pensions. Both the Securities Act of 1933[26] and the Securities and Exchange Act of 1934[27] required pension trusts purchasing stock in employer corporations to file reports of such activities annually.

In 1947, as a beginning step toward basic standards, the Labor Management Relations Act[28] required a written pension agreement, irrevocable use of funds for benefit payments, and equal union-management representation in fund administration, with arbitration of disputes. In 1948, the National Labor Relations Board ruled that the Act imposed a duty on employers to bargain with representatives of their employees on the subject of pensions. After this decision was affirmed by a federal court in *Inland Steel* in 1949,[29] the collectively-bargained pension plan flowered as a part of the private retirement system.

With the continued growth of pension plans throughout the 1950's, legislation became necessary to protect participants. Congressional investigations disclosed looting and mishandling of pension funds, and the worst abuses concerned the following insurance practices: kickbacks in the form of exorbitant commissions to agents controlling a plan to achieve its adoption; excessive administration fees; discrimination between policyholders; and embezzlement of premiums, occasionally in a conspiracy with administrative officials.[30]

The Welfare and Pension Plans Disclosure Act of 1958[31] was the outgrowth of these studies. Congress considered the best way to prevent these abuses was complete disclosure and reporting to beneficiaries, participants, and the Secretary of Labor of financial and other information concerning the plans. However, only limited reporting was actually required, and the Act failed to provide necessary enforcement and investigative powers. Its effectiveness was to be determined by the fortuitous policing that might emanate from plan beneficiaries. Because of this lack of power, at least one-third of covered plans failed to file descriptions and reports.[32]

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25. CABINET COMMITTEE REPORT 11.
26. 48 Stat. 74 (1933).
27. 48 Stat. 881 (1934).
28. 61 Stat. 136, 157 (1947), 29 U.S.C. §186 (1964).
29. Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949); Inland Steel Co. v. United Steelworkers of America, 77 N.L.R.B. 4 (1947).
30. S. Rep. No. 1440, 85th Cong., 2d Sess. 3, 11 (1958).
31. 72 Stat. 997 (1958), 29 U.S.C. §§301-09 (1964).
32. Comment, *The Report of the President's Cabinet Committee on Private Pension Plan Regulation: An Appraisal*, 63 MICH. L. REV. 1258, 1260 (1965).

This early legislation was fortified by the Welfare and Pension Plans Disclosure Act Amendments of 1962, giving the Secretary of Labor authority to issue rules and regulations, conduct investigations, and secure injunctive compliance with the Act. Bonding of fiduciaries was required, and offering, accepting or soliciting bribes or kickbacks in connection with establishing a plan, embezzlement of funds, and knowingly making false reports were made federal offenses.[33] Although the Act was considerably strengthened by these amendments, it still remains primarily a device for gathering information.

Another tool for gathering information concerning union administered pension trusts was provided by the Labor-Management Reporting and Disclosure Act of 1959.[34] The provisions of this Act overlap in some measure those of the Welfare and Pension Plans Disclosure Act, although only concerning large union retirement plans. Annual reports regarding investments, employee benefits, and the like are required. The primary information-gathering device still remains the Welfare and Pension Plans Disclosure Act.

The regulation of the scope and operation of private retirement systems is found in the Internal Revenue Code and Regulations.[35] Although the threat of criminal prosecution provides a deterrent for pension abuses, the only effective enforcement lies in the power of the Internal Revenue Service to grant or disallow the "qualified" status of a pension plan. Qualification of a plan is generally desirable because of the tax advantages to both employer and employee.[36] The employers' contributions to the plan are not taxed to employees when made, but only upon distribution, and then are granted long-term capital gain treatment for certain lump sum distributions, or are taxed at annuity rates when the employees' income is usually lower.[37] Earnings accumulated by the pension plan remain free of tax until distributed.[38] Contributions are generally deductible as business expenses in the year in which they accrued or made.[39] On the other hand, employer contributions to nonqualified plans are only deductible when accrued or made to the extent that employee rights are vested, and these payments are then taxed to the employees.[40]

The requirements for qualification of a plan are minimal. General standards are set forth in section 401 (a) of the Internal Revenue Code of 1954 as follows: there must be a written contract, trust, or other binding instrument creating the plan, which must be a permanent program, communicated to the employees; the plan must be for the exclusive benefit of the employees or their beneficiaries, and it must be impossible to divert any part of the corpus or income to any other purpose before satisfaction of all liabilities;[41] the plan must benefit employees in general and not just a limited

33. 76 Stat. 35 (1962).
34. 73 Stat. 519 (1959), 29 U.S.C. §401 (1964).
35. INT. REV. CODE OF 1954, §§401-04, 501-04.
36. CABINET COMMITTEE REPORT 3.
37. INT. REV. CODE of 1954, §§402 (a) (1) (2), 403 (a) (1).
38. INT. REV. CODE of 1954, §501 (a).
39. INT. REV. CODE of 1954, §404 (a).
40. CABINET COMMITTEE REPORT 3.
41. INT. REV. CODE of 1954, §401 (a) (2).

number. To meet this last requirement, 80 per cent or more of all employees with five years of service must be included, in the event that 70 per cent or more of all employees are *eligible* for coverage, or, if less than the prescribed percentage are participants, the eligibility classification must not discriminate in favor of employees who are officers, shareholders, or supervisors. Once the plan is in effect, there must be no discrimination in favor of this latter group in eligibility, contributions, or benefits. Variations in contrbutions are permissible so long as the plan in its over-all operation does not discriminate in favor of the group mentioned. Contributions or benefits based on compensation excluded from the OASI wage base may differ from contributions or benefits within such wage base as long as the differences are offset by benefits available under Social Security on a percentage basis. Such a plan is considered *integrated* with OASI.[42]

The regulatory requirements of the Internal Revenue Code are concerned with plans being used solely for employees, that employees will receive the benefits from contributions, and that the tax incentives will not provide an opportunity for discriminatory bonanzas favoring managerial personnel or corporate shareholders. Policy decisions regarding benefits and administration, as well as investment of trust funds, have been left to the employer's discretion.

Report of the President's Committee

Pressures emanating from crosscurrents in private pensions, together with problems inherent in the size of an institution responsible for the welfare and financial stability of a major segment of the American population, led the President to appoint a committee on March 28, 1962, to review legislation and administrative practices relating to corporate pension funds and other private retirement and welfare programs. The committee was composed of Secretaries of Labor; Treasury; and Health, Education and Welfare, as well as the Director of the Budget; Chairman of the Council of Economic Advisors; Chairman of the Board of Governors of the Federal Reserve System; and the Chairman of the Securities and Exchange Commission – hence its name, the "Cabinet Committee." After submitting a preliminary report late in 1962 to the President's Labor-Management Advisory Committee, the final report was made public in January 1965.[43] The findings and recommendations of the committee have spearheaded government interest in widespread reform of many aspects of private retirement.

The report of the President's Cabinet Committee is summarized in topical outline fashion.[44] An understanding of its conclusions are necessary as background material for current efforts to solve any problems in private pensions.

The size of the private retirement system, emphasized by President Johnson as reason enough to provide regulatory legislation,[45] will increase rapidly

42. *See generally* E. WOOD, J. CERNY & H. RAFUSE, TAX ASPECTS OF DEFERRED COMPENSATION 12-36 (1965).

43. CABINET COMMITTEE REPORT.

44. *Id.* at vi-xvi.

45. 113 CONG. REC. H 1407 (daily ed. Feb. 16, 1967).

in the next decade. By 1980, total contributions are expected to rise to $11 billion a year, and benefit payments will amount to $9 billion annually. The number of beneficiaries will increase to about 6.5 million, and total reserves will grow to approximately $225 billion. It is little wonder that the private retirement system is regarded as a major element in the economic security of American workers, representing a source of financial power and having a significant impact on manpower in our economy.

The OASI program is viewed as remaining the base for assuring adequate retirement income to workers and their dependents. Private pensions act as a supplement to the public system. This social purpose provides justification for the indirect subsidy derived from favorable tax treatment. The committee recommended that public policy continue to encourage the growth of private retirement and improve the basic soundness and equitable character of the plans. Private pensions will never replace the public system, but as assured supplementary benefits they can provide retirement incomes reasonably related to living standards in the economy.

One of the most serious problems facing the private pension system is the effect of retirement plans on labor mobility. Seniority and other benefits based on length of service, together with pension expectations, tend to reduce manpower mobility by tying workers to a particular employer. Rapid technological changes in our economy indicate a need for a mobile labor force. The older worker, in addition to being relatively stationary, is the victim of discrimination in employment, in part because of pension costs. The committee recommended flexibility in the administration of the private pension system and emphasized that compulsory earlier retirement is not suitable as a means of dealing with unemployment.

Present law does not impose any minimum standards of vesting for employees of other than the self-employed.[46] The committee viewed the problem of vesting of benefits after reasonable service and to enhance mobility in the work force. A reasonable measure of vesting will strengthen the economic security of the retired worker and justify private pensions' favored tax status on the ground of broad social purpose. The committee recommended a system of graded deferred vesting based solely upon length of service for both single and multiemployer[47] plans.

Funding was viewed by the committee as inadequately safeguarded by existing law, and which could result in the complete or partial failure of employees to receive pension benefits. Recommendations for legislation in this area where minimum standards for stated benefit and fixed contribution plans, initial actuarial certification and periodic review, and minimum guidelines or ranges of standards with respect to actuarial assumptions. Regular audits of pension fund assets and an appropriate transition period to absorb additional costs were also recommended.

The committee made no specfic legislative suggestions in the areas of portability and reinsurance, which are devices transferring accumulated

46. INT. REV. CODE of 1954, §401 (d) (e), *as amended* 80 Stat. 1539 (1966).
47. For a discussion of multiemployer plans see text accompanying notes 83-86.

pension credits and guaranteeing benefits in the event of certain terminations. Both of these proposals are related to vesting and funding recommendations.

Tax laws, while giving encouragement to the growth of private retirement, have also conferred some benefits, which the committee felt were unwarranted, and continued some practices that did not reflect its concept of public policy. The committee recommended that:

(a) the option to establish plans for salaried or clerical employees only should be eliminated;

(b) the period of deferred coverage for any employee should be lowered from five to three years;

(c) employees of tax-exempt institutions should receive favored tax treatment only if their plans qualify under rules applicable to taxable employers;

(d) some limitation on benefits and contributions should be required;

(e) credit to the employer should be limited to no more than one-half the OASI benefit;

(f) capital gains treatment of lump sum distributions should be replaced with income averaging;

(g) the exemption from taxation of the increase in value of employer securities upon distribution should be eliminated;

(h) gift and estate taxes should apply to transfers of interests in qualified plans in the same manner as to other interests in property; and

(i) profit-sharing plans should be included in implementation of the committee's vesting recommendations.

The committee also suggested an appropriate transition period and special procedures where costs would be substantially increased by its proposals.

Although it noted the existence of problems, the committee had no program in several areas. For investments of pension funds, no conformity to any prescribed rule respecting the proportion of stocks to other investments was suggested. No new standards of fiduciary responsibility were proposed, although the committee felt that there appeared to be a need for strengthened statutory provisions assuring compliance. No regulatory agency was suggested as a guardian of the interests of employees and their beneficiaries. The committee did, however, recommend a maximum limitation on the portion of a retirement fund that may be invested in the stock or obligations of the employer company and suggested that additional information be supplied under the Welfare and Pension Plans Disclosure Act.

In the three and one-half years[48] following the publication of the report of the President's Committee, much consideration has been given to its recommendations. A number of bills have been introduced in Congress,[49]

48. Research for this study was concluded in October 1968.

49. S. 1103, introduced by Senator Javits, covers vesting, funding, portability, and reinsurance. Some others include H.R. 4462, introduced by Representative Dingell, covering portability and vesting and H.R. 686 introduced by Representative Holland and its com-

and extensive hearings have taken place, at which committees, governmental agencies, representatives of labor and management, and knowledgeable commentators in the field of private retirement have made their views known. Not all of its recommendations will become law, and of those that are accepted by Congress the earliest will be enacted in 1969.

The most urgent pension issues facing Congress in the future will be those concerning mandatory vesting, minimum funding, reinsuring pension benefits, increasing fiduciary responsibility, and broadening and enlarging Social Security. A program of legislative reform of our existing private retirement system has begun. This study will consider the major problems facing Congress and the Treasury concerning vesting, funding, and integration against the background of the recommendations of the Cabinet Committee, review pending legislation, and will suggest proposed solutions.

VESTING AND LABOR MOBILITY

One of the more controversial recommendations made by the Cabinet Committee concerns a minimum vesting requirement. "Vesting" has been defined as a guarantee to the worker of a right or equity in a pension plan based upon all or part of his accrued retirement benefits should his employment terminate before he becomes eligible for retirement.[50] The term "vesting" is not normally applied to the benefits purchased by the employee's own contributions since he is entitled to the return of his own contributions on withdrawal from the plan.[51]

Three types of vesting are found in pension plans, distinguished by the requirements the worker must fulfill to achieve a vested position. Under deferred full vesting, eligible workers retain a right to all accrued benefits upon meeting the specified requirements, such as age 40 and 10 years of service. Under deferred graded vesting, workers acquire a right to a certain percentage of accrued benefits upon fulfilling the requirements, with the percentage increasing as additional requirements are met, until fully vested. For example, there may be 50 per cent vesting on completing ten years of service, with an additional 10 per cent for each additional year, up to 100 per cent for fifteen years or more of service. Immediate full vesting is the third type, under which all benefits are fully vested as soon as they are earned.[52]

Although the concept and use of vesting provisions in pension plans is not new, actual incorporation into plans has been limited until recent years, especially in noncontributory and collectively-bargained pension plans. In

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panion, S. 1635, introduced by Senator Hartke, covering reinsurance. The Yarborough-Perkins bill, S. 1024 and H.R. 5741, covers disclosure and limits investment in employer stock. In 1968 the Labor Department sponsored the "Pension Benefit Security Act," S. 3421 and H.R. 17046, providing for mandatory vesting, funding, and plan termination insurance and generally implemeting the Cabinet Committee's Report.

50. U.S. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR, BULL. No. 1407, LABOR MOBILITY AND PRIVATE PENSION PLANS 11 (1964).

51. CABINET COMMITTEE REPORT 33.

52. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 14.

1952, only 25 per cent of the plans reviewed by the Bureau of Labor Statistics contained any vesting provisions, of which three-fourths were contributory.[53] By the early 1960's the Bureau reported that vesting was provided by two out of three private pension plans, covering three out of five workers. Vesting was reported to be more common in single employer plans than in multiemployer plans, with about seven out of ten single employer plans (covering about the same proportion of workers) having vesting, as compared with about one out of three multiemployer plans (covering about one out of four workers) having vesting. Nearly 80 per cent of the workers covered by contributory plans had vesting provisions, as compared with 55 per cent of workers in noncontributory plans.[54]

Vested retirement benefits are a valuable asset to a worker. The worth of the median vested benefit to a 3,600 dollar-a-year worker with 10 years service would be 1,662 dollars if purchased at age 45, or 3,550 dollars if purchased at age 65. The 8,400 dollar-a-year worker with 30 years service would have gained an asset valued at 11,238 dollars if the median benefit were purchased at age 45, or 23,998 dollars if purchased at age 65. As might be expected, vested benefits vary widely at different service and earnings levels. For the middle 80 per cent of workers earning 4,800 dollars with 20 years service, the range was 38 dollars to 105 dollars per month. At the 8,400 dollar level, with the same length of service, the range was 48 dollars to 219 dollars per month.[55]

Few plans contain only the two benefits of normal retirement and some form of vesting. Other major benefits such as disability and early retirement protect the worker in different situations. However, one benefit is seldom a complete substitute for another.

Private initiative and collective bargaining have led to a wide variety of plan provisions. Unions usually are more interested in normal retirement benefits at the inception of a plan. Costs are, of course, one vital factor in pension planning decisions.

The Bureau of Labor Statistics analyzed major benefits in a large group of plans and reported that at least one of such benefits was found in most plans.[56] In almost one-tenth of the plans, with one-tenth of the workers, normal retirement age had to be reached before a worker received any plan benefits. In contrast, 30 per cent of the plans with 40 per cent of the workers provided all three major benefits that supplement normal retirement. However, in two-fifths of the plans with 20 per cent of the workers, a disabled worker had to substitute early retirement or vesting for disability retirement. The following table illustrates the distribution of these major benefits.

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53. U.S. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR BULL. NO. 1147, PENSION PLANS UNDER COLLECTIVE BARGAINING (1953) studied 300 large collectively bargained pension plans.

54. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 12.

55. U.S. BUREAU OF LABOR STATISTICS, DEP'T OF LABOR BULL. NO. 1485, PRIVATE PENSION PLAN BENEFITS 86 (1966).

56. *Id.* at 88.

TABLE 5
Major Benefits Provided in Addition to Normal Retirement[57]

	Per cent	
	Plans	Workers
All plans studied	100.0	100.0
No other benefit	9.4	10.0
Disability, early retirement, and vesting	30.9	39.1
Disability and early retirement	9.9	17.2
Disability and vesting	6.0	4.9
Disability only	5.0	8.5
Early retirement and vesting	27.3	14.4
Early retirement only	8.5	4.7
Vesting only	3.1	1.1

Requirements for Vesting

With the rare exception of plans with immediate full vesting, most plans impose conditions on qualification for vested benefits. The most common form of vesting, deferred full vesting, requires substantial periods of service as well as minimum age levels. Ten years of service or less was needed for deferred full vesting by about 45 per cent of the plans covering the same fraction of workers. Over one-half the plans with about the same proportion of workers required 15 or more years of service. Minimum service requirements are shown in the following table.

TABLE 6
Minimum Service Requirements[58]

	Per cent	
Minimum Service	Plans	Workers
All plans with deferred full vesting	100.0	100.0
No service requirement	0.2	0.2
Less than 10 years	17.5	7.7
10 years	24.8	37.9
11-14 years	3.3	2.6
15 years	30.5	37.3
16-19 years	1.2	1.0
20 years	13.8	8.1
21-24 years	0.2	0.4
25 years	7.6	4.0
26-29 years	0.4	0.3
30 years	0.4	0.4

In addition to length of service requirements, minimum age levels were required by 70 per cent of the plans with the same fraction of workers. Age 40 was required by about 25 per cent of the plans covering over 45 per cent of workers studied. Minimum age requirements are illustrated in Table 7.

57. *Id.*
58. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 15.

TABLE 7
Minimum Age Requirements[59]

	Per cent	
	Plans	Workers
All plans with deferred full vesting	100.0	100.0
No age requirement	30.4	29.8
Age 40 and under	27.2	46.2
Age 45	8.8	8.6
Age 50	9.9	8.1
Age 55	20.8	6.5
Age 60	3.0	0.8

The combination if minimum age 40 and 10 or 15 years of service, found in plans negotiated by the automobile workers and steelworkers or plans influenced by these provisions, applied to over 40 per cent of workers having deferred full vesting. Another 30 per cent of workers had no age requirement, but service requirements of 10 or 15 years were most common. Generally, service requirements increased where no minimum age was specified.[60]

Age and service requirements of pension plans with deferred graded vesting, general union plans, were more varied than those with deferred full vesting. Workers could qualify for lower initial benefits with less service at an earlier age than in plans with deferred full vesting, but full vesting under graded deferred plans generally required longer service than under deferred full vesting plans. Ten or 15 years was the most common requirement to achieve initial vesting. The basic percentage varied from 5 per cent at 5 years service to 75 per cent at 10 years, with the most common level reached at 50 per cent for 10 years service. Fifteen years was required for full vesting in 85 per cent of the plans. More than one-half of the workers were in plans with no age requirement, but had service requirements of 15 years or longer.[61]

Early retirement and vesting are interrelated benefits. Approximately 75 per cent of private pension plans covering three-fourths of the workers provided for early retirement. This benefit was more prevalent in single-employer plans than among multiemployer plans and was more common in contributory plans, in plans not established through collective bargaining, and in salaried workers' plans.

Length of service requirements for early retirement were comparable to those for disability retirement. Fifteen years service was the most common service level, although 10 years were needed in a sixth of the plans covering 25 per cent of the workers. A fourth of the workers needed 20 years or more and a fifth of the workers could qualify with less than 10 years of service.[62]

Minimum age requirements were most frequently placed at 55 and 60 in nearly 95 per cent of the plans covering 85 per cent of the workers. Com-

59. *Id.*
60. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 15-16.
61. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 16.
62. *Id.* at 25-26.

binations of age 55 and 10 to 15 years service were required for over 20 per cent of the workers, while another 30 per cent were in plans requiring age 60 and 10 or 15 years service. Employer consent, or request, was a condition required by nearly 50 per cent of plans covering almost 40 per cent of the workers.[63]

Disability retirement is akin to vested benefits in the sense of providing an income supplementary to OASI benefits. However, almost half of the plans, covering 30 per cent of the workers, provided no disability benefits whatever.[64]

The Bankers Trust Company conducted a series of surveys of industrial pension plans providing valuable supplementary information concerning the recent growth of vesting provisions. These studies, conducted at intervals since 1943, have developed their own illustrative terminology. The term "pattern plan" refers to a form of plan that has been introduced through adoption by various international unions and negotiated, with some minor variations, throughout industry in general. In this type of plan, except in the steel industry, pensions are in a flat dollar amount, which may vary with years of service but not with the compensation rate of the employee. The term "conventional plan" refers to a plan that provides benefits varying both with years of service and with rates of compensation and that is not of the "pattern" type. Almost all plans adopted prior to 1950 were conventional.[65] "Full vesting" refers to the whole accrued benefit whether termination is voluntary or involuntary, and "partial vesting" refers to only a specified percentage of the accrued benefit, or future service benefits only. The following table demonstrates vesting provisions in "pattern" plans during the 1956-1959 period and the 1960-1965 interval.

TABLE 8

Vesting Provisions for Pattern Plans[66]

Provisions for Full Vesting	1960-1965 Plans	1956-1959 Plans
Age 60 after a specified period of credited service	3%	10%
Age 55 after a specified period of credited service	3	10
Age 50 after a specified period of credited service	4	1
Age 45 after a specified period of credited service	6	9
Age 40 after 15 years of credited service	37	21
Age 40 after 10 years of credited service	27	16
10 years of credited service	10	4
Other requirements for full vesting	3	8
Plans with only partial vesting	1	3
Plans with no vesting	6	18
Total	100%	100%

63. U.S. BUREAU OF LABOR STATISTICS, *supra* note 55, at 67-68.
64. *Id.* at 33.
65. BANKERS TRUST COMPANY, 1965 STUDY OF INDUSTRIAL RETIREMENT PLANS 7 (1965).
66. *Id.* at 19.

There is a discernible trend toward more liberal vesting in the later period, particularly at the age 40 and 10 to 15 years service levels. Ninety-four per cent of all plans during 1960-1965 provided some form of vesting compared with 82 per cent in the previous period. Table 8 shows not only the trend toward more liberal requirements, but vesting in a greater number of plans. Employees aged 40 with 15 years of service fully vest in 75 per cent of the pattern plans studied in 1960-1965, compared with 42 per cent in the previous study. Fully 50 per cent of the plans studied in the later period added or liberalized vesting, while no plan was made more restrictive.[67]

Conventional plans also developed more liberally in vesting during the same intervals. Ninety-seven per cent of the conventional plans studied provided vesting during 1960-1965, compared with 90 per cent in 1956-1959. Most conventional plans have enjoyed vesting for some time. At the age 40 and 15 years of service level, 33 per cent of these plans provided vesting in the later period, compared with 21 per cent in the previous study.[68] Age and service requirements are summarized in the following table.

TABLE 9

Vesting Provisions of Conventional Plans[69]

Provisions for Full Vesting	1960-1965 Plans	1956-1959 Plans
Vesting on completion of a period of credited service		
10 years or less	12%	6%
15 years	10	8
20 years or more	8	10
Vesting on attainment of		
Age 55	2	2
Age 60	1	2
Vesting on completion of a period of credited service ranging from 5 years too 25 years or more and attainment of		
Age 40 or less	12	7
Age 45	14	11
Age 50	13	11
Age 55	14	15
Age 60	7	11
Vesting only on layoff	1	2
Plans with only partial vesting	3	5
Plans with no vesting	3	10
Total	100%	100%

Vesting and Manpower Policy

The ultimate effectiveness of the vesting provided by the various plans in effect is, of course, the important aspect of this benefit. Based upon Bureau of Labor Statistics' surveys, the Cabinet Committee found that the vesting

67. *Id.*
68. *Id.* at 20.
69. *Id.*

provided by most plans was illusory. For example, the prospects of a worker achieving a vested benefit, or becoming entitled to early retirement, can be illustrated by considering the hypothetical worker entering a pension plan at age 25. Ninety per cent of the plans would not give any form of vested benefit within the first ten years of service, or until age 35. If the employee remained until age 40, with 15 years of service, over two-thirds of the plans would still not provide any vested benefits. By age 50, with 25 years of service, 45 per cent of the plans would still not provide vested benefits. Thereafter, requirements preventing vesting tend to vanish, with vesting becoming almost universal at age 65.[70]

Even with an evident trend toward more universal vesting of pension benefits without governmental intervention, as illustrated by the Bureau of Labor Statistics' and Bankers Trust Company's surveys, the Cabinet Committee considered vesting to be of such prime importance that it did not want the decision of inclusion or exclusion of vesting provisions to be made by private parties and proposed a minimum vesting provision be included as a prerequisite to qualification for favorable tax treatment. As a minimum requirement, deferred graded vesting, with 50 per cent after 15 years and full vesting after 20 years was recommended.[71]

Vesting is probably one of the most meaningful aspects of pension coverage. To understand the significance of the Cabinet Committee's proposal in this area, it is necessary to examine union, management, and public policy factors in the pension system.

The union concept of the function of pensions is that employees earn the right to receive pension benefits because they are working for reduced compensation in order to acquire these deferred benefits. In addition, the human depreciation concept would require all industry, in the absence of adequate governmental programs, to fulfill an obligation to workers to provide for their maintenance after their active working careers have been concluded.[72] Pension plans without vesting provisions often deny the employee his "deferred wages," leave him without adequate income in retirement, and impair his mobility by tying workers to the job in which pension credits would be lost if employment is terminated.

Management, on the other hand, contends that private pension plans had their origins in retaining valuable workers, in reducing labor turnover and its attendant costs, and in rewarding long service. These business reasons for providing retirement benefits are still alive.[73] It seems that there should be some middle ground between union and management views.

Governmental interests in vesting stems from a diversity of reasons: as a matter of equity and fair treatment, an employee covered by a pension plan is entitled, after reasonable service, to protection of his retirement benefit against termination of employment; vesting fulfills the concept that the worker earns deferred wages in employer contributions to a pension plan;

70. CABINET COMMITTEE REPORT 39.

71. *Id.* at 42. *See also* Comment, *supra* note 32, at 1263.

72. D. MCGILL, *supra* note 8, at 17-19.

73. CABINET COMMITTEE REPORT 1.

and workers who voluntarily or involuntarily terminate employment after long service retain pension rights. Vesting also enables employers to eliminate employee discontent with pensions and provides an additional fringe benefit with which to attract personnel. By providing widely available retirement benefits, vesting strengthens the nation's retirement program, making benefits available to a greater number of workers and enhancing the security function of the private pension system. Labor mobility is a vital manpower factor, and the labor system functions with the workers' freedom to change jobs to parts of the economy where services can be utilized. A lack of vesting may not be a major deterrent to mobility, but it does inhibit movement in important segments of the labor force such as professional, technical, white-collar, and some manual workers. The deterrent effect of a lack of vesting may become more of a future problem as more employees are covered by pension plans.[74]

The effect of vesting upon labor mobility is significantly different in the three types of vesting. Immediate full vesting offers the maximum protection of pension rights, accordingly most strongly supports mobility, but is by far the costliest method of vesting. It also assures benefits for workers with little service, which is not one of the basic pension tenets. In fact, its infrequent use is attributable to these two factors.

The most common form of vesting, deferred full vesting, guarantees a worker meeting the requirements for his full accrued benefits. If he terminates employment, after meeting the vesting requisites, he stands to lose future accruals of benefits, usually at higher levels, but this is only one factor to be considered in changing employment. Under deferred full vesting, where there is a point of time when the worker becomes fully vested, the "locked-in" effect of this type of vesting is greater than under deferred graded vesting where the worker is gradually entitled to a full vesting of benefits.

The grading of vesting over a period of service concurs with the traditional pension concept of rewarding long continuous service and tends to reduce the costs of vesting, making it more attractive to employers. Of course, excessive service requirements would nullify the benefits to labor mobility that may be achieved.[75]

The largest group changing employment in any given year is under 25 years of age. Thereafter, the number of employment changes made voluntarily decreases rapidly with age. In addition to the effect of technological changes, accumulated benefits such as seniority, security, and other fringe emoluments weigh heavily in favor of job retention for older workers. Workers holding jobs for short periods may, however, retain mobility throughout their working lives.[76]

High age and long service requirements in vesting benefits counteract the mobility potential of vesting. However, service requirements are not usually so great as to negate vesting's positive effect on potential mobility. Approximately 45 per cent of workers in plans with vesting need complete 10 or fewer

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74. *Id.* at 39-40.
75. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 22.
76. Goldworn, *supra* note 10, at 247.

years of service to qualify and an additional 40 per cent participate in plans requiring between 11 and 15 years. The key element for mobility is usually the age requirement for vesting, generally 40 years or more. The 10-year service requirement in many plans may not be as significant a restriction as the attainment of age 40. Moreover, plans that require the attainment of ages 45, 50, or 55 may effectively deny vesting and hence impair mobility for workers with as much as 15 years or more of service.[77]

Involuntary separations must be considered apart from normal vesting provisions. Since such vesting operates beyond the control of the worker, even though protecting the separated worker meeting age and service requirements, the contribution to voluntary mobility is negligible.[78]

Exhaustive as the Cabinet Committee's analysis of vesting as it affects labor mobility may have been, a general conclusion that lack of vesting inhibits worker mobility may not be justified. Indeed, the committee suggests that a limited and selective effect upon mobility is observed. Caution must be employed in evaluating this factor as a justification for mandatory vesting.[79] Other social reasons, such as retirement security, for a higher quality of vesting may be more important.

Costs are the basic deterrent to immediate expansion of vesting provisions. The interplay of various factors makes this area one of the most important in any consideration of vesting, together with collective bargaining and portability.

Vesting Costs and Other Considerations

One of the most troublesome aspects of the Cabinet Committee's recommendations for mandatory vesting is the difficulty of accurately predicting the cost of providing vested benefits. The variety of plans in many diverse industries having different turnover experiences makes this area almost speculative. Without better information it will be difficult to draft meaningful legislation.

The committee's findings relative to the cost of vesting indicate the lowest expense to plans that now meet one or more of the suggested standards. Two-thirds of the plans fit into this category, and amending them to conform to the suggested graded deferred vesting (50 per cent after 15 years, full vesting after 20 years) will not involve excessive cost. Many plans now condition full vesting upon the attainment of age 40, and eliminating this requirement would not greatly increase cost because relatively few workers withdrawing before age 40 are apt to have more than 15 years of service.

The committee also believed that plans limiting vesting to involuntarily separated workers would incur a small increase in vesting benefits of voluntarily terminated workers, since voluntary withdrawal among workers with 15 years of service would probably be infrequent. This limitation may not be desirable in periods of recession.

Obviously, the largest cost increase will occur in providing vesting for those plans that do not presently provide this benefit. Estimates by the

77. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 22-23.
78. *Id.*
79. Goldworn, *supra* note 10, at 249.

committee, covering all but a small percentage of plans, indicated that deferred full vesting after 20 years of service (including premembership service) would not add more than 6 per cent to the cost of providing normal retirement benefits at 65 years of age, and that the deferred grading of vested benefits, recommended by the committee, would seldom add more than 8 per cent. The basis for these estimates has not been clearly stated.

Multiemployer plans without vesting, the most numerous of the type of plan without this benefit, have different factors for consideration since the problem does not relate to all terminating employees but only those leaving the coverage of the plan as a whole. Higher numbers of participants in such plans are likely to attain the 15 years of service needed to qualify for vesting, and small proportions of these workers are likely to withdraw from the plans after 15 years and before retirement. In union plans, the need to remain a dues-paying member until retirement may place an unwarranted burden upon workers.

The committee concluded that adopting its basic recommendations regarding vesting would increase costs by 5 per cent for a large majority of the plans and rarely would it exceed 10 per cent.[80] Again, the computations for these cost estimates were not published.

Graded deferred vesting has been found to be more financially manageable than full vesting with the same basic qualifications. However, as in full vesting, to reduce cost there is a tendency to place the initial period required for vesting just above the length of service achieved by most employees. For short-term employees, graded vesting has no advantage over deferred full vesting unless the initial qualifying period is shorter than it would be under a full vesting formula. Graded vesting, whatever its shortcomings, seems to indicate progress toward more effective benefit coverage.[81] It is hard to oppose this approach to effective retirement planning if costs can be reasonably ascertained.

Studies comparing hypothetical cost relationships for selected vesting provisions have determined that graded deferred vesting confers the most benefits at the least cost. Immediate full vesting is obviously the most expensive method and, considering employer motivation to provide pensions, may be completely unworkable. Combinations of ages, 40, 45, and so on with 10 or 15 years of service are noticeably less expensive than the straight 10- or 15-year conditions. Graded vesting providing 50 per cent of normal retirement benefits after 10 years of service, and 10 per cent per year thereafter, would be less costly than deferred full vesting after 10 years. One conclusion, however, is obvious: the more liberally a vesting formula protects employee benefits, the more expensive the formula is. Obviously, the costs of different vesting provisions will vary with the particular circumstances of each plan or employee situation.[82]

Closely related to vesting is the transferability of pension credits from one pension plan to another, called "portability." Multiemployer plans

80. CABINET COMMITTEE REPORT 45-46.

81. M. BERNSTEIN, THE FUTURE OF PRIVATE PENSIONS 250-51 (1964).

82. *Id.* at 250-52.

provide the closest approach to full portability of pension credits. Multiemployer plans are generally of two types, industry-wide plans and area or geographical multiemployer plans. Created out of existing multiemployer collective bargaining arrangements, these plans have taken their place among other uniform conditions of employment and accommodate the ability of workers to shift from one employer to another within the bargaining unit. Such plans cover about three-fifths of the workers under multiemployer collective bargaining and are relatively young. Less than 10 per cent of the plans were established before 1950 and, with a spurt after 1954, 60 per cent of the plans were less than 6 years old in 1960.[83] Such plans generally are lacking in vesting and early retirement benefits. Portability of pension credits, the distinguishing characteristic of multiemployer plans, means that the worker remains covered and continues to accrue service credits as long as he is employed by one of the participating employers. Reciprocity between plans provides additional portability. However, only about 10 per cent of the plans have these arrangements and these rarely cover pensions established by different unions. On the other hand, about a fourth of the workers covered by multiemployer plans are covered by reciprocal arrangements, and a large portion of these workers were under International Ladies' Garment Workers' plans, which operate as a large pension plan covering nearly all union members.

Multiemployer plans were developed in industries where employees typically shift from one employer to another. Portability of pension benefits, therefore, evolved as a natural feature of these plans.[84]

As many single employer plans originated, at least in part, from the employer's desire to encourage workers to stay with the company until retirement, the growth of vesting and early retirement provisions represents a substantial erosion of that purpose. Similarly, the growth of multiemployer plans, while not necessarily motivated by the desire to hold workers, is related to the desire to conserve the labor force on the part of management and on the part of the union to preserve its membership. Union requirements may be more stringent than economic conditions warrant. A tendency to increase mobility by increasing vesting and early retirement would relax the ties holding the worker to the multiemployer group. This result is far less significant if the multiemployer plans cover all jobs in an industry or occupation since, in many instances, the worker is already bound to the employer group by the specialized nature of his training. Such workers have a traditional tendency to cling to their trades and markets even when the likelihood of steady employment is not present. A lack of vesting and early retirement may reinforce this inclination. Multiemployer pension plans may tend to immobilize the unemployed, especially those workers with a large stake in the plan. The larger the benefits provided, the greater its potential influence on a decision to leave its shelter.[85] The shelter can become illusory if remaining under its protection is expensive.

83. U.S. BUREAU OF LABOR STATISTICS, *supra* note 50, at 36.
84. *Id.* at 39.
85. *Id.* at 40.

Although multiemployer plans, through their general lack of vesting and early retirement provisions, may tend to discourage voluntary movement outside the plan, it is probable that a higher proportion of workers in such plans expect to spend their working lives within its scope. The chief immobilizing effect may then be to hold workers to a declining industry or craft at a time when voluntary changes are desirable. An increase in vesting and early retirement benefits should serve to offset this tendency.[86] This outcome would be highly desirable.

The Cabinet Committee recommended a study of portability for single employer plans to handle fragments of vested benefits accrued under different employers. Although no specific legislation was recommended, the committee suggested several possible methods of approaching this problem. A central clearinghouse or other institutional arrangement for transferring and accumulating private pension credits, perhaps through the machinery of the OASI system, was suggested to provide record keeping, greater portability, consolidation of pension credits, and promotion of wider coverage of small firms. In addition to suggesting a central private pension fund for small employers, an option of an employer voluntarily to contribute vested benefits upon separation to a special fund, was also recommended for study. This option would free the employer from keeping records and paying small benefits after retirement. Such contributions might be combined in computing total supplementary benefits for a worker.[87]

A major problem in the fragmentation of vested rights occurs because of the fixed dollar amounts of deferred benefits. When an employee is separated with vested rights, the amount of the benefit is determined by the formula in use at that time and is expressed in a fixed sum — with the exception of the use of a variable annuity for all or part of the benefit. If a great amount of time elapses between vesting and retirement, the value of the benefit is subject to considerable erosion. Inflation during the last 20 years amply illustrates the vulnerability of a deferred fixed benefit. Benefit improvements, caused by favorable earnings, increased wages, collective bargaining, and inflation do not apply to employees already separated with vested rights. Vesting, as presently conceived, is aptly labeled "cold storage" vesting. Benefits, geared to conservative rates of assumed interest and earnings, are indeed frozen as of separation. Such employees are not permitted to participate in the benefits that they generate.[88] Any plan to administer vested benfits should equitably consider an increment for favorable earnings, as an offset for inflation, if not for increases in wages and other fringe benefits. Current inflationary tendencies may render fixed benefits greatly inadequate.

Proposed Legislation

Proposed legislation requiring mandated vesting for tax qualifiication is already before Congress and undergoing extensive committee hearings.

86. *Id.* at 50.

87. CABINET COMMITTEE REPORT 55-57.

88. M. BERNSTEIN, *supra* note 81, at 258-59.

The earliest date for enactment of any legislation appears to be in 1969.[89]

Under present law, there is no specific requirement that a pension plan contain vesting provisions other than the provision that vesting must occur upon attainment of normal retirement.[90] Nevertheless, the Service has guarded vesting provisions closely to prevent prohibited discrimination in favor of the managerial group. No general rule seems applicable, and the facts in each case determine whether the specific vesting provision contains the element of discrimination. This observation is particularly true for small, noncollectively bargained pension plans. For example, a pension plan that allows no vesting until retirement where most of the participants are migratory will not qualify.[91] In most situations where lower-paid employees rarely stay until retirement, some form of vesting after a reasonable period of service or participation may be required in order to avoid a discriminatory result.[92]

Full vesting is also required upon termination of a plan or upon the complete discontinuance of contributions. A company with a large turnover experience may obtain tax qualification if vesting is provided after "a reasonable waiting period."[93] A qualified plan may provide for discontinuance of benefits to a retired employee for cause that must be distinctly specified such as, taking a position with a competitor of the employer, divulging the employer's trade secrets to competitors, or for the suspension of benefits for any period of time during which primary insurance benefits under the Social Security Act are discontinued because of employment after retirement. Provision may also be made for the granting of less liberal benefits under such circumstances. However, no provisions may discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated.[94]

There are also basic vesting differences between pension and profit-sharing plans. While vesting is not required until retirement, or to prevent discrimination, or upon termination in a pension plan, under the usual type of profit-sharing plan an employee acquires a 10 per cent vested right in his interest annually from the date he becomes a member of the plan, thus requiring 10 years to achieve 100 per cent vesting. Notwithstanding a lack of specific legislative authority, District Directors have administratively required profit-sharing benefits to vest within 5 years in some cases. There is no indication that this constituted an abuse of discretion. There appears to be a disparity among districts in this regard and in the treatment accorded different plans within the same district. Employees terminating employment under a profit-sharing plan are entitled to receive their vested benefits,

89. S. 1103 and H.R. 4462, *supra* note 49, introduced in 1967, have been followed in 1968 by S. 3421, introduced by Senator Yarborough on May 2, as well as H.R. 13544, which closely parallels Senator Javits' S. 1103.

90. Rev. Rul. 57-163, pt. 5(b)(2), 1957-1 CUM. BULL. 128, 147. *See also* Goldworn, *supra* note 10, at 246.

91. E. WOOD, J. CERNY & H. RAFUSE, *supra* note 42, at 29.

92. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 222 (Sellin ed. 1960).

93. P.S. No. 22, Sept. 2, 1944; Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, 120.

94. Rev. Rul. 82, 1953-1 CUM. BULL. 288; Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, at 120.

the nonvested balance being reallocated to participating employees who continue their employment. Payment of vested amounts may be deferred until the terminated employee reaches retirement age, although this deferment requires administrative effort in keeping track of the worker until retirement. In comparison, under a pension plan, terminating employees forfeit nonvested benefits other than their own contributions plus interest. Generally speaking, much shorter vesting will be required in profit-sharing plans as compared with pension plans.[95]

In the District of Florida, a rule of thumb for pension vesting has been 10 per cent per year after the first 3 to 5 years depending upon each case, the turnover rate, type of employees, and other factors. Less vesting may also be accepted in union plans. The standard applied appears to be whatever vesting the Service feels is required to prevent the prohibited group from acquiring all the benefits. If forfeitures will inure to the benefit of the prohibited group, faster vesting will be required.[96]

The rule requiring vesting on termination presents no problem in a profit-sharing plan. Distribution or continuation of the trust as a qualified trust, if the termination were justifiable, are alternatives. Similarly, no complications would be found in termination-vesting in a pension plan funded by individual annuity policies. In the case of a trusteed-pension plan, where participants have no vested rights at termination, problems do arise.[97] A dying enterprise often will discharge its employees before it finally goes under. In many such cases, the employees thus terminated will not satisfy the normal, early retirement or vested benefit requirements. In an attempt to salvage some benefits for these workers, Revenue rulings have created the vesting on termination rule, that is, the normal eligibility requirements are eliminated.[98] Liability to pay for such benefits is limited to existing plan resources. However, unless "termination" occurs, and occurs early in the process of decline, many of the separated employees may not benefit from it.[99]

An address by Assistant Secretary of the Treasury Surrey in mid-1967 described some staff proposals under consideration by the Administration in regard to mandatory vesting.[100] These are not yet official proposals. The staff proposals regarding vesting were premised upon the conclusion that vesting of pension benefits is a desirable and needed part of the private retirement system. Secretary Surrey reported little genuine disagreement with the principal of vesting. This conclusion may not be entirely without dispute. The idea of deferred full vesting may have almost universal accept-

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95. E. WOOD, J. CERNY & H. RAFUSE, *supra* note 42, at 5-6.

96. Group interview with Carroll Gilbert, Pension Reviewer, Audit Division, Internal Revenue Service, in Miami, Florida, Dec. 1, 1965.

97. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 244-45 (Sellin ed. 1960).

98. Rev. Rul. 61-157, pt. 5 (c) (2), 1961-2 CUM. BULL. 67, 88.

99. Treas. Reg. §1.401-6 (c) (1963); Bernstein, *Private Pension Eligibility: Some Problems and Proposals*, 13 PRAC. LAW. No. 1, at 77, 89 (1967).

100. Address by Stanley S. Surrey, Ass't Secretary of the Treasury, American Pension Conference in New York City, May 11, 1967, in P-H PENSION & PROFIT-SHARING REP. ¶15,112.

ance, while immediate full vesting would be universally opposed. Graded deferred vesting really hinges on accurate cost estimates.

The mechanics of a vesting standard and the mode of transition are the primary vesting issues. The Treasury proposed a form of deferred graded vesting in which vested rights would be granted after 10 years of service. The 10-year period would generally begin to run at the time of initial employment. In order not to require vesting of small benefits, an employee's service before age 25 could be disregarded if not taken into account under the pension plan. The required vesting would apply only to the normal form of benefit, such as a straight life annuity or a life annuity with a term certain, but not be applicable to other benefits such as early retirement. The amount of benefit that should be vested in an employee leaving before retirement age would be a specific portion of the benefit he would have received at retirement, determined by the ratio of his actual credited service to the credit service he would have had if employed until retirement age. No minimum age requirement was recommended.[101]

On the matter of a transition to the new vesting standard, the Treasury proposed a broad rule that would provide that the new vesting standard need only be applied with respect to benefits for service after the new requirement goes into effect. That is to say, only benefits for future service – service after the effective date of the change – need be vested. Service prior to that date would count toward 10 years required service before vesting.

An additional transition method was also proposed. Because employers may be unwilling to differentiate between future and past service, since to do so would not distinguish between long-service and short-service employees, they may prefer a transition more favorable to long-service workers. Optional phasing-in of the 10-year vesting standard would be made available under which it would not become fully applicable until 10 years after the legislation becomes effective.

One alternative would permit a plan to adopt a 20-year vesting standard – applicable to the full benefit earned to the date of termination – for employees who leave during the first year after the legislation becomes effective and then systematically to reduce this standard so that after 10 years all employees leaving with more than 10 years of employment would receive vested rights.

Under another alternative, the 10-year standard would apply immediately but only with respect to a specified percentage of an employee's benefits depending on when he left the company: if the worker left in the first year after the effective date of the legislation only 10 per cent of his benefit would need be vested; if he left in the second year, 20 per cent; and so on.[102]

Under either of the foregoing alternatives, there would be no distinction between past and future service benefits, unlike the broad transitional rule. In any event, no change in plan provisions would be required for the first 2 or 3 years after legislation is enacted in order to allow time for renegotiation of labor contracts. A total transition period would actually be 12 to 13

101. *Id.* at ¶15,203.
102. *Id.* at ¶15,204.

years. Thus, the staff proposal does not call for 10-year vesting immediately, but within 12 or 13 years from the date a bill is enacted.

New plans would not be required to meet any vesting standard for employees leaving during the first 5 years the plan is in effect. This delay would recognize that often plans are initially set up to meet the situation of a few long-service employees nearing retirement age.[103] The Treasury does not seem to have calculated the cost of its proposals, which is a most important factor.

Proposed legislation, introduced in first session of the 90th Congress to implement the Cabinet Committee's recommendations, has still not come to the floor. H.R. 4462 introduced by Representative Dingell would require that an employee's rights be vested fully after 10 years of employment. The bill would also set up a special fund to accept deposits of amounts transferred from qualified trusts in settlement of an individual's vested rights under the plan when his employment is terminated before eligibility for benefits. If the individual is employed by another employer and covered under another plan, the amounts credited to his account in the special fund could be transferred to the plan then covering him.[104] The bill has been referred to the House Ways and Means Committee.[105] This legislation appears entirely too superficial for serious consideration.

Senator Javits introduced a comprehensive bill on pension and profit-sharing plans, S. 1103, which provides, inter alia, for full vesting of benefits at age 45 with 15 years of service. In the alternative, 60 per cent vesting after 10 years of service and 100 per cent vesting after 20 years of service may be provided. These requirements were minimal, and more liberal vesting could be adopted. A portability clearinghouse to facilitate the voluntary transfer of credits between plans having similar benefit features and actuarial assumptions was also included.[106] The Senate Finance Committee has not yet reported on this bill.[107] Additional legislation has been introduced in Congress in 1968 covering many aspects of previous bills. The Labor Department's proposed legislation, S. 3421[108] and H.R. 17046,[109] entitled the "Pension Benefit Security Act" provides for mandatory vesting for all plans, including profit sharing, money purchase, and unfunded pension plans. This act proposes almost universal coverage of all employers, excepting only government administered plans, overseas plans for noncitizens, and H.R. 10 plans.

In regards to plans requiring vesting, the bill necessitates full vesting of benefits for all employees with 10 or more years of service after age 25. A plan would be prohibited from having eligibility requirements of an age higher than 25 or of more than 3 years service. An employee's entire service would be counted for vesting purposes, *except* pre-age 25 service, service during which an employee declined participation in a contributory plan,

103. *Id.*
104. H.R. 4462, 90th Cong., 1st Sess. (1967).
105. P-H PENSION & PROFIT-SHARING REP. ¶15,095.
106. S. 1103, 90th Cong., 1st Sess. (1967).
107. P-H PENSION & PROFIT-SHARING REP. ¶15,096.
108. S. 3421, 90th Cong., 2d Sess. (1968).
109. H.R. 17046, 90th Cong., 2d Sess. (1968).

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service with a predecessor employer unless its plan is continued, and service that has not been continuous.

All existing plans of 5 years duration or longer would be required to comply with these minimum vesting standards. Such a plan may vest all benefits for all employees with 10 years of service, based on service after the effective date of the bill, vest a rising percentage of benefits for past and future service 10 per cent the first year after the bill's effective date and 10 per cent per year thereafter, achieving full vesting in the tenth year, or, vest all accrued benefits on a declining scale, for all employees with 20 or more years of service in the first year, for all employees with 10 years of service in the second year, and so on, to reach full vesting for all employees with 10 or more years of service in the tenth year.

Newly established plans would be allowed either to vest all benefits in the sixth year of operation for employees with 15 or more years of service, reducing the service requirement by one year each year thereafter, meeting 10 years of vesting in the tenth year or, to vest an increasing percentage of benefits, 50 per cent for 10 years of service in the sixth year of operation, 60 per cent in the seventh year, reaching 100 per cent in the tenth year.

Enforcement of compliance would be under the Secretary of Labor, a departure from existing practice, having the approval of the Treasury. The proposals involved are basically within the field of employer-employee relations and do not include any tax provisions.

The swirling crosscurrents of legislation, proposals and further study have produced several serious areas of concern for private pensions. From a social viewpoint, it is hard to take issue with the principle of vesting, but mandatory vesting for all pension plans poses a number of difficulties. First, pension plans are basically a developing American institution, and they have to attend to one need and then to another. In their earlier stages of growth they have given priority to the needs of the older worker, those on the verge of retirement. This emphasis has been at the temporary expense of vesting provisions, rapid funding, early retirement, or survivor protection. These other needs have been gradually met over subsequent periods of improvement. Requiring all plans to give priority to vesting will tend to displace fulfillment of other basic needs and may also tend to make it more difficult to establish plans initially. This result is counter to the basic social need to extend retirement protection. An inflexible order of priority may be created by mandatory vesting.[110] This cannot be as useful as the present system.

Second, the Cabinet Committee's cost estimates are considered by some observers to be conservative. Without knowing how they were calculated, they may be unrealistic. The extra cost will have to be borne by the employees in one way or another, either directly in decreased benefits or as taxpayers. Reduction of benefits, which would render noncontributory plans contributory, delay of benefit increases that would otherwise have been granted, termination of marginal plans and stiffling the hitherto healthy growth of voluntary private retirement plans may result from excessively stringent

110. Tilove, *The Adequacy of Private Pension Plans—Another View*, N.Y.U. 18TH ANNUAL CONFERENCE ON LABOR 421, 432 (1966).

Published by UF Law Scholarship Repository, 1968

vesting requirements.[111] The committee recognized that mandatory vesting would serve no useful purpose if it disrupts the existing private pension system or discourages the establishment of new plans. Yet, recommendations were made without a complete analysis of the problems involved.

Third, government interference with a marked trend toward voluntary liberalization of vesting and early retirement will probably interfere with the bargaining process. The timing and degree of vesting are now negotiated by the employer, his pensions advisors, the Internal Revenue Service, and the union, if any. A firm statutory requirement may result in lower benefits with liberal vesting, a situation inappropriate for certain industries where higher benefits are deemed necessary.[112]

Nevertheless, the consensus among pension observers is that some form of mandatory vesting is inevitable. In the view of some pessimistic commentators present vesting proposals may be the beginning of immediate full vesting. It seems obvious that more stringent vesting will have an immediate effect upon benefits, lowering or retarding increases, especially for past service benefits. Costs are dependent upon too many variables to be forecast accurately in blanket percentages. It is to be hoped that further study will precede the enactment of mandatory vesting.

FUNDING, REINSURANCE, AND FIDUCIARY RESPONSIBILITY

Additional recommendations have been made by the Cabinet Committee in the areas of funding, reinsurance, and fiduciary responsibility – all directed to the end of providing promised pension benefits. The committee found that pension plans without adequate funding and other safeguards may turn out to be empty or only partially fulfilled promises. Thus, the broad social purpose of encouraging the growth of a sound private retirement system as a supplement to Social Security through tax concessions will fail.[113] The committee failed to observe that these promises are either bargained for or granted by the employer – even if assisted by tax incentives.

While funded pension plans were virtually unheard of less than 50 years ago, they generally have been replaced during the past 20 years with funded plans among large and medium sized companies. Use of unfunded plans has been relegated mainly to small concerns, to filling in gaps in funded plans, and to providing additional compensation for top level executives.[114] A tax-qualified plan must be a funded plan[115] and, accordingly, most recent growth in private pensions has been in funded plans. Other factors in this movement to funding are increases in the number of employees being granted pensions, increased power of labor bargaining units to secure pension benefits, depression experience with the inability of companies to fulfill pension obliga-

111. P-H PENSION & PROFIT-SHARING REP. ¶15,075.

112. *Id.*

113. CABINET COMMITTEE REPORT 50.

114. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 258 (Sellin ed. 1960).

115. Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, 98.

tions, and the development of large insurance and trust company expertise in devising and managing pension plans.[116]

Although not uniformly adopted, the term "funding" is often used to indicate the manner in which contribution rates are calculated and funds accumulated, and the term "financing" is used to denote the manner in which the funds are administered and benefits provided.[117]

Funding Methods

Funding of pension plans is the process of accumulating, generally over a period of many years, assets in a pension fund that are irrevocably designated to pay benefits to plan participants in the future. In an unfunded pension plan, the employer does not segregate assets for the payment of pension benefits as they fall due, but he normally adopts a bookkeeping practice to indicate the accumulation of surplus for that purpose. In contrast, a plan is fully funded when the accumulated assets are at all times at least equal to accrued liabilities. Intermediately, and in almost universal use, is the practice of partially funding accrued liabilities. This is the area of controversy at present. Disagreement over the degree of partial funding sufficient to insure adequate security of anticipated benefits has generated the minimum funding issue.[118]

Accrued liabilities represent the present value of future benefits owed to participants. Definitionally, accrued liabilities are composed of three components: current service liabilities, past service liabilities, and liabilities from retroactive increases in the benefit levels, if any. Current service liabilities represent the present value of future benfits that are based upon employee service performed during a particular year, usually the current one. Past service liabilities represent the present value of future benefits that are based on employee service performed prior to the inception of the plan. Upon establishment of a plan, there are usually a number of older employees with many years of service. If this older group has only a few years before retirement, contributions based on future service will be inadequate to provide a reasonable pension. Past service credits rectify this situation. Lastly, liabilities from retroactive increases in benefit levels represent the present value of future benefit increases that are based on employee service performed prior to the inception of the increase.[119]

Accrued liabilities may be funded, partially funded, or unfunded. Unfunded accrued liabilities are often the result of so-called past service credits, as well as retroactive benefit increases. In addition, accrued liabilities may also reflect any deficits or surpluses arising from inadequate or excessive past contributions.

The organization and administration of a pension plan is termed its "financing," and the choice of a financing method determines to a great

116. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 258-59 (Sellin ed. 1960).

117. *Id.* at 260.

118. CABINET COMMITTEE REPORT 48; Comment, *supra* note 32, at 1265.

119. Comment, *supra* note 32, at 1266.

extent who, between employer and the holder of the funds, will bear the risks of investment yield and mortality after retirement and will have a bearing on the method of funding.

The trust fund is probably the oldest form of the funded plan and the one in most frequent use today. Contributions of cash or securities are made systematically to the trustee who invests them. Actuarial evaluation is required periodically to avoid over or under funding. When an employee becomes entitled to a pension, the trustee pays it directly from the funds in its possession.[120] Investments may be made in stocks, bonds, or insurance contracts. If insurance is involved, the trustee usually buys individual annuity contracts, which may or may not contain life insurance. These insurance contracts are then held by the trustee until the employee retires. The plan may be self-administered or run by an administrative committee appointed by the employer with a bank, trust company, or individuals as a trustee, or it may be jointly administered by company and union representatives, or be union administered with the same choices as to a bank, trust company, or individuals as trustee. The plan with trustee usually offers more flexibility than an insured plan. For a small employer the plan with a trustee is uneconomical to administer and too limited to provide diversification of investments. Pooled pension trust funds are provided by some banks to overcome this limitation.[121]

Group annuity contracts sold by insurance companies provide single premium deferred annuities if and when the employee becomes eligible for benefits under the plan. Premium rates are guaranteed for a fixed period, usually 5 years, subject to adjustment at the end of each period with respect to future premiums. The insurer assumes risk of mortality and investment yield. Premiums are calculated to provide for administration costs and a profit.

The deposit administration method of financing is a hybrid of the trust fund and the group annuity forms. Contributions are made to an insurance company, which acts as a trustee accumulating funds for the ultimate purchase of annuities. As with group annuities, the insurer guarantees the investment yield and annuity premium for a fixed period, subject to periodic adjustment. Upon retirement, the insurance company charges the fund with the cost of a single premium immediate annuity, which is thereafter paid to the participant. Deferred annuities may be provided in the plan to be purchased prior to retirement and charged against the fund. A trustee can be used in connection with a deposit administration plan, paying for insurance policies from a trust fund.[122]

A split-funded plan is designed to obtain some of the advantages of both the insured plan and the trusteed plan. A portion of the funds is invested in annuity contracts and the remainder is placed in a trust and invested in common stocks or other assets.

120. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 268 (Sellin ed. 1960).

121. E. WOOD, J. CERNY & H. RAFUSE, *supra* note 42, at 186.

122. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 268-69 (Sellin ed. 1960).

Special financing methods, usable primarily for self-employed retirement, include investment in "open-end" regulated investment companies through a custodial account in a bank; annuity, endowment, or life insurance contracts through a custodial account in a bank; face-amount certificates, with or without a trust; and special United States retirement bonds.[123]

Various cost methods are available to fund retirement benefits provided by pension plans. The unfunded, or pay-as-you-go plan is the simplest treatment, paying retirement benefits directly out of employer funds. Not tax qualified, the unfunded plan provides deductions only in the years in which pensions are paid and to the extent reasonable.[124]

The funded plan most similar to the pay-as-you-go type is the terminally funded plan. Under this arrangement, no funding takes place until employees retire. Annuities are then purchased, or funds set aside to provide benefits. Modifications can be made, such as a 5-year terminal funded plan in which funding commences when an employee reaches an age 5 years prior to retirement. Funding is then divided on a level basis over the remaining years of employment.[125]

Another cost method is the entry-age-normal-cost method. The cost of benefiits anticipated to be paid at normal retirement is determined for each employee. Total costs are averaged out from the age at which the employee would have been eligible for participation to normal retirement. Designed to spread the total cost on a level basis to retirement, it is used in a self-administered plan and can be compared with the level premium method of determining insurance premiums.[126]

Under the unit-credit-cost method, estimated costs are determined for each unit of benefit accruing to the credit of a participant. The past service liability is amortized in future years and contributed annually in addition to normal cost. This amortization may be fixed by a collective bargaining agreement, or contributions for past service credits may be made to coincide with the deduction limitation of 10 per cent per year.[127] The unit-credit-cost method is used in some self-administered plans and generally in group annuity plans. The average cost of benefits tends to increase as the covered employees mature.[128]

The frozen-initial-liability method is intended to keep the past service costs and funds unaffected by any difference between experience and the assumptions in the initial estimate. Effects of differences are carried into the subsequent normal costs. Normal cost for the first year of the plan, and past service cost at the beginning of the year, may be determined in the same manner as the entry-age-normal-cost method. Unfunded past service cost at the beginning of the second year is computed by adding to the previous past service cost interest for one year and subtracting from the total the sum of

123. E. Wood, J. Cerny & H. Rafuse, *supra* note 42, at 187-88.

124. Int. Rev. Code of 1954, §404 (a) (5).

125. Goodman, *Funding Benefits Under Tax Qualified Pension and Annuity Plans*, 45 Taxes 25, 34 (1967).

126. *Id.* at 34-35.

127. Int. Rev. Code of 1954, §404 (a) (1) (C).

128. Goodman, *supra* note 125, at 35.

the past service contribution for the first year and interest at the same rate to the end of the year. Normal cost for the second year is determined by subtracting the sum of assets and unfunded past service cost at the beginning of the year from the estimated present value at such time of the total benefits expected to be paid. The remainder is spread over the expected future service of participants as a level percentage of expected future compensation, and this procedure is continued in determining costs in future years.[129]

A similar procedure is used in the attained-age-normal method. At the beginning of the plan, the initial past service cost is determined in the same manner as under the unit-credit-cost approach, and the current cost for the first year is calculated by spreading the estimated present value at the beginning of all benefits anticipated for future service of the original participants over their expected future service as a level percentage of expected future compensation. The cost in future years may be then determined as under the frozen-initial-liability method.[130]

The individual-level-annual-cost method is used to determine the cost of benefits on a level annual basis from the time each employee enters the plan to retirement. Contributions in equal annual amounts and increments thereon accumulate to the amount required to provide the anticipated retirement benefits. The aggregate-cost method is similar, except that an average rate is used for all employees. A contribution rate is determined each year by first subtracting from the present value of all benefits to be paid in the future the balance in the fund and then dividing the remainder by the present value of future covered compensation of current active participants. This rate is applied to covered payroll and determines the amount of the contribution.[131]

The choice of a funding method will depend upon the type of financing called for by the plan, whether past or future service benefits are to be funded, the employer's cash position, and tax considerations.[132] Three methods of determining the deduction limitation are available. Either 5 per cent of covered compensation,[133] a level distribution,[134] or normal cost plus 10 per cent of past service liability[135] may be selected. No one method will produce the largest deduction in every instance. In a plan with many employees and a large covered payroll, the first method may produce the largest deduction. Where a number of participants are within a few years of retirement, the second method may produce this result. Generally, however, the third method is most frequently used.[136]

The only existing minimum funding required by present tax law calls for contributions sufficient to cover current service liabilities and the interest

129. *Id.*

130. *Id.* at 36.

131. *Id.*

132. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 272 (Sellin ed. 1960).

133. INT. REV. CODE of 1954, §404 (a) (1) (A).

134. INT. REV. CODE of 1954, §404 (a) (1) (B).

135. INT. REV. CODE of 1954, §404 (a) (1) (C).

136. Goodman, *supra* note 125, at 37.

charges on other unfunded components of accrued liabilities.[137] This minimum standard for qualification applies only to plans in which one or more of the employer's 25 highest paid employees is a participant. Present tax law is not designed to assure adequate funding but is intended to prevent discrimination in favor of near-retirement-age, high-salaried employees by a termination of the plan after this group have received full pensions, leaving insufficient funds to pay the other employees.[138] This result is probably all that tax law should be concerned with accomplishing.

Adequacy of Funding

The Cabinet Committee found that present standards of funding require strengthening to provide more adequate funding as well as enforcement of minimum requirements at qualification of a plan as well as during its existence. Acknowledging that only about 700 basic retirement plans covering fewer than one-half million workers are completely unfunded and that the great majority of pension plans are already operating with funding procedures meeting the committee's requirements, recommendations for minimum funding standards have been made.[139] The committee found that inadequate funding places unwarranted financial risk upon employees during retirement. If funds are not available to meet promised pensions, hardships and ill feeling will be generated. The committee asserted that present tax law allows the employer too much discretion in selecting a method of funding accrued liabilities and that this flexibility may lead to failure to pay promised benefits. The committee did not recognize that many pensions are bargained for by unions — and if funding is inadequate, it is often not the fault of the employer. However, the committee's recommendations have raised an inquiry into the adequacy of present funding requirements and practices in private pensions. An examination of the functioning of present funding is necessary to evaluate these findings.

A recent study of pension funding concludes that most of the large private pension plans are well funded and use both conventional funding methods and realistic actuarial assumptions. Of 93 plans examined, only 8 were not funded. The remaining plans reported using all of the conventional funding methods, with the entry-age-normal-cost method used most frequently. Minor change was reported in retirement age assumptions between 1939 and 1964, although changes in mortality and interest rate assumptions gave more realistic, thorough conservative, estimates of plan costs.[140]

Source materials for these studies came from reports of a selected number of larger pension funds under the Welfare and Pension Plans Disclosure Act of 1958. Of the 93 plans used in the study, nonretired membership in 1959 was 5.3 million and nonretired membership in 1964 was 5.4 million. All plans reporting nonretired membership in excess of 25,000 were included.

137. Treas. Reg. §1.401-4 (c) (1963).
138. Comment, *supra* note 32, at 1267.
139. CABINET COMMITTEE REPORT 47-54.
140. Krislov, *A Study of Pension Funding*, 89 MONTHLY LABOR REV. 638 (1966).

Of the 85 plans that were funded, 10 with a combined membership of 700,000 did not report liabilities in sufficient detail to calculate funded ratios. The remaining 75 plans, covering 4.2 million workers, reported liabilities of $24.1 billion and assets of $16.7 billion in 1964, or an average funded ratio of 69 per cent. Distribution of these plans as to individual plans and nonretired membership is shown in Table 10.

TABLE 10

Funded Ratios, 1964[141]

Funded Ratio	Number of Plans	Nonretired Members (thousands)
Total	75	4,240
Less than 20 per cent	4	111
20-39 per cent	14	842
40-59 per cent	10	808
60-79 per cent	15	807
80 per cent	32	1,672

Older plans studied were more adequately funded than younger ones, as might be expected. Of the plans reporting funding ratios of 80 per cent or more, 19 had been in existence for at least 25 years. Three of the 4 plans reporting funding below 20 per cent were organized in the 1950's.[142]

In contrast, 1959 found the 75 plans reporting liabilities of $14.8 billion and assets of $9.9 billion, or an average funded ratio of 67 per cent. Table 11 illustrates this distribution as to individual plans and nonretired members.

TABLE 11

Funded Ratios, 1959[143]

Funded Ratio	Number of Plans	Nonretired Members (thousands)
Total	75	4,264
Less than 20 per cent	10	464
20-39 per cent	13	712
40-59 per cent	12	967
60-79 per cent	13	662
80 per cent	27	1,447

In the 1959 study, as in the 1964 reports, the older plans tended to be more adequately funded. A movement toward more adequate funding for all plans is observed, coming with plan maturity. The average funded rates increased from 67 to 69 per cent. This increase is significant because of plan improvements and benefit increases during this 5-year period. Of the 27 plans with funding of 80 per cent or more, 17 had been in existence for

141. *Id.* at 639.
142. *Id.* at 639.
143. *Id.*

at least 25 years, and of the 10 plans with funded ratios below 20 per cent, 7 were established in the 1950's.[144]

Multiemployer union negotiated plans were not as well funded as single employer plans. None of the 16 multiemployer plans had a funded ratio as high as the average ratio for all plans in either 1959 or 1964. Multiemployer plans were typically started in the 1950's and considerably later than most single employer plans. In both years studied, many of the larger plans were quite well funded. The number and coverage of plans reporting a funded ratio of less than 40 per cent decreased from 23 plans covering 1.2 million workers in 1959 to 18 plans with one million participants in 1964.[145] Unions are generally more concerned with higher benefits than with rapid funding.

Different types of cost methods were employed in funding the 93 plans studied. Distribution of cost methods among numbers of individual plans and their membership is illustrated in the following table for 1964:

TABLE 12

Distribution of Cost Methods, 1964[146]

	Number of Plans	Nonretired Members (thousands)
Total	93	5,384
Aggregate cost	14	641
Entry age normal cost	31	2,141
Unit credit	15	897
Individual level annual premium	12	489
Attained age normal	5	366
Liability funded for retired members only	1	22
Not stated	7	403
Unfunded	8	425

The aggregate cost and individual level annual premium methods accumulate assets generally faster than other methods. Of 12 plans using the individual level annual premium method, 10 reported assets and liabilities in enough detail to calculate a funded ratio. Five of the 10 reported funded ratios of nearly 90 per cent in 1964, and all had improved since 1959. Aggregate cost funding was confined to plans in the telephone industry, where all plans were almost fully funded in 1964, and all reported a higher ratio than in 1959. Significantly, many of these plans anticipated full funding by 1968.[147]

Other funding methods accumulate assets less rapidly — such as entry age normal cost, unit credit, and attained age normal. These are the major funding methods. About one-third of the plans covering approximately 40 per cent of the workers used the entry age normal cost method. Fifteen plans

144. *Id.*
145. *Id.*
146. *Id.* at 640.
147. *Id.*

covering almost one-sixth of the workers used the unit credit cost method. The funding pattern for this number of plans was similar to the entry age normal cost group. Funded ratios varied in 1964 from a low of 15 per cent to a high of 89 per cent. Nearly all plans increased their funding ratios between 1959 and 1964. New plans and multiemployer plans appeared to have the weakest funding of the group.[148]

The picture given by the foregoing study is at variance with the committee's grave concern over inadequate funding. In fact, it would appear that much of the committee's concern is groundless. An examination of specific instances where inadequate funding has resulted in a loss of benefits to covered employees is required to evaluate fully the minimum funding dispute in the light of these findings.

The failure of the Studebaker pension plan to pay the valid claims of several thousand former workers with "vested" rights to pension benefits, coming with the shutdown of the company's plant in South Bend, Indiana, in 1963, focused attention upon the unfortunate results occurring when a plan terminates without completely funding benefits.[149] Not only were all employees discharged, but almost all employes between the ages of 40 and 60 with 10 or more years of service, who thereby were entitled to vested benefits, had little, if anything, to show for such services. The employees without vested rights received nothing.

Studebaker Corporation has pointed out that until the pension plan came into existence, hourly employees were not covered by any retirement arrangements. The plan provided that years of service with the company to be counted included past service. Older employees thereby suddenly acquired rights of considerable value, which they did not previously possess. The company had to provide for these past service credits for a large number of long-service employees and chose funding over a 30-year period. The problem arose because the life of the plan was insufficient to fund these liabilities entirely.

During the 14 years of its existence, the Studebaker plan accumulated assets of $37.9 million. It provided pensions for 4,626 individuals, 3,401 of whom were receiving pensions after the plan's termination. From 1950 until 1964, $13.9 million in pensions were paid out. Upon termination in November 1964, the plan paid out $21.5 million to purchase annuities for retired employees. After termination, it paid out $2.4 million in lump-sum distributions to 4,080 employees with vested rights but not eligible for retirement. Under the terms of the termination agreement eligible employees attaining age 60 by November 1, 1964, could apply for pensions; former employees with vested rights, if terminated prior to November 1, 1961, could apply for pensions if they became 65 by November 1, 1964; disability pensions were provided for those disabled prior to November 1, 1964; and annuities were purchased guaranteeing full lifetime pensions for those re-

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148. *Id.*

149. Bernstein, *Shortcomings of Private Pension Plans: Problems When an Employer Departs, Decays or Disappears*, 18 N.Y.U. ANN. CONFERENCE ON LABOR 437, 443 (1966).

tired. Assets remaining after the purchase of annuities were distributed to those with vested rights.[150]

Of the lump-sum distribution of $2.4 million, individual payments ranged from 250 dollars to 1,200 dollars, and averaged 600 dollars. The average age of the employees in this group with vested rights was between 51 and 52 years, and the average service with the company was almost 23 years. More than 20 of this group were close to minimum retirement age and had service credits of more than 40 years.[151]

The Studebaker plan represents a case where an orderly funding schedule was insufficient to safeguard vested benefits, even though it met the minimum standard suggested by the Cabinet Committee for stated benefit plans of funding past service credits over 30 years.

The less publicized but equally painful 1955 Packard shutdown in Detroit had the same result as Studebaker, but was even more severe. Not only were there no funds to pay vested credits, but funds were inadequate to pay full benefits of retirees. Packard also established its plan in 1950, and adopted a 30-year schedule of funding past service credits.[152]

It is readily apparent that plan terminations during early years may have similar results for pension benefits, unless arrangements are made to assume these obligations. However, aside from well publicized cases such as Studebaker and Packard, incomplete data is available to measure the extent of benefit loss upon plan termination.

A recent study by the Bureau of Labor Statistics of pension plan terminations was made by examining reports filed under the Welfare and Pension Plans Disclosure Act for a group of 99 terminated plans, each with 100 participants or more. Of this number, sufficient data was available to measure participant benefit loss in only 26 cases.

In 10 of the 26 terminations, including Studebaker, some participant benefit loss occurred. Covering over 10,000 workers, including 8,500 Studebaker employees, the assets of these plans averaged about one-half of their reported liabilities, but benefit loss was probably less than this fraction. Six other plans had insufficient assets to fund accrued liabilities, but no immediate losses occurred since participants were transferred to other plans. The remaining 10 plans with 2,300 workers appeared to be almost fully funded. This group of plans was generally older than the typical terminating plan, and consequently had a longer period to fund their obligations.[153]

It is obviously important to a measurement of benefit loss upon plan termination to ascertain when such terminations are most likely to occur.

Of 8,100 qualified retirement plans terminated during the years 1955-1965, over half were pension plans. Data from the termination records of the Internal Revenue Service show that terminating plans tended to be young and small in size. More than half were no more than 6 years old, and two-

150. 21 P-H PENSION & PROFIT-SHARING REP. No. 34, at 7-8 (1966).

151. 21 P-H PENSION & PROFIT-SHARING REP. No. 35, at 3 (1966).

152. Bernstein, *supra* note 99, at 81.

153. Beier, *Terminations of Pension Plans: 11 Years' Experience*, 90 MONTHLY LABOR REV. No. 6, at 26, 29-30 (1967).

thirds covered fewer than 25 employees. The most frequently stated reasons for termination were company and plan mergers, financial difficulties, and business dissolution. The 4,300 terminated pension plans covered approximately 225,000 employees affecting, on the average, about 20,000 workers a year — about one-tenth of one per cent of total pension coverage.

A marked upward trend in frequency of terminations was evident. The rise in number did not follow an even path, fluctuating in a manner that in part reflected changing business conditions. The greatest number of terminations occurred in 1961, a year of relatively low economic activity. On the other hand, during 1963, a relatively good business year, not only did terminations increase but many were attributed to financial difficulty.

The median age of terminated plans was 6 years. Three out of 10 terminations involved plans no more than 3 years old. Approximately one-fourth of the plans were of more than 10 years duration. The older plans were substantially larger than newer terminating plans. Half of the participants were in plans in existence for 9 years or more.[154] Some terminated plans were large, but most covered relatively few employees. Ninety per cent had fewer than 100 workers, and 45 per cent had fewer than 10. The median plan had 13 members, and coverage of the median plan had dropped from more than 15 participants in the late 1950's to about 10 employees during the mid-1960's.

Mortality among younger plans was attributed to both a tendency for plans to be less stable in early years and other differences not directly related to age. The high proportion of small plans among all pension plans largely accounts for their high proportion among terminations. The decline in the median size may reflect a reduction in average size of new plans, but since a higher incidence of financial difficulty or organizational change occurs in smaller companies, a higher rate of termination is predictable. The spreading of pension plans into industries having higher mortality may have affected the termination rate. Multiemployer plans, or a pooling device among small employers, would seem to offer greater stability to employees.[155]

Although a lack of information prevented a determination of benefits lost through plan terminations, some inferences could be drawn as to the magnitude of loss in the typical case, using traditional funding patterns. Employers were found to adopt one of several actuarial methods that eliminate abrupt fluctuations and sharp increases in the amount of yearly contributions. Even though the system selected would provide for substantially lower contributions once the liabilities have been funded, such reductions would seldom be realized because of periodic increases in plan benfits. The more customary methods will, on the average, fund between 20 and 40 per cent of accrued benefit obligations by the end of the 5th year of operation. Between 45 and 65 per cent of accrued benefits will be funded by the end of the 10th year if there have been no major plan amendments or asset changes. Increased benefits have been found to be offset by increases in asset values.

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154. *Id.* at 26-27.
155. *Id.*

These funding patterns suggested that, unless coverage was continued through the transfer of credits to other plans, members would stand to lose between 60 and 80 per cent of their total accrued benefits if their plan terminated in its 5th year. Most of this loss would be attributable to past service credits. At 10 years, the total loss would range between 35 and 55 per cent, assuming only modest changes in plan amendments and assets. In all cases, a system of priority may allocate the loss among participants from none to 100 per cent.[156]

Although lack of detailed information prevented a more accurate appraisal of the magnitude of benefit losses, it is apparent that the largest risk area occurs during the first 10 years of life for a pension plan, both from the standpoint of a high incidence of terminations as well as the lowest level of funding benefits for past service credits. This condition will probably always exist, at least to some degree, due to economic fluctuations that inevitably occur.

Financial Solvency

The committee found that actuarial standards for tax qualification were insufficient to guarantee that promised benefits will in fact be paid and recommended minimum standards with frequent periodic review of assumptions. Adequate funding may require a system of insurance to protect members in event of premature terminations. The committee also felt that fiduciary responsibility should be strengthened through appropriate regulation. These proposals affect the ability of a pension plan to meet its obligations as stated and are considered together for this reason.

Actuarial soundness has been defined as existing where the level of current and expected future contributions are adequate to meet all future benefits to be paid. This definition would not require adequacy upon a chance termination. From a practical viewpoint, soundness would seem to require the ability to meet all valid claims arising on termination.[157]

The committee found it advisable to recommend acturial certification of the funding process at the beginning of every plan and periodically thereafter. Basic guidelines, or ranges of standards for actuarial assumptions were also recommended.[158] No specific standards were offered, however.

In creating a pension plan, an actuarial estimate of factors influencing its cost must be made, including the expected interest rate, rates of mortality, termination of employment, disability, retirement, salary progression, age of spouses, rates of remarriage of widows, and probability of parenthood, in addition to expenses of administration.[159]

These assumptions are of considerable importance in determining whether the calculated assets and liabilities are a reasonable estimate of the eventual assets and liabilities. If the actuary assumes an interest rate in

156. *Id.* at 30.
157. M. BERNSTEIN, *supra* note 81, at 201.
158. CABINET COMMITTEE REPORT 53-54.
159. TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 281 (Sellin ed. 1960).

excess of the actual earned rate, then the fund is being over-credited with assets that it will not have. Conversely, if an interest rate is assumed that falls below the actual earned rate, then the fund will accumulate more assets than required to fund the benefits.

Each assumption must be based upon accumulated information and the actuary's judgment in applying the data to the group participating in the plan. For example, the use of a general mortality table is likely to understate the number of deaths and overstate the cost of a plan covering a group in a hazardous occupation. Similarly, the same table is likely to overstate the number of deaths and understate the cost of a plan in an occupation noted for longevity. The selection of an interest rate will depend upon prevailing economic conditions and the plan's investment policy. Plans investing heavily in common stock are likely to assume higher interest rates than plans that do not.[160]

A recent survey, based upon information furnished under the Welfare and Pension Plans Disclosure Act, indicates that in 1964, 71 out of 77 plans examined reported interest rate assumptions of at least 3.25 per cent, with 12 plans reporting a rate of 4 per cent. Interest rates have been on an upward trend during the period from 1959 to 1964. Insured pension plans reported increases for this interval from 3.96 per cent to 4.53 per cent in 1964, while corporate pension plans during the same period have averaged over 4 per cent. The interest rate assumption is of particular importance in evaluating a plan's liabilities since, in a typical plan, a variation of one-fourth of one per cent in the interest rate assumption can be expected to produce a difference of 6 to 7 per cent in the over-all valuation of liabilities.[161]

Mortality rate assumptions are based largely upon annuity tables developed by life insurance companies. Based upon observed mortality rates, these tables do not reflect possible changes, and the actuary must make adjustments in the use of the older tables. Use of more recent tables, with adjustments for improvements in mortality rates, will result in a more realistic estimate of cost. More than half of the 77 plans studied were using 1951 annuity tables, and most of this group had made adjustments for expected improvement in mortality rates.

Unlike the trends in interest rates and mortality tables, retirement age assumptions have not changed significantly between 1959 and 1964. Eighteen plans, mostly in the telephone industry, reported using retirement age assumptions based upon their own experience. Of the remaining 42 plans, 60 per cent in both 1959 and 1964 used retirement ages of from 65 to 67 years. The proportion of workers retiring before 65 has increased. In 1964, about two-thirds of the women and one-half of the men receiving Social Security benefits were under 65 years of age.

It would appear that some plans should reduce their retirement age assumptions. However, since many plans reduce benefits for early retirement, there may be no impact upon plan cost as the number of early retirements

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160. Krislov, *supra* note 140, at 640.
161. *Id.* at 641.

increases. Further, the increase in total number of early retirements under Social Security may not typify the situation with each pension plan.[162]

Significant variations are observed in the foregoing study of interest mortality and retirement rate assumptions. Only if the assumptions made can be reasonably expected to reflect the plan's experience can the assets and liabilities be adequately projected to achieve a funded ratio that is a reasonable estimate of benefit security.

The choice of a method of funding determines the level of contributions and their timing. This, in turn, determines the ability of the plan to meet valid claims in the event of termination. For example, one plan might employ a funding method calling for high initial contributions decreasing during the life of the plan, and another might use a method requiring low initial contributions. Both methods may employ assumptions that are actuarially sound. However, in the case of an early termination, the former will be in a much better position to pay vested benefits than the latter. Clearly, actuarial soundness does not imply an ability to meet benefits upon premature termination. In this respect, some "sound" plans are more sound than others.[163]

The Cabinet Committee recommended serious study of the matter of reinsuring pension benefits from loss upon termination. Rejecting any thought of employer guarantees of benefits, the committee suggested study along the lines of a government agency, akin to the Federal Deposit Insurance Corporation, to strengthen pension assets, although this is hardly a good analogy. Doubt concerning questions of insurable risk, administration, and experience upon which to base premiums prevented the committee from making any specific judgment on this issue.[164] The cost of such a program would be very high and perhaps not worth the effort. Nevertheless, from surveys of benefit losses, it is readily apparent that the greatest risk of pension plan mortality and the lowest funded ratio occurs in the first 10 years of pension plan life. Vesting and funding cannot, without prohibitive costs, solve the problems of premature terminations and resulting benefit loss. However, improving the pension system under current proposals will not be complete without some examination of the resinsurance issue.

One form of insurance, the idea of imposing the burden of a guarantee of plan benefits upon the employer, has been proposd. Such a plan would require the employer to guarantee vested credits and particularly those earned since the inception of the plan. Most criticism of this proposal has come in the area of past service credits. A compulsory employer guarantee of past service credits might curtail their establishment entirely because the liability imposed would be prodigious. The cost, if calculable, would be prohibitive. A California statute, which originally required such full funding of past service credits, effectively discouraged including these benefits in pension plans subject to this act.[165] Past service credits benefit older employ-

162. *Id.* at 642.
163. M. BERNSTEIN, *supra* note 81, at 201.
164. CABINET COMMITTEE REPORT 58.
165. CAL. CORP. CODE §28403 (Deering 1962), *as amended;* BERNSTEIN, *supra* note 81, at

ees, and it would be poor policy indeed to discourage provisions for their retirement. More realistic would be guarantees of future service credits or more stringent funding requirements. Other private financing proponents favor a special loan pool to enable employers encountering difficulty to borrow in order to meet benefit drains. However, employers in such straits and under no obligation to provide benefits would be the least inclined to do so.[166]

Although serious questions exist as to the validity or desirability, most active interest centers around a public guarantee system or reinsurance program under which valid benefit claims would be guaranteed. Funded through a "pool" of premiums and earnings from a large number of plans, such a fund could make payments for individual plans when they were unable to do so. With reinsurance, proponents maintain, saving could be reduced substantially. Premiums based upon the life expectancy of the plan would be small since many large single and multiemployer plans have long life expectancies. However, premiums for some high risk plans could equal the contributions needed to fund the plan. Limiting reinsurance to only low risk plans and encouraging high risk plans to enter a supplementary OASI plan arrangement would be one solution, but this would defeat the policy of encouraging private retirement. Although public or private agencies could be the reinsurer, an inappropriate analogy has been attempted with FDIC. The low risks involved in insuring bank deposits and risks involved in insuring pension promises can hardly be compared. Problems of the runaway plant, disappearance of plans through merger, and the moribund company increasing plan benefits in a fraudulent attempt to cash in on insurance benefits are only a few of the problems facing reinsurance.[167] The most difficult problems would be ascertaining premium costs and then deciding whether the risks are worth it. It seems unfair to subject well financed plans in stable industries to the cost of premiums to support poorly financed plans in short-lived enterprises. The list of problems seems endless. Nevertheless, a worthwhile insurance system providing minimum protection for plans conforming to minimum standards may be a desirable social objective.[168] It should not be at public expense, however, if private retirement is to remain "private." Any initial program will be an experiment.

More complete fiduciary responsibility in the form of disclosure and supervision of plan administration and investment policy has been proposed. In a message to Congress on February 16, 1967, asking for legislation to protect the American consumer, President Johnson urged enactment of a "Welfare and Pension Plan Protection Act of 1967." This proposal envisioned standards of fiduciary responsibility for plan administrators, yearly audits of plan books, more complete disclosure of financial activities, maximum limits on investments in stock of the employer company, an extension of

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166. M. BERNSTEIN, *supra* note 81, at 254.

167. U.S. CONGRESS JOINT ECONOMIC COMMITTEE, SUBCOMMITTEE ON FISCAL POLICY, STAFF MATERIALS, OLD AGE INCOME ASSURANCE: AN OUTLINE OF ISSUES AND ALTERNATIVES 29-30 (1966).

168. M. BERNSTEIN, *supra* note 81, at 255.

enforcement and investigative powers, and legal remedies for losses incurred by beneficiaries caused by breaches of faith by plan administrators.[169]

The Cabinet Committee made relatively minor recommendations in this area. Proposing a strengthening of statutory provisions to insure compliance with existing fiduciary standards, and greater disclosure of relevant information concerning plan administration, the committee felt that it was premature to recommend a regulatory agency to act as guardian for the collective interests of plan participants. It suggested limiting investments in employer stock to 10 per cent and distributing greater information under the Welfare and Pensions Plan Disclosure Act concerning investment holdings and activities.[170]

Within the framework of existing law, pension trustees have considerable latitude in investing pension funds and in practice, most plans receive and follow excellent investment advice. The Welfare and Pension Plan Disclosure Act avoids regulation of investments,[171] and applicable tax law makes no effort to do so.[172] Although the restrictions against self-dealing investments beneficial to the employer serve as a limitation,[173] and disclosure must be made of reasons for investment in securities of the employer,[174] there is no present prohibition against self-dealing investment practices.[175] Some restrictions may well prove beneficial. A qualified pension plan will not lose its status if the Internal Revenue Service is satisfied that the plan is operated for the benefit of the participants[176] and does not disregard the most elementary investment practices.[177] The cost of an investment must not exceed fair market value at time of purchase, there must be a "fair return," sufficient liquidity must be maintained, and safeguards that a prudent investor would observe must exist.[178] No close supervision is exercise as a practical matter, however. There is little uniformity of judgment in the field of investments, in any event. Supervision would be difficult, indeed.

Nevertheless, some restriction of investment discretion may be anticipated. Common stock investments have increased considerably in recent years. A recent analysis by the Securities and Exchange Commission indicates that the common stock holdings of noninsured private pension funds, the second largest institutional holder of stock, increased from $1.1 billion at the end of 1950 to $39.7 billion at the end of 1965.[179] Larger percentages of private pension assets are invested in common stocks. Aside from mortgages and other investments of the Teamsters Union in Las Vegas gambling hotels, golf courses, a department store, a Detroit hotel, and a subdivision near Tampa,

169. 113 CONG. REC. H. 1407 (Feb. 16, 1967).

170. CABINET COMMITTEE REPORT 73-79.

171. 29 U.S.C. §308 (h) (1964).

172. Treas. Reg. §1.401-1 (b) (5) (i) (1964); INT. REV. CODE of 1954, §401 (a).

173. INT. REV. CODE of 1954, §503 (c).

174. Treas. Reg. §1.401-1 (b) (5) (ii) (1964).

175. Treas. Reg. §1.401-1 (b) (5) (i) (1964); Comment, *supra* note 32, at 1269.

176. Treas. Reg. §1.401-1 (b) (5) (i) (1964); Comment, *supra* note 32, at 1269.

177. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 135.

178. Goodman, *Strict Rules Limit Investment of Qualified Pension and Profit Plans*, 14 J. TAXATION 153 (1961).

179. SECURITIES AND EXCHANGE COMMISSION, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 276-278 (1966).

which have attracted considerable notoriety,[180] but which have not proved to be unsound, there is little evidence that all pension plans, both union and jointly managed, are not well counselled and invested soundly. The large majority of common stock holdings are of the "blue-chip" variety.

However, the apparent lack of interest shown by members in the pension plans in which they participate, especially union plans, creates a situation in which those who manage the plans may lack effective supervision. The highly contingent right each employee has in the plan increases this immunity. In order to enforce standards of fiduciary responsibility, a legally identifiable beneficiary with sufficient legal interest in the trust res is necessary. The equity of many plan participants is so tenuous that they can seldom complain. It has been observed that the limited right of workers to complain reinforced by little inclination to do so assures plan trustees of a life of tranquil humanitarianism, if they are so disposed — and if they are not, they will still have the tranquility.[181]

Another facet of fiduciary responsibility exists in management of union funds. Some jointly managed plans are effectively union managed. A potential conflict of interest occurs between the union as plan administrator and as a representative of the workers. Although union administration of multi-employer plans may achieve lower costs through the use of union records, the opportunity exists to charge union administrative costs against the pension plan. A union can use plan management to control its members. Indeed, in the public interest, plan administration should not be identified with either unions or management. If funds were managed apart from either union or employer control, less supervision and concern over unethical fiduciary practices and investments would be required, and a more objective watchdog in union supervision would be obtained. Recent proposals by the President indicate that the trend is toward public regulation. Administrative decisions will still have to be made by plan officials for the foreseeable future, but it would appear that government supervision of plan administration is approaching reality.[182] If this supervision is not unduly restrictive, an even better investment situation may be obtained.

Proposed Legislation

Several bills dealing with minimum funding requirements, reinsurance, and standards of fiduciary responsibility have been introduced in the 90th Congress. Some of these bills are receiving serious consideration, and one or more may be enacted thereby changing existing law relative to some aspects of private retirement. This is particularly so in the case of increased standards of fiduciary responsibility.

The Cabinet Committee recommended that, with regard to stated benefit plans, a minimum funding requirement of full funding of all current service liabilities and full amortization of accrued liabilities. Past service credits

180. 108 CONG. REC. 20941 (1962).

181. U.S. CONGRESS JOINT ECONOMIC COMMITTEE, *supra* note 167, at 45.

182. *Id.* at 30.

would have to be fully funded within 30 years from the inception of a new plan or, in existing plans, within 30 years from the enactment of the proposed requirement. Retroactive increases in the level of benefits would have to be fully funded on the same basis as past service credits, that is, within 30 years after the event giving rise to the liability. As a minimum standard for funding fixed contribution plans, the committee recommended that contribution commitments be realistically related to benefit promised and actually paid.[183]

Assistant Secretary of the Treasury, Stanley S. Surrey, reviewing recent developments in May 1967, outlined several staff proposals for funding and reinsurance. Pointing out the vital need for adequate funds to pay promised benefits, Secretary Surrey noted that no amount of fine print in a pension plan explaining that a vested benefit may be something different in the end from an actual benefit will soothe the feeling of unfairness and deception on the part of the employee, nor will it prevent the real hardship that the deprivation of a vested and therefore expected benefit may mean. Although without a valid basis, an aggrieved employee may indict the employer and his government for any failure of funds.[184] Secretary Surrey further attempted a comparison between pension participants, on one hand, and life insurance beneficiaries and savings depositors on the other. These matters are not analogous because both life insurance and savings accounts are created by contributions of the owners, while most pensions are wholly noncontributory.

Staff proposals for strengthening funding requirements include measuring its funding adequacy by comparing assets with liabilities for vested benefits at least every 3 years. Discarding for the present any attempt to devise standard actuarial assumptions for all factors, the staff found the most meaningful issue to be whether assets will equal vested liabilities and acceptance of this as the ultimate goal for funding. Plans would be given 25 years to reach this goal, and each plan would have a funding target each year — in terms of a percentage of assets measured at market value to vested liabilities — which it must meet, and this target would be increased at an annual rate of 4 per cent of vested liabilities. A more liberal transitional schedule would exist for the first few years after such legislation is enacted.

In order to solve the problem of termination prior to full funding, the staff proposed reinsurance in the form of a common fund to which each plan would make contributions. If a plan is terminated for business reasons, amounts from the common fund would be available to make up the difference between its funding target and its vested liabilities not covered by assets in the plan. This termination protection would not apply to the extent an employer has not met his prescribed funding target, whether because of a deficiency in contributions or an abnormal drop in the value of the assets in the fund. Penalties would be applied to a plan if it remained below its funding target for more than 3 years.[185]

183. CABINET COMMITTEE REPORT 52.
184. Address by Stanley S. Surrey, *supra* note 100.
185. *Id.*

The Javits bill, S. 1103,[186] contains provisions for minimum funding standards. Employer contributions must be sufficient to meet all current costs and existing plans must fully fund all past service costs existing on January 1, 1968, within 40 years from that date. New plans set up on or after this date, or plans that are amended on or after that date to add new past service costs, must fully fund the past service costs within 30 years from the date of amendment or establishment. Experience dificiencies would have to be made up within 5 years from the date the deficiency is determined. This is the only proposed legislation now pending that attempts to establish any minimum funding standards.[187] This bill is probably intended for preliminary discussion rather than actual passage.

Several bills have been introduced dealing with reinsurance. The Hartke bill, S. 1635,[188] also introduced in the House by Representative Kupferman as H.R. 9307,[189] would establish a federal insurance program for private pension plans, administered by the Secretary of Health, Education and Welfare, who has enough burdens under present law. Senator Hartke introduced a similar bill in 1965, S. 1575,[190] which would have insured beneficiaries against loss of benefits arising from either insufficient funding due to a cessation of operations by the employer or losses on the sale of investments required to pay benefits. S. 1635 insures against the first of these contingencies. Limits of protection remain the same – monthly retirement of disability benefits would be insured up to 50 per cent of an employee's average monthly wage in the 5-year period of his greatest earnings or 500 dollars per month, whichever is less. A premium rate would be established by the Secretary, with a maximum of one per cent for each dollar of unfunded obligations. Insurance under this program would be required for tax qualification. Self-employed plans would also be required to insure themselves under this program with the only exception of one or more owner-employees who have established a plan exclusively for his or their own benefit, or their survivors.[191] Without further study, this legislation could create an unwieldy situation.

The Javits bill also contains provisions for a federal reinsurance program to insure against termination of the employer's business before the unfunded liabilities are funded, at a premium not to exceed one per cent of the unfunded liabilities.[192]

H.R. 686,[193] introduced by Representative Holland, also would establish a federal reinsurance program in which all qualified pension plans would have to participate, insuring against loss of benefits due to failure of the employer to contribute because of closing his facilities or due to losses on the sale of fund investments.[194] In the event of a number of plan failures,

186. S. 1103, 90th Cong., 1st Sess. (1967).
187. P-H PENSION & PROFIT-SHARING REP. ¶15,096.
188. S. 1635, 90th Cong., 1st Sess. (1967).
189. H.R. 9307, 90th Cong., 1st Sess. (1967).
190. S. 1575, 89th Cong., 2d Sess. (1965).
191. 21 P-H PENSION & PROFIT-SHARING REP. No. 4, at 5 (1966).
192. P-H PENSION & PROFIT-SHARING REP. ¶15,096.
193. H.R. 689, 90th Cong., 1st Sess. (1967).
194. P-H PENSION & PROFIT-SHARING REP. ¶15,095.

the taxpayers would have a moral obligation to guarantee the success of reinsurance — hardly "private" retirement.

The Labor Department bill, S. 3421, and H.R. 17046, entitled the "Pension Benefit Security Act," in addition to mandatory vesting, also calls for minimum funding and plan termination insurance, excluding plans that provide for fixed contributions and that do not provide an amount expected to be paid as a fixed benefit.

In addition to the present minimum requirement of funding current service costs plus interest on past service liabilities, 100 per cent funding after 25 years is required. Newly created plans would have to reach 20 per cent after 5 years of operation, with the ratio of assets to liabilities increasing by 4 per cent each year thereafter.

Existing plans would enter the funding schedule at current ratios, with a 3 per cent increase in funding each year during the first 5 years operation.

Amendments adding vested liabilities can result in adjusting the funding target. The funded ratio may be decreased in proportion to the ratio that the increased liabilities bear to the plan's total liabilities after amendment. If vested liabilities are increased more than 25 per cent, the added liabilities may be treated as a new plan with separate funding targets.

Reports on funding would be required every three years, and plans failing to meet the standard could be ordered to suspend accumulation of vested liabilities. Enforcement is given to the Secretary of Labor, who can order termination of a suspended plan.

The act proposes the creation of a pension benefit insurance corporation to provide termination insurance to protect plan beneficiaries against loss of benefits. A three-year basis would be used for insurance. Coverage would be equal to the plan's vested liabilities, less 90 per cent of the plan's assets or of the assets needed to meet the funding standard, whichever is greater. The reduction from 100 per cent is designed to provide a uniform limited hedge against loss due to a decline in the securities market.

Premiums would be based upon a uniform percentage of vested but unfunded liabilities. Rates would be set by the corporation, and for the initial three-year period would not exceed 0.6 per cent of the amount insured. Failure to pay premiums would result in cancellation of insurance, and operation of an uninsured plan would be unlawful. Wilful violation of the act would be subject to stringent criminal penalties. A separate fund would be created in the Treasury to hold premiums and other moneys received by the corporation, from which all claims and expenses of operation would be paid.

This legislation is unquestionably the most important pension development during the second session of the 90th Congress. The degree of regulation required is high and makes employers answerable to two federal agencies for pension plans. This is a nontax bill covering areas traditionally handled by tax legislation.

Several major bills have been introduced increasing the standards of fiduciary responsibility. The Yarborough (administration) bill, S. 1024,[195]

195. S. 1024, 90th Cong., 1st Sess. (1967).

the Javits bill, S. 1103, and the McClellan bill, S. 1255,[196] and a companion bill to S. 1024, H.R. 5741,[197] introduced by Representative Perkins, have all been introduced in the 90th Congress. In view of the President's Consumer Protection Message delivered in February 1967, passage of one or more of these bills is almost a certainty.

The administration bill, S. 1024, entitled "The Welfare and Pension Plan Protection Act of 1967," in effect rewrites the Welfare and Pension Plans Disclosure Act to require more detailed disclosure by qualified plans, to provide for yearly audits, impose fiduciary responsibility on plan administrators and make them personally responsible for losses caused by their breach of faith, limit investment in employer company stock by a pension plan, and strengthen enforcement of the disclosure law. Senator McClellan's bill, S. 1255, would go even further in strengthening the Disclosure Act by prohibiting removal of funds beyond the jurisdiction of federal courts, limiting the length of terms of trustees, prohibiting specific acts and increasing penalties for violations. Senator Javits' bill, S. 1103, required an executed trust agreement for the benefit of employees, no deposits of investments outside the United States, independent annual audits open to inspection, and that no officer or employee of the employer or a labor organization can receive loans or special benefits. These requirements would not apply to banks, trust companies, or insurance companies.

Under the Yarborough bill, S. 1024, trust relationships may be created by operation of law. The board of directors of every corporation adopting a pension or profit-sharing plan and the officers of any union signing a contract in which such plans are agreed would become fiduciaries. Prohibited transactions such as sales and purchases to and from an employer go beyond the provisions of sections 503 (c) (4), (5) of the Internal Revenue Code[198] concerning transactions for less than an adequate consideration. In cases of two or more corporate trustees, each trustee is required to use reasonable care to prevent a cotrustee from committing a breach of trust. Exculpatory clauses would be null and void.[199] This legislation could go too far in creating trust liabilities beyond those normally contemplated by a pension trustee.

Representative Pucinski introduced H.R. 1119[200] requiring more detailed disclosure of investment transactions, and Representative Holland introduced H.R. 692[201] requiring disclosure of the turnover of participants in pension plans. It required annual reports on the number of participants whose coverage was terminated during the year, the number who had vested rights, and the number who had various amounts of service.[202] These bills are harmless and would probably add some useful information. Representative Wydler

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196. S. 1255, 90th Cong., 1st Sess. (1967).

197. H.R. 5741, 90th Cong., 1st Sess. (1967).

198. INT. REV. CODE of 1954, §§503 (c) (4)- (5).

199. *Proposed Legislation Affecting Duties of Trustees Under Pension and Profit Sharing Plans*, 2 REAL PROPERTY, PROBATE & TRUST J. 388 (1967).

200. H.R. 1119, 90th Cong., 1st Sess. (1967).

201. H.R. 692, 90th Cong., 1st Sess. (1967).

202. P-H PENSION & PROFIT-SHARING REP. ¶15,092.

introduced H.R. 5906[203] making it a crime to fail to make required contributions to pension plans, imposing a penalty of a 10,000 dollar fine or 6 months imprisonment, or both for a willful violation.[204] This proposal is, of course, completely unrealistic.

Opposition to mandatory funding requirements comes equally from management and labor. The basic reason is the cost to existing plans and the retarding of creation of new plans. Union representatives, concerned with multiemployer plans, point out that the likelihood of termination is remote, and they are historically quite correct. A plan may not be fully funded and yet be actuarially sound. Management opposes minimum funding on grounds of loss of flexibility as well as increased cost, which are both valid objections.

There can be little argument with the principle that employees should have reasonable assurance that promised retirement income will be forthcoming. While minimum vesting would create rights for employees, which had not been voluntarily given by employers, minimum funding merely attempts to assure benefits already promised. And, as with minimum vesting, the question is whether a minimum standard is appropriate and worth the cost. It has been estimated that the Cabinet Committee's minimum funding recommendations would increase costs at least as much as the vesting requirements. Although most plans studied appear to fall within the minimum standards, the increased costs may force some employers to terminate present plans or decrease benefits.[205] The larger hazard appears to be premature termination, within the first 10 years of plan existence.

The most urgent problem in reinsurance is what risks are feasibly insured. To some degree, many terminations are within the employer's control, such as sale or merger of the company. The fragmentation of the private pension system makes it difficult to devise standards equally fair to all tax qualified plans. Consolidation of plans would be one solution to this lack of uniformity. Reinsurance appears to come the closest to this goal since it extends to each plan the assurance of continuity enjoyed by all.[206] Yet, no one can seriously suggest reinsurance as a substitute for adequate funding. Nor can one accurately forecast the cost of reinsurance.

The present tax requirements for funding tend to discourage rather than encourage rapid funding. In preventing the acceleration of tax deductions for contributions, the practical effect is also to retard funding. A program of reinsurance, unless carefully coordinated with minimum funding, would give plans an incentive to fund as little as possible, with high benefits and early vesting. The risks involved could be quite large, particularly in times of recession when there would be a rapid increase in the number of business failures. The proposal of contingent federal liabibity to underwrite emergency situations, such as a stock market debacle or a major recession, has been

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203. H.R. 5906, 90th Cong., 1st Sess. (1967).
204. 22 P-H PENSION & PROFIT-SHARING REP. No. 1, at 2 (1967).
205. Comment, *supra* note 32, at 1269.
206. U.S. CONGRESS JOINT ECONOMIC COMMITTEE, *supra* note 167, at 18.

made.[207] But, as it has been observed, is it fair for consumers to finance the cost of plans and then as taxpayers pay the pensions?[208] Obviously, it is not.

It appears almost certain that standards of fiduciary responsibility will be strengthened by enactment of some of the pending legislation. Funding and reinsurance appear to be on their way, but not so quickly. Actuarial standards have been shelved by the Treasury staff in their study proposals, no pending legislation covers this aspect of pension planning. The only question seems to be one of degree. The extent to which management and labor will no longer have pension discretion in the interest of employee benefit security is a matter of conjecture. Hopefully, careful study will precede the enactment of specific requirements in this regard.

INTEGRATION WITH SOCIAL SECURITY

Another important recommendation made by the Cabinet Committee concerns integration of qualified plans with the basic OASI system. The committee recommended that integration be continued, but that the employer be given credit for no more than one-half of the social security benefit, on the theory that this would be consistent with the financing of OASI benefits through equal tax contribution from employers and employees.[209] This suggestion, which appears destined for serious consideration and probable adoption, will have far-reaching effects upon the existing private pension system.

The committee reasoned that under present tax law, in determining whether the scale of benefits in a proposed plan discriminates in favor of higher paid employees, the Internal Revenue Service includes the benefits paid under OASI to the extent that these are financed by employer contributions. Presently, 78 per cent of maximum benefits are attributable to the employer's contributions. This percentage represents that part of the employee's benefits that cannot be attributed to employee contributions. A plan that would be considered discriminatory in favor of higher compensated employees standing alone may qualify if benefits under the plan together with 78 per cent of the Social Security benefits considered jointly are not discriminatory. The committee's objection to this approach is that it attributes more benefits to the employer than he has paid for with his own contributions and, in fact, credits the employer with everything not directly paid for by the employees.[210] The committee failed to point out why this is any more incorrect than the arbitrary "fifty-fifty" approach they recommended.

The foregoing problem and its solution by the committee is simple to state, but application of it to integrated plans will encounter problems of comparing the total benefits under OASI with the benefits payable under a specific type of pension plan. Benefits under Social Security include life

207. Shield & Fefferman, *The Challenge to the Private Pension System*, 20 J. AM. SOC'Y CERTIFIED LIFE UNDERWRITERS 197, 212 (1966).

208. U. S. CONGRESS JOINT ECONOMIC COMMITTEE, *supra* note 167 at 20.

209. CABINET COMMITTEE REPORT 62-63.

210. *Id.*

annuities, benefits to widows, wives, children and parents, death benefits, and disability benefits. Rarely will be benefits of any private pension plan completely parallel those available under OASI.[211]

President Johnson, in his Message on Older Americans to Congress, submitted on January 23, 1967, called for sweeping increases in Social Security benefits to be financed by increases in the amount of earnings credited toward benefits. Now at a level of 6,600 dollars per year, covered compensation is proposed to increase to 7,800 dollars in 1968, to 9,000 dollars in 1971, and to 10,800 dollars in 1974. Corresponding increases in the rate of contribution will be made to 4.5 per cent in 1969 and 5 per cent in 1973.[212]

On January 2, 1968, President Johnson signed into law H.R. 12080,[213] entitled the "Social Security Amendments of 1967."[214] No immediate increase in the over-all tax rate of 4.4 per cent occurred, but benefit increases began in February 1968, and will continue, increasing the taxable wage base to 7,800 dollars in 1968.[215] Obviously, the extensive increases in benefits, wage base, and tax rates will have a great effect upon private pension plans.[216]

The combination of proposed changes in integration and increases in Social Security benefits and taxes will have to be carefully coordinated with existing pension plans. An examination of the current process of integration and current proposals for its change is necessary to develop the depth of this problem.

Mechanics of Integration

Integration is a means of equating the values under different types of benefit systems for the purpose of establishing factors for comparison. This is required to avoid discrimination in favor of upper level employees. For the purpose of meeting nondiscriminatory coverage requirements, exceptions apply to compensation used in determining OASI benefits.[217] A classification is not considered discriminatory merely because it excludes employees whose entire remuneration is subject to the Federal Insurance Contributions Act (FICA) tax. Neither is a plan considered discriminatory merely because the contributions or benefits based on that part of an employee's compensation that is not subject to FICA tax differ from the benefits that are subject to such tax. A plan is not considered discriminatory merely because the contributions or benefits differ because of any retirement benefits under state or federal law.[218]

Retirement benefits provided under state or federal law are parts of a public system. For integration purposes, the public system is treated as part

211. TAXATION OF DEFERRED EMPLOYER AND EXECUTIVE COMPENSATION 286 (Sellin ed. 1960).

212. 113 CONG. REC. H. 443 (daily ed. Jan. 23, 1967).

213. H.R. 12080 90th Cong., 1st Sess. (1967).

214. *Id.*

215. Pub. L. No. 90-248 (Jan. 2, 1968).

216. 22 P-H PENSION & PROFIT-SHARING REP. No. 22, at 1-2 (1968).

217. Goodman, *Concepts of Integration of Pension and Profit Sharing Plans*, INS. L.J. 721, 722 (1965).

218. INT. REV. CODE of 1954, §401 (a) (5).

of the employer's plan, and his own separate plan picks up where the public system leaves off. The problem of integration then becomes one of determining the value of benefits under the public system, reducing that to a rate of compensation, and then applying this rate to excess compensation under the plan for an offset on account of benefits under the public system or restricting a stepped-up benefit rate under the plan. In determining whether a classification is discriminatory, consideration is given to the total benefits resulting to each employee under the plan and under the public system in ascertaining whether such total benefits establish an integrated and correlated retirement system that satisfies the requirements for qualification.[219] Under the present approach, the solution achieved is admittedly arbitrary.

An integrated plan may be one of three types: an excess plan, an offset plan, or a stepped-up benefit rate plan. An excess plan is one under which employees whose remuneration is below a minimum compensation level, such as 6,600 dollars per year, are excluded either because of an eligibility requirement or because benefits are based only on compensation in excess of the stated level. An offset plan does not exclude any employee or any portion of compensation due to a minimum compensation requirement, and applies uniform benefit rates to all covered employees regardless of the rate of pay, but a higher rate of employer contribution is applicable to compensation above a stated level than to compensation below such level.[220]

The first step in the integration process is to determine a unit of comparison. This provides a standard that establishes the ratio of the benefits under the public system to the compensation on which such benefits apply. The resulting rate is the ceiling on benefits under the employer's plan as applied to compensation over and above the remuneration upon which benefits under the public system are computed. In theory, under a properly integrated plan, the benefits, as a percentage of compensation in excess of the compensation on which the benefits are computed under the public system, are no greater under the employer's plan than under the public system. This percentage is the basic integration rate.[221]

As an illustration, when the maximum compensation level under Social Security was 3,600 dollars, the basic integration rate was 37.5 per cent.[222] This rate remained unchanged when the covered compensation rose to 4,200 dollars and to 4,800 dollars.[223] These rates were established by determining the percentage that the total OASI benefits bore to the maximum average monthly compensation under Social Security and then reducing by the percentage attributable to employee contributions. For this purpose, the total OASI benefits have been considered to be the maximum primary insurance benefit, plus 50 per cent for supplementary and survivor benefits, for a total of 150 per cent of the primary benefit. The proportion of the total benefits

219. Treas. Reg. §1.401-3 (e) (1) (1963).

220. Mimeo. 6641, 1951-1 CUM. BULL. 41, *as modified by* Rev. Rul. 61-75, 1961-1 CUM. BULL. 140. *See also* Goodman, *supra* note 217, at 723.

221. Goodman, *supra* note 217, at 724.

222. Mimeo 6641, *supra* note 220.

223. Treas. Reg. §1.401-3 (3) (2) (i) (1963).

attributable to employee contributions has varied from 6.25 to 22 per cent of the total benefits.[224]

When the basic integration rate was established at the 3,600 dollar level, the primary insurance benefit of 80 dollars was used as the numerator, over the maximum average monthly compensation of 300 dollars as the denominator, resulting in a first step rate of 26.67 per cent. This was then increased by 50 per cent for supplementary and survivor benefits, totalling 40 per cent. This percentage was reduced by 6.25 per cent for the portion attributable to employee contributions, producing a basic integration rate of 37.5 per cent. At the 4,800 dollar level, the maximum primary benefit had risen to 127 dollars and the portion attributable to employee contributions had increased to approximately 22 per cent. Dividing 127 dollars by 400 dollars equals 31.75 per cent, and 150 per cent of that equals 47.625 per cent, reduced by 22 per cent, again produced a basic rate of 37.5 per cent. Adjustments were required for early retirement, death benefits, or where benefits at retirement were not in the form of a life annuity. This rate also required at least 15 years of service and normal retirement age of not lower than 65 for men and 60 for women. Conversions were necessary from the 37.5 per cent rate, applicable to flat benefit plans, to a 1.24 per cent rate for unit benefit plans, and a 9.37 per cent for money purchase plans.[225]

New Integration Rules

The increase in the Social Security wage base to 6,600 dollars in 1965 prompted review of existing integration formulas.[226] One early view considered a basic rate of 27.27 per cent (4800/6600 x 37.5 per cent) for pension plans integrating with compensation above 4,800 dollars per year.[227] This was a simple solution that did not draw the fire of objectors.

In September 1966, the Treasury issued Announcement 66-58,[228] requesting comments upon an illustrative formula derived from the application of existing integration concepts to the new wage base. This approach called for a new basic rate of 24 per cent, applicable to compensation in excess of 4,800 dollars. The Service pointed out that under the 1965 Social Security Act, the maximum benefit payable to an eligible employee retiring in 1966 is 132.70 dollars, or 34.5 per cent of average monthly wages. An eligible employee retiring in the year 2004, the first year of maximum old-age benefits under the Act, would receive a maximum of 168 dollars, or 30.5 per cent of average monthly wages. The average of these percentages is 32.5 per cent. Further, the Service stated that the total OASI benefits continue to be approximately equal in value to 150 per cent of the primary insurance benefits. Therefore, the total maximum benefit with respect to the average employees now in the work force was considered as equivalent to a straight life annuity

224. Treas. Reg. §1.401-3 (e) (2) (1963); Goodman, *supra* note 217, at 724.
225. 79 Stat. 286 (1965).
226. Goodman, *supra* note 217, at 725-26.
227. *Id.*
228. Announcement 66-58, 1966 INT. REV. BULL. No. 38, at 87.

beginning at age 65 of 48.75 per cent of average monthly wage, or 150 times 32.5 per cent.

In considering the percentage of the Social Security contribution now attributable to the employees, the Service assumed that the average employee now in the work force will retire in 1990, and that such employee, eligible for the maximum benefits, will contribute 52.5 (assuming a 3.5 per cent interest rate) or 56.8 per cent (assuming a 3.75 per cent interest rate) of the cost of his Social Security benefits.

The announcement reasoned that even though less than 50 per cent of an employee's benefit is attributable to the employer, since the Social Security system is funded through equal employer-employee contributions, 50 per cent of the total benefit should be attributed to each. In applying a 50 per cent fraction to 48.75 per cent of average monthly wage, regarded as the equivalent of the maximum benefit, a basic rate of 24 per cent was produced. How this percentage is any more or less valid than the present formula was not explained.

Employing this proposed formula, a noncontributory pension plan, integrated at the 6,600 dollar level, could not give an employee normal annual retirement benefits (without death benefits) in excess of (a) 24 per cent of average annual compensation in excess of 4,800 dollars times his pre-1966 service percentage, plus (b) 24 per cent of average annual compensation in excess of 6,600 dollars times his post-1965 service percentage. Average annual compensation was defined as average annual compensation over the 5 highest consecutive years. As a transition, benefits based on service in 1966 and later years would be adjusted to conform to these maximums, and new plans giving credit for service prior to 1966 would also have to comply.

Subsequently, the Treasury issued Announcement 66-71,[229] emphasizing that the foregoing formula should not in any way be construed as a proposal, but was offered only to furnish data on the possible results of an application of existing integration concepts. The reaction to Announcement 66-58 was so overwhelmingly opposed to the bases suggested that the Treasury felt it necessary to support its approach by additional clarification. Chairman Mills of the House Ways and Means Committee elaborated on the tentative nature of this proposal on October 21, 1966,[230] and Secretary of the Treasury Fowler followed with another qualification in an address on October 22, 1966.[231] Even these attempts to mollify objectors have not quelled the storm.

Revenue Ruling 67-10[232] provided interim integration rules for taxpayers establishing new plans or amending the integration features of existing plans, but the Service cautioned taxpayers that these rules should not be interpreted as indicative of the ultimate rules to be incorporated in the amended regulations.

The interim integration formula for a plan providing benefits or employer contributions only with respect to compensation in excess of a compensation

229. Announcement 66-71, 1966 INT. REV. BULL. No. 43, at 62.

230. P-H PENSION & PROFIT-SHARING REP. ¶15,088.

231. *Id.* at ¶15,089.

232. Rev. Rul. 10, 1967-1 CUM. BULL. 84.

level higher than 4,800 dollars per year will satisfy present integration requirements if the rate of benefits or employer contributions with respect to compensation in excess of the compensation level does not exceed the applicable rate determined under the existing formula of 37.5 per cent multiplied by the ratio of 4,800 dollars to the compensation level; that is, a new basic rate of 27.27 per cent. For example, a noncontributory plan that (a) is limited to employees earnings in excess of 6,600 dollars a year, (b) provides no death benefits before retirement, (c) provides normal retirement benefits only in the form of a straight life annuity, and (d) only after completion of 15 years of service and attainment of age 65 will qualitfy if the normal annual retirement benefits cannot exceed 27.27 per cent (37.5 x 48.66) of average annual compensation over 6,600 dollars, where average annual compensation is defined as the average over the highest 5 consecutive years. Determination letters issued to plans satisfying these integration requirements may be relied upon until the amended regulations are issued[233]

The Internal Revenue Service issued its proposed new integration rules in Announcement 68-49[234] in July 1968. The proposed regulations set forth a rate of 30 per cent as the new integration percentage. This figure was arrived at by valuing the maximum Social Security benefit package as a percentage of the maximum wage base and by treating the employer as providing 50 per cent of the package.

Since the average of the rate of maximum Social Security benefits received today and the rate payable in 2006 is 36 per cent of the average monthly wage, total benefits are considered to be 1.5 times this amount, or 54 per cent. If half is attributable to employer contributions, a rate of 27 per cent would result. However, future Social Security changes may raise this rate and, accordingly, the proposed rate is 30 per cent.

A transitional period, not requiring any changes in existing plans until January 1, 1971, is provided. Only benefits accrued for service after December 31, 1970, need conform to the new formula. For benefits for service after this later date, a plan may retain its present integration wage level, although this may not meet the new standards. For example, if a pension plan presently provides a 37.5 per cent pension on wages in excess of 4,800 dollars and no pension on wages below that level it may, under the proposed rules, continue to integrate at the 4,800 dollar wage level with respect to future benefits, even though Social Security benefits are now earned on the first 7,800 dollars of wages rather than 4,800 dollars, as was the case prior to 1966. To retain a nondiscriminatory character it must, however, on or before January 1, 1971, either add a 7.5 per cent pension on wages below that level or reduce the rate of benefits on wages above that level, so that the difference is no more than 30 per cent with respect to wages below that level.

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233. *Id.* at 85.

234. P-H PENSION & PROFIT-SHARING REP. ¶15,089; Announcement 68-49, 1968 INT. REV. BULL. No. 29, at 27.

Review of Proposed Changes

A number of commentators have remarked upon the various Treasury proposals, which have ranged from the 24 per cent of Announcement 66-58 to the presently proposed 30 per cent rate. Vigorous protests greeted efforts to integrate at the 24 per cent level – and well they should. In addition to being a purely arbitrary rate based upon hypothetical assumptions, its use would have been definitely injurious to the private pension system. A 50 per cent assumption of employee contributions is also unrealistic. No one presently receiving Social Security benefits has paid for 50 per cent of the cost. Each of the many increases in the past has been financed out of current contributions made for covered employees not yet retired. In fact, unless the benefit level is frozen, which is unlikely, and the program placed on an actuarial funding basis such a situation can never develop. Even the previous assumption of 22 per cent for employee contributions represented an overstatement, in the face of continued benefit liberalization. Actually, the employee contributions will not reach the 50 per cent level for years – certainly one reason why it may be considered inappropriate to apply a 50 per cent factor now.[235]

An additional criticism notes that the Treasury's continued use of the assumption that survivor and family benefits add only 50 per cent to the primary benefit has created a corollary assumption that an increase in the primary benefits has been paced by an identical percentage increase in supplemental benefits. This assumption grows increasingly implausible. The total value of supplementary benefits is nearly 210 per cent of the primary benefit. The increase in the assumed employee contributions to 50 per cent would come at a time when the value of the primary benfit was assumed to be substantially above its actual level.[236] This is a very pointed criticism of Treasury reasoning.

If a decline in the integration percentage from 37.5 to 30 per cent is adopted, while not as stringent as the 24 per cent proposal of Announcement 66-58, the ultimate result will be a decrease in total retirement benefits above the 6,600 dollar level and growing larger in proportion to increases in covered compensation.

Any change in the integration percentage may lead employers to reduce private pension benefits because of the greater contributions to Social Security, or to meet prior commitments at the risk of greater discrimination in favor of some classes of employees.[237] This result cannot assist the present healthy private retirement system. Many voices in labor and industry speak in favor of retaining the present rate of 37.5 per cent. Lowering the rate to 30 per cent will require many plans to reduce benefits for employees above the wage base or increase benefits for lower paid workers. If the employer could not afford an increase in pension costs, he would be forced to reduce benefits

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235. Bret & Lutz, *Treasury Proposals Would Limit Pension Plan Benefits; Probable Effect of I.R.S. Action*, 26 J. TAXATION 112, 114 (1967).

236. *Id.*

237. *Id.*

above the wage base.[238] A shift in benefits from higher paid employees to lower paid workers would curtail development and extension of the private pension system, in the view of one critic.[239]

A lowering of the integration rate not only will disturb the balance of existing plans but also will retard the structuring of benefits in proportion to the retiree's need to maintain his prior standard of living. Measured by reducing preretirement expenses by those not required after retirement, such as taxes and work-related expenses, the need not covered at each level by Social Security is the private pension goal. A survey of supplemental income needed above the maximum primary benefit, payable in 1988, for individuals with final average earnings of 13,200 dollars, 19,800 dollars, and 26,400 dollars demonstrated the percentage requirements clustered around the 37.5 per cent level.[240] A needs-related program of old-age assistance has long commanded general acceptance.[241]

One basic criticism of any integration rules is that they should be expressed by statute instead of regulations.[242] Actuarial designations for each category of benefits (Old Age Benefits, Survivor and Death Benefits, and Disability Benefits) has been suggested.[243] These standards should be legislatively adopted and not left to the Treasury Department.

However, the compromise rate of 30 per cent is a midground from which some progress may be made. It neither presents a drastic departure from 37.5 per cent, nor does it impose a rigid schedule for transition of existing plans. Recent hearings before the Internal Revenue Service have not yet produced the final formula, but it is hoped that the same spirit of compromise will continue to prevail.

In the view of other commentators, the expansion of the Social Security system and the reduction of the percentage level of integration represents the beginning of the end for the private pension system.[244] The eventual curtailment of private retirement system and its replacement by a two-tier Social Security system has been submitted in theory by some government staff personnel. Consisting of a basic compulsory plan and a voluntary supplementary plan, the basic plan would be mandatory and the additional benefits left to collective bargaining decision or to the choice of the individual self-employed. Larger benefits could be provided because, like Social Security today, both plans would be basically unfunded.[245] This supplementary plan would definitely squeeze the private pension industry to a point where it might be no longer feasible to provide private pension benefits other than the "brass-hat" or executive compensation program used in Great Britain. When one observes the current efforts to increase Social Security benefits,

238. 21 P-H PENSION & PROFIT-SHARING REP. No. 50, at 8 (1967).
239. 22 P-H PENSION & PROFIT-SHARING REP. No. 1, at 5 (1967).
240. Bret & Lutz, *supra* note 235, at 115.
241. U.S. CONGRESS JOINT ECONOMIC COMMITTEE, *supra* note 167, at 26.
242. Goldworn, *supra* note 10, at 250.
243. Bret & Lutz, *supra* note 235, at 115.
244. Lindquist, *Important Trends in Pension and Profit-Sharing Plans*, 44 TAXES 827, 835 (1966).
245. U.S. CONGRESS JOINT ECONOMIC COMMITTEE, *supra* note 167, at 28.

increase Social Security taxes, and decrease the percentage of integration, while proposing other changes to raise costs and increase benefits regarding vesting and funding, it is obvious that some restriction of private pension coverage is inevitable if these efforts continue.

CONCLUSION

Federal regulation of the private retirement system appears certain, with only the question of degree yet to be resolved. The concept of the private pension system as a government-subsidized supplement to OASI forecasts even greater control than initially proposed. Several observations concerning current proposals will be offered to conclude this article.

Growth of the private pension systems has been attributed to lenient tax laws by the Cabinet Committee and Treasury, and this assistance is offered as a reason for federal regulation. To credit only tax policy with the current size of this institution is not accurate. A combination of a number of socioeconomic forces, including high corporate profits during World War II and the impetus of collective bargaining following the *Inland Steel* decision, together with the great depression of the 1930's and the needs of business to attract and retain good employees all worked to develop the private pension system into what it is today. Small business may not have been attracted to private pensions without tax incentives, but major industry would have had to provide private retirement with or without the aid of our tax laws.

It would appear that apart from investment and fiduciary control contained in the Welfare and Pension Plan Disclosure Act, the only effective government supervision of private pensions is exercised by the Internal Revenue Service. But whether this function is really their job may be questioned. A special Retirement Commission, devoted entirely to supervising the private pension system, comparable in scope and authority to the Securities and Exchange Commission, would offer expertise and provide more effective control. The Internal Revenue Service is primarily a revenue collecting agency. Whether a pension plan is functioning properly is hardly a matter for its concern. To its credit, the Service has done a good job of preventing gross abuses in administration and discrimination, but if the private system has grown so large that it requires regulation because of its size alone, then it should be regulated properly. The Internal Revenue Service is not equipped to perform this task. The creation of a federal agency, such as a Retirement Commission, to administer federal laws relating to private retirement is proposed. Further, all except purely tax laws should be removed from the Internal Revenue Code and codified separately. Present tax law performs far more than its intended purpose of collecting national revenue in the field of private retirement. Historically, it simply grew to be this way. This fact does not excuse the results. Appropriate statutes should be designed to treat the problems. A pension and retirement act to preempt the area to control over all private retirement, to be administered by a Retirement Commission, with the power to issue regulations interpreting this legislation, is also proposed.

The Cabinet Committee endorsed the private pension system, noting that public policy should continue to provide appropriate incentives to private plan growth and improving the basic soundness and equitable character of such plans, set a stronger foundation for future development.[246] The most important pension issue today is whether such regulation will permit the private pension system to continue at all.

The primary charges against the private retirement system, brought by the Cabinet Committee, are that despite its rapid growth and basically sound character, it is not growing fast enough. Inadequate vesting, inadequate funding, inadequate coverage, lack of guarantee of benefits and control over administration are the basic issues.[247]

No minimum standard of vesting is provided by present law, with the exception of vesting on termination. Studies subsequent to the Committee's report indicate a trend toward more liberal vesting in private pensions even without any minimum requirements. The core of the present problem is the quality of such vesting. Deferred full vesting, a form frequently used, leaves too great a gap for employees who need to change jobs before retirement. This situation is not only unfair, but has a deterrent effect upon labor mobility. A minimum age requirement also appears to be the one factor limiting effective vesting under present practices. Years of service alone should accomplish the desired purpose and be more effective in providing vesting. Of course, costs are a basic consideration. Vesting should assure promised benefits, not cause them to be eliminated. Related to vesting is the question of transferability of pension credits or portability. Freezing benefits as of the date of separation further reduces the ability of private retirement to maintain an adequate standard of living. The existing OASI machinery would appear to provide the most effective and least expensive method of keeping track of vested credits. Multiemployer pools of pension credits may be voluntarily attempted to maintain investments of pension funds.[248]

If one can assume the validity of the Committee's cost estimates, the best alternative in vesting is a plan of deferred graded vesting, with a 10-year minimum service requirement for vesting 50 per cent of benefits, with full vesting after 20 years of service. This method would provide the greatest benefit security at the least cost.

A transitional period should be offered to plans in which the cost of mandated vesting and funding together will run above 10 per cent of current levels. Several alternatives should be provided to insure flexibility. This procedure should solve the portability problem, while enhancing labor mobility.

Present concern with inadequate funding does not seem justified by studies completed subsequent to the Committee's report.[249] Although data is incomplete for an evaluation of the entire pension system, funding is in-

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246. CABINET COMMITTEE REPORT viii.

247. Shield & Fefferman, *supra* note 207, at 199-201.

248. U.S. BUREAU OF LABOR STATISTICS, *supra* note 55; BANKERS TRUST COMPANY, *supra* note 65.

249. Krislov, *supra* note 140.

creasing in most plans studied, averaging 69 per cent in 1964. The chief assault upon present funding practice centers around overly optimistic promises of benefits and inordinately long funding of past service credits. The dispute is basically over actuarial assumptions. Yet current staff proposals for mandatory funding have omitted any effort at developing standard actuarial assumptions. Lengthy past service funding has not been established as the reason for the spectacular plan failures, Studebaker and Packard, which triggered current funding concern. Both of these plans utilized a 30-year funding schedule for past service credits – the method recommended by the Committee.

The greatest concern should be with premature plan termination. The largest benefit losses occur when plans terminate within the first 10 years of existence.[250] Reinsurance would do more to eliminate these unfortunate results than the most elaborate mandatory funding, short of immediate full funding, an obviously unworkable alternative. Although costs are almost impossible to forecast accurately, a "pool" of premiums from qualified plans to guarantee benefits of all participating plans meeting minimum standards would provide benefit protection at little more than nominal cost to any participant. A higher contribution should be required of plans in the first 10 years of their existence when the risk of benefit loss would be the greatest, and with minimum investment standards, both the risk of loss from premature termination and investment declines should be protected. A suggested premium of one per cent of current cost could be attempted initially. This rate would be an experimental premium since there is no real basis for estimating this cost.

One can hardly dispute the need for more adequate pension disclosure when attempting to gather information with which to evaluate some of the proposals made for private pension legislation. Higher and more definite standards of fiduciary responsibility are also needed. Both should become law during 1968.

Most plans are already funding benefits over the 25- to 30-year period suggested by the Treasury and the committee respectively. This requirement should not add as much to plan cost as mandatory vesting. However, it is believed more important to provide vesting than it is to achieve ultimate fulfillment of an arbitrary funding goal. A transitional period should be provided to enable plans to phase in both vesting and funding requirements when costs for both would be in excess of 10 per cent of current levels. Vesting should have a higher priority. A 30-year funding period for past service credits would seem adequate if coupled with a federally supervised program of reinsurance, administered by a Retirement Commission. If one can again assume the validity of the committee's cost estimates, these proposals would increase total vesting and funding costs by no more than 10 per cent and attempt reinsurance at a one per cent cost. Providing protection when and where needed should be more important than conforming to abstract concepts of pension eqality. These measures will probably retard

250. Beier, *supra* note 153.

some expansion of private pensions, but should be more than replaced by current amendments to Social Security.

No changes are necessary in existing integration concepts. Admittedly, the basic assumptions presently used are arbitrary, but no more so than those used by the Treasury in Announcement 66-58. If a change must be made, and one may well be inevitable, a lengthy transition period should be provided so as to do the least damage to the thousands of plans already integrated at the 37.5 per cent rate.

The Labor Department bill, entitled "Pension Benefit Security Act," introduced during the second session of the 90th Congress, appears more nearly to embody sensible features of mandatory vesting with transitional alternatives, minimum funding with power of enforcement, reinsurance benefits against the risk of premature termination at a reasonable cost, as well as supervision in the hands of the Department of Labor instead of the Internal Revenue Service. This legislation most closely parallels the opinions of this writer on the subjects of vesting, funding, and reinsurance.

The latest Treasury proposals for a change in the integration formula in Announcement 68-49 appear to be more acceptable than earlier versions. While no changes are felt necessary, at least if one is inevitable, a 30 per cent rate is not overly stringent and a fair transitional period is provided.

Government control and minimum requirements are almost a reality. These standards will guide private pensions toward uniformity, equality, and continuity allowing this institution to achieve a position in the front rank of the American economy. Members of Congress should approach the task of writing new laws with utmost caution and inquire exhaustively before accepting recommendations from the Cabinet Committee or Treasury staff. More detailed information concerning the private pension system than is now available should be gathered and analyzed. The future of private pensions depends upon prudent legislation.

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