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Kay G. Finley

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PAPER PREPARED BY STUDENTS IN THE UNDERGRADUATE LAW PROGRAM

THE PENSION REFORM ACT OF 1974: BRAVE NEW WORLD OF RETIREMENT SECURITY*

For many Americans, old age is a time of uncertainties and fears, the worst of which may be the fear of poverty after retirement. Fortunately, such fears have begun to abate in recent years, largely because of society's recognition that care for the elderly is a group responsibility. Social Security[1] and Medicare[2] are two examples of a congressional attempt to implement this concept on a national level. The most recent effort, signed into law on Labor Day, 1974, represents the most sweeping pension reform in this country's history — the Employee Retirement Income Security Act of 1974.[3]

More popularly known as the Pension Reform Act (PRA), this enactment comes 99 years after the establishment of the first private industrial pension plan.[4] Through the intervening years, pension plans have been subject to numerous improprieties because of the lack of effective regulation over their tremendous assets. The Act is a culmination of 14 years of study[5] and represents a determined congressional reaction to such notorious abuses as fiduciary malfeasance, actuarial incompetence, and inequitable forfeiture of pension benefits. It preempts, with minor qualification, all state law relating to employee benefit plans[6] and will necessitate massive revision of the vast majority of private pension programs.[7]

This note considers the historical forces leading to the enactment of the PRA and its operation in light of Congress' purported aim — to assure "the equitable character of [pension] plans and their financial soundness."[8] Special emphasis is given to the subjects of participation, vesting, benefit accrual, funding, and the new provisions for individual retirement accounts.

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*EDITOR'S NOTE: This note received the *Gertrude Brick Law Review Apprentice Prize* for the best student note submitted in the winter 1975 quarter.

1. 42 U.S.C. §§301 *et seq.* (1970).
2. 42 U.S.C. §§1395 *et seq.* (1970).
3. Pub. L. No. 93-406 (Sept. 2, 1974) [hereinafter cited as Act].
4. J. MELONE & E. ALLEN, PENSION PLANNING 1 (1966). The first plan was established by the American Express Company. *Id.*
5. Serious discussion of comprehensive pension reform began as early as the 86th Congress. Lindquist, *The Pension Remodeling Act of 1974,* 52 TAXES 873 (1974). In March 1962, President John F. Kennedy appointed a private pension study committee, which published its report in 1965. PRESIDENT'S COMM'N ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE PLANS (1965).
6. Act §514. The Act will not preempt state insurance, banking, and securities laws. Act §514(b)(2)(A).
7. Childs, *1974 Pension Reform Law Treatment of Participation, Coverage and Distribution,* 52 TAXES 864 (1974). *See generally* FORTUNE, Jan. 1975, at 78.
8. Act §2(a).

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No attempt is made to treat the topic of pensions exhaustively, for that is clearly impossible in a single law review note. Rather, an attempt is made to highlight the important features and thereby present a broad picture of where private pension law has been and where it is heading.

THE RISE OF PENSIONS

Although the beginnings of private pensions date back to the 1800's,[9] these programs did not become widespread until after World War II.[10] This slow rate of growth was due to the fact that the early plans were confined mainly to railroads, banks, and public utilities.[11] Most manufacturing companies, still relatively young at the turn of the century, were not confronted with the problems of superannuation faced by these other industries. Indeed, as recently as 1940, fewer than one-fifth of all employees in commerce and industry – or about 4.26 million – participated in pension plans.[12] Moreover, total assets and reserves in that year were a relatively insignificant $2.4 billion.[13]

In contrast, plan assets are currently estimated to be about $154 billion and are projected to reach $225 billion by 1980.[14] Private programs presently cover approximately 34 million wage and salaried workers,[15] and tax concessions allowed such plans account for a $4 billion annual revenue loss to the federal government.[16] "Of all the social claims that have piled up at the doorstep of the American system in recent times, few entail such sharply rising costs as private pensions," the unfunded obligations of which "represent one-quarter to one-third of the net worth of scores of large companies."[17] Among sizable corporations, payments to pension funds devour the equivalent of 20 percent of pre-tax earnings and the proportion is projected to increase further.[18]

No single element can be isolated as the underlying cause for this spectacular growth of private pensions. Certainly, by institutionalizing and augmenting the concept of an employee's right to retirement benefits, Social Security provided one catalyst for the expansion of such plans.[19] Likewise,

9. See text accompanying note 4 *supra*.

10. *See* J. MELONE & E. ALLEN, *supra* note 4, at 2.

11. *Id.* at 1.

12. INSTITUTE OF LIFE INSURANCE, PRIVATE AND PUBLIC PENSION PLANS IN THE UNITED STATES 3 (n.d.).

13. *Id.*

14. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 170 (1974).

15. R. NADER & K. BLACKWELL, YOU AND YOUR PENSION 5 (1973).

16. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 169 (1974).

17. FORTUNE, Jan. 1975, at 78.

18. *Id.*

19. Between 1935 and 1973, the number of workers covered by private plans increased twelvefold. *Compare* J. MELONE & E. ALLEN, *supra* note 4, at 2, *with* R. NADER & K. BLACKWELL, *supra* note 15, at 5. Plan assets have grown during the same period in excess of one hundredfold. *Compare* J. MELONE & E. ALLEN, *supra* note 4, at 2, *with* H.R. REP. No. 93-807, 93d Cong., 2d Sess. 170 (1974).

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increased longevity[20] and the postwar economic boom[21] added greatly to both the need and the means for such programs. Other factors, however, have contributed as well. Labor unions, relatively insignificant during the early history of pension planning, have blossomed since the 1930's,[22] adding impetus to the growing demands for retirement security.[23] Increased urbanization and the relaxation of family ties, combined with compulsory retirement at age 60 or 65, created a situation in which the elderly, ejected from the work force and unable to fall back on the traditional bonds of land and family, looked more and more to private pensions. But perhaps the most significant reason for the growth of industrial pension programs was the employers' own self-interest. Major tax incentives were created that allowed full deductions for contributions to pension funds.[24] In addition, a pension could be used to attract and retain valued employees until such time as they were no longer productive, and then to induce their voluntary retirement.[25] In sum, private pensions could be used to serve employees, employers, and society all at the same time. Thus, they have evolved as an essential component, along with Social Security and individual savings, in the tripartite key to retirement security.[26]

A PENSION PRIMER

An appreciation of the Pension Reform Act requires an acquaintance with the basic workings of pensions. A *pension plan*[27] may be broadly de-

20. The number of Americans over the age of 65 increased from 3.1 million in 1900, to 9 million by 1940, and to more than 20 million by 1970. READER'S DIGEST, 1973 ALMANAC AND YEARBOOK 368. This figure is projected to exceed 29 million by the year 2000. *Id.*

21. R. NADER & K. BLACKWELL, *supra* note 15, at 15.

22. Union membership has grown from 3.5 million in 1929, to 7 million in 1937, to over 20 million in 1970. R. SMITH, L. MERRIFIELD & T. ANTOINE, LABOR RELATIONS LAW 31, 41, 52 (1974).

23. J. MELONE & E. ALLEN, *supra* note 4, at 10-12.

24. See text accompanying notes 47-49 *infra.*

25. M. BERNSTEIN, THE FUTURE OF PRIVATE PENSIONS 10 (1964); J. MELONE & E. ALLEN, *supra* note 4, at 7-9.

26. Siegfried, *The Role of Private Pensions,* in PRIVATE PENSIONS AND THE PUBLIC INTEREST 7, 9 (1970); *Hearings Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance,* 93d Cong., 1st Sess., pt. 2, at 1265 (1973).

27. Pension plans should be distinguished from two other forms of deferred compensation: profit sharing plans and stock bonus plans. In a profit sharing plan, contributions are made from the profits of the employer, and the amount may be left to the employer's discretion. For example, such a plan may provide that each year the board of directors of the employer will determine the amount to be contributed. L. Lokken, Teaching Materials in Deferred Compensation 132 (1974) (unpublished manuscript, University of Florida Law School Library). *See also* J. MELONE & E. ALLEN, *supra* note 4, at 287-88.

"The distinguishing feature of a stock bonus plan is that all distributions to employees are in stock of the employer corporation. As in the case of a profit sharing plan the employer may retain the discretion to determine yearly the amount of its contribution to the plan," L. Lokken, *supra* at 53, although the contribution is not necessarily dependent on profits. "The requirement that all distributions be in employer stock is inflexible. . . . [Consequently] [s]tock bonus plans are relatively rare." *Id. See also* TREAS. REG. §1.401-1(b)(2)(iii).

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fined as an arrangement between an employer and his employees[28] for the establishment and maintenance of a fund that provides retirement income for the employees.[29] While there are almost limitless permutations of these plans, they generally may be categorized as either defined benefit or defined contribution plans.

A *defined benefit plan* establishes a fixed benefit for each employee, usually based on one of four benefit formulas.[30] Consequently, under a given formula, the amount the employer contributes[31] will be that portion of the defined benefit actuarially calculated to produce the desired pension.[32] Conversely, a *defined contribution, or money purchase, plan* fixes the rate of contribution by the employer,[33] and the amount of the benefit varies in relation to, for example, shifts in the figure to which that rate is applied, such as the employee's salary.[34]

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28. While there are other types of pension plans, such as those established by unions or fraternal organizations, and governmental plans, this note deals only with those established by private employers.

29. Other employee welfare plans often provide health care, insurance, disability payments, or other benefits not directly related to retirement income. These are not considered pension plans and are not within the scope of this note.

30. These formulas include: "(1) a flat amount formula which provides a flat benefit unrelated to an employee's earnings or service [*e.g.*, $75 a month to begin at retirement]; (2) a flat percentage of earnings formula which provides a benefit related to the employee's earnings but which does not reflect his service [*e.g.*, 20% of annual salary or 20% of career average salary. Obviously, under this formula, employer contributions will have to be recalculated after each employee raise to reflect the increased pension resulting from a larger multiplicand]; (3) a flat amount per year of service formula which reflects an employee's service but not his earnings [*e.g.*, $5 a month for each year of service]; and (4) a percentage of earnings per year of service formula which reflects both an employee's earnings and his service [*e.g.*, 1% of career earnings for each year of service]." J. MELONE & E. ALLEN, *supra* note 4, at 37.

It should be noted that upon establishment of a plan, an employer may choose to apply its benefits retroactively to current employees with prior service accumulations. This decision would produce "prior service costs" that would have to be accounted for in determining contributions so as to assure a defined benefit.

31. In the context of pensions, "contribute" means "pay." *Op. No. 8—Accounting for the Cost of Pension Plans* (1966), 2 ACCOUNTING PRINCIPLES BULL. 6539, 6554 (1971).

32. J. MELONE & E. ALLEN, *supra* note 4, at 33. These determinations are based on actuarial assumptions and valuations, taking into consideration such factors as employees' ages and salaries, employee turnover, and anticipated return on the pension fund's investments. *Id.* ch. 4.

33. *Id.* at 33. A typical defined contribution plan would require an employer to make an annual contribution of either a flat amount or a certain percentage of each employee's compensation. It might alternatively require the contribution of a certain amount for a given number of units of production, *e.g.*, 90¢ per ton of steel. A separate account would be set up for each employee, which would be credited with his allocated share of employer contributions and earnings on the fund's investments. At retirement, the total amount in an employee's individual account would be used to provide his benefit, often through the purchase of an annuity contract.

34. Other factors resulting in variation of benefits might include length of service at retirement (the longer the service, the more contributions that have been made and the higher the benefits), the cost of an annuity contract at retirement (if investments at that particular time are bringing lower returns, the same amount of money will purchase de-

Pensions differ according to whether the employees contribute any part of the cost. Thus, a *contributory plan* may allow or even require employees to contribute,[35] while a *noncontributory plan* is financed entirely by the employer. Another means of classification is based on whether the plan is funded or unfunded. *Funded plans* provide for the gradual accumulation of assets, generally in a trust, to meet future demands.[36] On the other hand, *unfunded plans* are operated on a "pay as you go" basis whereby the employer contributes only those benefits actually due and makes no provision for future liabilities.[37]

Typically, pension plans require a minimum period of employment with the company or the attainment of a minimum age, or both, before an employee may participate in, or become a member of, a plan.[38] When an employee meets these eligibility requirements, his *participation*, or membership, in the plan begins and, in the case of a funded plan, the employer starts to make contributions for his benefit. During the employee's years of participation, his pension benefits accrue gradually. In effect, the employee is earning a small part of his pension each year. The annual rate at which this eventual retirement benefit accumulates is the *benefit accrual* rate.[39] For example, a plan might provide for a benefit accrual rate of three percent each year. Thus, during each year, the employee would be credited with an additional three percent of his pension. After ten years he would have accrued 30 percent of his normal retirement benefit and would accrue 100 percent after 33 1/3 years.

The accrued benefits become *vested*,[40] or nonforfeitable, at some point in his participation. Some plans provide for 100 percent vesting after a certain number of years of service; others provide for graduated vesting schedules. Still others defer vesting altogether until the employee retires at the normal retirement age. When an employee is fully vested, his accrued benefit is nonforfeitable, regardless of future employment.[41]

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creased benefits) and the retiree's age or sex (if a particular individual's life expectancy is relatively long, his annual benefits will be correspondingly decreased).

35. Contributory plans usually contain a provision whereby the employer's contributions are proportional to the employee's contributions. Where such contributions are mandatory rather than voluntary, the employee who does not contribute is not entitled to any pension benefits, and the employer contributes nothing toward his retirement. Where the plan allows for voluntary contributions, the employee often may allot up to approximately 10% of his compensation to the pension fund, but if he elects not to contribute, the employer still pays some minimum amount toward his retirement. J. MELONE & E. ALLEN, *supra* note 4, at 58-59.

36. Funded plans utilize any of several actuarial cost methods, only some of which are approved by the American Institute of Certified Public Accountants. For a concise discussion of this area, see *Op. No. 8, supra* note 31, at 6539.

37. *Id.* at 6555. "Pay as you go" is not an acceptable cost accounting method in the opinion of the American Institute of Certified Public Accountants. *Id.*

38. See text accompanying notes 154-189 *infra*.

39. See text accompanying notes 192-207 *infra*.

40. See text accompanying notes 208-228 *infra*.

41. At first blush, the dual schedules (*i.e.*, accrual rate and vesting rate) for determining an employee's nonforfeitable right to a given pension benefits seem superfluous. An employee who is first told that he has earned or accrued X dollars but then informed that he only

To illustrate these concepts, assume that in 1965 the *ABC* Company established and began to fund a noncontributory defined benefit plan providing for a pension equal to 50 percent of the employee's average annual rate of compensation. To be eligible to participate, an employee must have worked for *ABC* for two years. The benefit accrual rate is three percent a year. Full vesting occurs after 25 years — 50 percent after 15 years with an additional five percent vesting during each of the next 10 years. The employee must retire when he reaches age 65, at which time he will begin to collect his pension.

Employee Jones went to work for *ABC* in 1955, when he was 30. In 1975 he earns $12,000. His normal retirement benefit would be 50 percent of $12,000, or $6,000 each year. His accrued benefit would be three percent of that amount multiplied by 20 years, or $3,600. Since the vesting schedule requires 25 years for his accrued benefit to become fully vested, however, he does not have an enforceable right to the $3,600. Rather, he is 75 percent vested -50 percent after the first 15 years, plus five percent times five years. In other words, if Jones were to resign in 1975, he would receive only $2,700 a year, or 75 percent of 60 percent of his normal retirement benefit, and that would not become payable until 1990, when he reached age 65.

ABC would, of course, have to contribute enough money to the pension trust over the years to provide Jones' retirement benefit. In 1965 when the plan was adopted, he would have already accrued 30 percent of his pension. That 30 percent would be part of the plan's past service cost and, depending upon the funding method selected, *ABC*'s contributions for 1965 and subsequent years would include either interest on the amount of unfunded liability[42] or an amount in partial amortization of that liability. *ABC* would also pay each year the portion of eventual pension benefits arising from employees' service in that year.

In contrast to the complexities involved in *ABC*'s defined benefit plan, the *XYZ* Company in 1965 adopted a defined contribution plan that pro-

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has a right to ½ X dollars might feel somewhat bewildered and perhaps even cheated. His natural reaction might be that, at least for the sake of simplicity, there should be only one determinative schedule. While this attitude is understandable, there are arguably valid reasons for the application of two formulas. A basic accrual rate will, of course, always be necessary so as to provide the employer with a steady accretion of pension liabilities and thereby prevent the costly bunching of such liabilities in any one year. Moreover, an incremental accrual rate reflects the fact that an employee is earning only part of his eventual pension benefit each year. On the other hand, a vesting schedule is a device with which to restrict employee turnover and insure loyalty by threatening the forfeiture of all or part of the worker's accrued benefits should he decide to change jobs. While this concept raises serious policy considerations (*e.g.*, whether an employer should be allowed to restrict labor mobility while receiving tax subsidies, or whether an employer should be required to bestow a pension on every employee who comes through his shop), the accounting that would be required to merge the underlying principles of a vesting schedule with those of an accrual schedule would make any hybrid formula more, rather than less, complicated.

42. While paying only the interest on past service costs would merely keep those liabilities from getting larger and do nothing to decrease their size, this was all that was required under prior tax law. TREAS. REG. §1.401-6(c)(2)(ii); H.R. REP. No. 93-807, 93d Cong., 2d Sess. 73 (1974). See text accompanying notes 240-246 *infra*.

vides for a retirement annuity. Each year *XYZ* contributes to its pension trust an amount equal to three percent of each employee's salary for that year. The *XYZ* plan has the same two-year participation requirement and the same normal retirement age but provides for full vesting after 10 years of participation. Employee Smith began working for *XYZ* in 1955 at the age of 30 and was therefore eligible to participate when the plan was adopted in 1965. Smith also earns $12,000 a year, so each year *XYZ* contributes $360 – three percent of $12,000 – to the trust for him. Smith's accrued benefit is simply the balance in his account; that is, the amount of *XYZ*'s contributions plus all investment income allocated to him. After the requisite ten years, the entire amount in his account, $3,600 plus interest, is completely vested. Should Smith resign in 1975, that amount would be used to purchase an annuity contract for him, with payments to begin in 1990.[43]

In view of the relative simplicity of defined contribution plans, the more technical sections of this note consider the most common kind of pension coverage: funded, noncontributory, defined benefit plans.[44] Unless otherwise indicated, the PRA provisions discussed may not be applicable to other varieties of pensions.

THE NEED FOR REFORM

Tax Law

Recognizing the desirability of private pensions, Congress has used tax subsidies since 1926[45] as a means of encouraging employers to set up retire-

43. Plans often provide for early retirement with reduced benefits. *Compare* note 196 *infra*.

44. This statement must be qualified: while defined contribution plans are more numerous, defined benefit plans cover more employees. There are numerous reasons for the prevalence of funded, noncontributory, defined benefit plans. Funded plans allow the smallest outlay of contributions for each employee because payments in early years will earn interest until the employee retires. Also, funded plans provide the greatest retirement security for employees. Should the employer using an unfunded plan become insolvent, all pensions would be severely curtailed or eliminated altogether. Where a plan is *fully* funded, however, employer insolvency will have no effect on accrued benefits. J. MELONE & E. ALLEN, *supra* note 4, at 75-79.

With respect to employee contributions, most plans are noncontributory because employee contributions must always be made with after-tax dollars while employer contributions involve before-tax dollars. Thus, it is much more economical for the employer to simply pay a proportionately lower wage and contribute to a plan without such payments being subject to reduction because of tax liability. M. BERNSTEIN, *supra* note 25, at 217-21.

The abundance of defined benefit plans is attributable to the fact that, in contrast to defined contribution plans, investment risks are borne by the employer, not the employee. It will be remembered that defined contribution plans fix employer contributions but benefits vary, in part because of variations in investment yields. Under a defined benefit plan, however, the benefits are fixed and any discrepancy in investment returns must be accounted for through increases or decreases of employer contributions. Because retirement security is an important aspect of deferred compensation, most rank-and-file workers prefer defined benefits. L. Lokken, *supra* note 27, at 54.

45. R. NADER & K. BLACKWELL, *supra* note 15, at 15.

ment plans for their employees. Until 1942, in effect, three basic tax breaks were extended to all pension trusts.[46] First, employers could deduct their contributions when they were made.[47] In addition, the income earned on the accumulated contributions was exempt from taxation.[48] Finally, the amounts contributed were not currently taxable to the employees;[49] their tax liability arose only as they actually received the benefits after retirement. Because pension income was usually less than the pensioners' earnings during their working years, the payments were taxed at lower marginal rates.

Unfortunately, however, Congress' plan did not always work to the benefit of those employees for whom it was intended. High-ranking corporate officers often set up pension plans for themselves and excluded all other employees from participation.[50] As a result, the Treasury Department urged amendments to the tax provisions that would have been "so strict . . . as to disallow the favorable tax treatment for the great bulk for [*sic*] even the bona fide pension plans."[51] Unwilling to abolish the privileges granted to bona fide pension plans and equally unwilling to permit further abuse of those privileges, Congress responded in 1942 with something in the nature of a compromise[52] — the "qualified" pension plan.[53] To retain the tax benefits of earlier law, plans had to be broadened in their coverage so as not to discriminate in favor of officers, stockholders, or highly paid employees.[54] There were also other qualification requirements, many of which were the same as under the pre-1942 tax provisions. A pension plan had to funnel con-

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46. J. SEIDMAN, 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS — 1953-1939, at 1377 (1954).

47. Int. Rev. Code of 1939, §23(p).

48. Int. Rev. Code of 1939, §165(a).

49. Int. Rev. Code of 1939, §165(b).

50. J. SEIDMAN, *supra* note 46, at 1385.

51. *Id., citing* 88 CONG. REC. 6378 (1942) (remarks of Representative Disney).

52. *Id.*

53. Int. Rev. Code of 1939, §§23(p), 165 (now INT. REV. CODE OF 1954, §§401-04).

54. The statute sets out a rule of thumb: a plan is considered not to discriminate in coverage if at least 70% of all employees with 5 years of service participate, or if 70% are eligible and 80% of the eligible employees actually participate. Int. Rev. Code of 1939, §165(a) (now INT. REV. CODE OF 1954, §401(a)(3)). This standard is stated in terms of alternatives primarily to encompass both contributory and noncontributory plans. For example, a plan could have eligibility requirements that would permit 70% of the employees to participate but also require employee contributions of a certain amount of salary. If the contribution were so burdensome that only the highly paid employees would be willing to participate, the plan would be discriminatory in fact. See Rev. Rul. 72-58, 1972-1 CUM. BULL. 111. To guard against this sort of hidden discrimination, the Internal Revenue Code contains the "80% of 70%" formula. If 80% of the eligible employees actually participate, the plan is deemed not to discriminate in coverage.

Other tax incentives were granted to qualified plans also. Death benefits paid to an employee's beneficiary are not includible in the employee's gross estate for federal estate tax purposes, INT. REV. CODE OF 1954, §2039(c); nor is the first $5,000 includible in the beneficiary's gross income, despite the fact that the employee had a vested right to receive the benefit during his life, INT. REV. CODE OF 1954, §101(b)(2)(B). In addition, lump sum distributions of pension benefits were accorded capital gains treatment until 1969 when Congress began to phase out such treatment. INT. REV. CODE OF 1954, §402(a)(5).

tributions through a trust,[55] and the plan had to operate for the exclusive benefit of employees.[56]

The tax treatment accorded nonqualified plans was considerably less favorable. An employer could deduct contributions only if the employee's rights to those contributions were vested when the contributions were made, and only in the year of payment.[57] A nonqualified trust was taxed on the "interest"[58] it earned,[59] and contributions had to be included in the employee's gross income if his rights were vested when the employer made the contributions.[60] In other words, the employer could deduct the contribution only if the employee realized taxable income when it was made.[61]

Until 1962 sole proprietors and partners who maintained qualified plans for their employees were not allowed to deduct any contributions made on their own behalf.[62] As this situation tended to discourage small employers from adopting pension plans,[63] Congress amended the Internal Revenue

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55. Strictly speaking, it is the trust that qualifies. If a plan meets the requirements of §401(a), then the trust is qualified for tax exemption under §501(a). Plans with qualified trusts are called "qualified plans," as are those plans otherwise meeting the requirements of §401(a) but utilizing certain custodial accounts or annuity contracts in lieu of trusts. INT. REV. CODE OF 1954, §§401(f), (g). As used in this note, the term "qualified plan" has its more usual meaning: a pension plan with a qualified trust.

56. Although it need not provide benefits for all employees, a plan must benefit the employees in general. TREAS. REG. §1.401-1(b)(3). This interpretation reinforces the anti-discrimination provisions and has served as the peg on which many court decisions involving alleged discrimination have been hung. *See, e.g.,* Loevsky v. Commissioner, 471 F.2d 1178 (3d Cir.), *cert. denied,* 412 U.S. 919 (1973); Cornell-Young Co. v. United States, 469 F.2d 1318 (5th Cir. 1972); Auner v. United States, 440 F.2d 516 (7th Cir. 1971); Container Serv. Co. v. United States, 345 F. Supp. 235 (S.D. Ohio 1972); Hall v. United States, 303 F. Supp. 326 (D. N.Dak. 1969), *remanded by* 398 F.2d 383 (8th Cir. 1968); John Duguid & Sons, Inc. v. United States, 278 F. Supp. 101 (N.D.N.Y. 1967); Bernard McMenamy, 54 T.C. 1057 (1970). Courts have uniformly looked beyond the plan's description to its actual operation to determine whether it discriminates in favor of the prohibited class – officers, shareholders, and highly paid employees.

Recognizing that employer contributions constitute one-half of Social Security taxes, the Treasury Department has allowed reductions in employer payments to private pension trusts so as to "avoid making duplicating contributions to Social Security and the qualified plan with respect to the same compensation." L. Lokken, *supra* note 27, at 132.

57. H.R. Rep. No. 77-2333, 77th Cong., 2d Sess. (1942), *cited in* J. SEIDMAN, *supra* note 46, at 1381. There was no carryover of excess deductions to subsequent years, as is the case with qualified plans. INT. REV. CODE OF 1954, §404(a)(1)(D).

58. "Interest" includes investment earnings in pension terminology. *Op. No. 8, supra* note 31, at 6555.

59. H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 110 (1974).

60. Int. Rev. Code of 1939, §§23(p), 165(a), (b) (now INT. REV. CODE OF 1954, §§401-04, 641).

61. This must have created some interesting conflicts. Employees, on the one hand, were torn between a desire to have vested pension rights and a desire to avoid paying taxes on money they would not receive until retirement. On the other hand, employers wanted to deduct the contributions but also wanted to delay vesting until retirement.

62. J. MELONE & E. ALLEN, *supra* note 4, at 19.

63. *Id.*

Code in 1962 to allow deductions for contributions made on behalf of sole proprietors and partners.[64]

Given the tremendous amounts of money involved in pension funds,[65] with current aggregate yearly contributions of $20 billion,[66] employers have a powerful incentive to ensure that their pension plans qualify for the preferential tax treatment. The price of this preference to employers has been the extension of pension benefits to rank-and-file employees.[67] The congressional grant of $4 billion in annual tax subsidy[68] was justified only if the broad

64. At first, individual proprietors and partnerships were denied the tax benefits granted to corporations in establishing qualified plans in which the owners could participate. In 1962 this inequality was removed with the passage of the Self-Employed Individuals Tax Retirement Act (H.R. 10), Pub. L. No. 87-792 (1962). Sole owners or partners of unincorporated businesses, termed "owner-employees" in §401(c)(3) of the Internal Revenue Code, were for the first time permitted to set up plans in which they could participate (Keogh plans, so named for one of the sponsors of the bill). The purpose of enacting H.R. 10 was "principally to encourage employers to adopt plans covering a broad range of employees." L. Lokken, *supra* note 27, at 31. Special rules were added, however, to assure that such plans would actually be used to provide pensions and not merely as a means of putting aside money earned in a good year to be "distributed" in a less profitable year and taxed at lower rates. In other words, Congress sought to keep H.R. 10 plans from becoming tax-sheltered opportunities for owner-employees and shareholder-employees to select the year of taxation most favorable to them. Consequently, no payments can be made to an owner-employee before he is 59½ years old, unless he becomes disabled. INT. REV. CODE OF 1954, §401(d). H.R. 10 plans must cover *every* employee with 3 or more years of service, *id.*, and employees' rights are nonforfeitable when the contributions are made. *Id.* H.R. 10 restricted annual contributions on behalf of an owner-employee or a shareholder-employee of a Subchapter S corporation to the lesser of $2,500 or 10% of his earned income. Violation of this limitation could result in a number of penalties, including the permanent disqualification of the plan with respect to the owner or partner.

The PRA increases the contribution ceiling to the lesser of $7,500 or 15% of earned income or compensation but restricts to the first $100,000 the amount of earned income of an owner-employee or shareholder-employee that can be considered in applying the percentage limitations. These two ceiling figures appear to contradict each other: $7,500 is only 7½% of $100,000, or 15% of $50,000. In the context of the problem addressed by Congress, however, it takes on meaning with regard to the general policy of nondiscrimination. S. REP. No. 93-383, 93d Cong., 1st Sess. 28 (1973). Under prior law, $2,500 represented a minute proportion of the very substantial income earned by some owner-employees. Section 401(a)(5) of the Internal Revenue Code specifically provides that a uniform relationship of contribution to compensation is not considered discriminatory. If the same percentage rate were applied to lower-salaried, nonowning employees' income, the contributions on their behalf would be nominal. For example, an owner-employee with income of $200,000 would reach his contribution limit at 3.75%. The same rate of contribution for an employee earning $10,000 would result in annual contributions of $375 — a sum not likely to provide much retirement security. Thus, under the PRA, if an employer wants to take full advantage of the $7,500 deduction, he must contribute 7½% of his employees' salaries to the plan. *Id.*

65. See text accompanying note 14 *supra.*

66. FORTUNE, Jan. 1975, at 78.

67. L. Lokken, *supra* note 27, at 63.

68. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 169 (1974). *But see* Goetz, *The Myth of Special Concessions for Qualified Pension Plans,* 51 IOWA L. REV. 561 (1966). Professor Goetz' premise is that the tax treatment accorded qualified plans is the norm under general taxing principles and the treatment given to nonqualified plans is the deviation. *See also* Goetz, *Tax Treatment of Private and Public Pension Systems,* in PRIVATE PENSIONS AND THE PUBLIC INTEREST 85 (1970).

social aim of retirement security for more workers was furthered.[69] Still, tax law had its inherent limitations. Even if a pension plan were found to be discriminatory, the only sanction was disqualification. While this would disallow at least a part of the employer's deductions, thereby increasing the amounts necessary to fund a defined benefit plan,[70] disqualification would also punish the very person for whose benefit Congress initially granted the subsidy – the employee.[71] His pocketbook would be invaded by increased tax liability during his peak earning years. Because his marginal tax rate would be higher then than after retirement, the total tax paid on his pension would be greater. It is not surprising that tax regulation of pension plans has proved inadequate to protect the employee's interest, however, for the primary function of taxes is to raise revenue. The primary weapon with which to enforce congressional determinations of social policy in the tax arena is the imposition of additional taxes or the elimination of previous tax preferences.

Labor Law

With the exception of the Internal Revenue Code's regulation of qualified trusts, the first direct federal intervention in pension fund administration came with the Labor Management Relations Act of 1947 (LMRA).[72] Tax law, through its typical use of carrot and stick, had neglected the soft midsection of the pension formula. Union management of members' funds was virtually unregulated. Scandalous cases of extortion, bribery, and official misconduct began to surface shortly after the end of World War II.[73] The threat of plan disqualification was of little intimidating effect to indifferent and unscrupulous union officers charged with the administration of the vast holdings of pension funds. Section 302(c)(5) of the LMRA[74] was a congressional prescription designed to ensure that union fiduciaries were given a stake in the unmolested transfer of pension benefits from employer to employee.

The LMRA exempted pension contributions from a general prohibition against payments by management to labor organizations[75] and established broad guidelines governing the administration of the funds by union officials. Among other requirements, union pension funds were to be audited annually and were to be kept in separate accounts to prevent commingling with other union funds. Most significant, however, was the requirement

69. L. Lokken, *supra* note 27, at 64.

70. Since trust income would be taxable, the employer's contributions would have to be larger to provide the same retirement benefit.

71. *Hearings Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pt. 1, at 249 (1973).

72. 29 U.S.C. §§141-88 (1970).

73. Landau, Merholtz & Perkins, *Protecting a Potential Pensioner's Pension – An Overview of Present and Proposed Law on Trustees' Fiduciary Obligations and Vesting*, 40 BROOKLYN L. REV. 521, 535 (1974).

74. 29 U.S.C. §186(c)(5) (1970).

75. *Id.* §186(a).

that pension funds be administered for the "sole and exclusive benefit" of the union membership.[76] Courts interpreted this provision to mean:

> The trustees of such a trust, while possessing a large measure of discretion in prescribing conditions of eligibility for benefits, owe a fiduciary duty to the employees and may neither impose unreasonable conditions of eligibility nor act arbitrarily in determining who is eligible.[77]

Criminal sanctions were imposed for violations of section 302, prescribing fines of up to $10,000 or one year imprisonment, or both.

The 1959 enactment of the Labor Management Reporting and Disclosure Act (LMRDA)[78] supported the LMRA by prescribing common law fiduciary standards for the administration of union pension funds.[79] Also in 1959, Congress passed the Welfare and Pension Plan Disclosure Act (WPPDA),[80] designed to uncover the mechanical operations of virtually every private pension plan having 26 or more participants.[81] An enforcement apparatus, created by amendment in 1962, imposed criminal sanctions for violations of the Act. Fundamentally, WPPDA required (1) the filing with the Secretary of Labor of a detailed description of the plan within 90 days of its establishment; (2) annual reports to the Secretary divulging plan assets, liabilities, and employer contributions; and (3) retention and availability of plan records for inspection by participants. In addition, WPPDA provided for civil enforcement of the Act by covered employees.

Collectively, the LMRA, LMRDA, and WPPDA provided the first governmental delineation of fiduciary standards for trustees of pension funds.[82] Although helpful within its intrinsic limitations, this legislative poultice called attention to other problem areas. There was still no assurance that employees would ultimately receive the funds ostensibly allocated for their benefit. Plan termination insurance was needed, since even the soundest investments can backfire. Furthermore, unless plans were adequately funded, the imposition of fiduciary standards was in many cases an exercise in futility, like installing a vault to protect a piggy bank. Moreover, without provisions for vesting, even the piggy bank might be forfeited. Clearly, more was required. The challenge was to cure, not to palliate.

Common Law

State law has been singularly ineffectual in meeting this challenge.

76. *Id.* §186(c)(5).

77. Lee v. Nesbitt, 453 F.2d 1309, 1311 (9th Cir. 1971). *Accord,* Roark v. Boyle, 439 F.2d 497 (D.C. Cir. 1970); Roark v. Lewis, 401 F.2d 425 (D.C. Cir. 1968); Kosty v. Lewis, 319 F.2d 744 (D.C. Cir. 1963); Danti v. Lewis, 312 F.2d 345 (D.C. Cir. 1962).

78. 29 U.S.C. §§401-531 (1970).

79. *Id.* §501. Section 501(b) of the LMRDA provides remedies for the breach of §501(a) fiduciary duties, including, but not limited to, damages.

80. 29 U.S.C. §§301-09, *repealed by* Act §111(a)(1).

81. 29 U.S.C. §303 (1970).

82. Landau, Merholtz & Perkins, *supra* note 73, at 547.

Traditionally, state regulation of employees' entitlement to pension benefits developed through judicial extrapolation of common law. Two basic theories were employed for this purpose: gratuity and contract.[83] Under the gratuity concept, employer contributions toward retirement income were designated gifts to their employees and, as such, were revocable at will.[84] In rare instances state courts held an employer's pension promise irrevocable on the basis of promissory estoppel.[85] Thus the promise, although a gratuity, became binding as the result of an employee's justifiable and detrimental reliance, evidenced by continued and faithful service.[86] In contrast to the gratuity principle, the contract theory considered pension plans to represent contractual obligations for deferred compensation undertaken in exchange for services rendered. As consideration for faithful service, pension benefits were the subject of a unilateral contract – a promise for a completed act – "and once the act is *completed* by the acceptor [the employee] the offer cannot be modified or withdrawn."[87]

The results of this juridical pigeonholing are irreconcilable. Protection under the contract theory was minimal, for benefits did not vest until completion of tenure upon retirement. Nonetheless, it represented a relative panacea in contrast to the utter lack of protection afforded workers by gratuity principles. Plainly, this piecemeal approach to the burgeoning phenomenon of private pensions was inadequate. The protrusion of common law principles[88] merely aggravated existing inequities between an employer and his employees. A pension is neither a gratuity nor simply consideration for long and faithful service, but constitutes deferred compensation that, but for its deferral, would have been manifested in take-home pay or fringe

83. Annot., 42 A.L.R.2d 461 (1955).

84. *See, e.g.*, Menke v. Thompson, 140 F.2d 786 (8th Cir. 1944), holding that all pensions are mere gratuities and, as such, are property of the company. *Id.* at 790; Hughes v. Encyclopaedia Britannica, Inc., 1 Ill. App. 2d 514, 117 N.E.2d 880 (1954), which held that the employer possesses unilateral authority as to the nature of the plan. *Id.* at 520, 117 N.E.2d at 882; Dolan v. Heller Bros. Co., 30 N.J. Super. 440, 104 A.2d 860 (1954), stating: "[I]t seems well settled in other jurisdictions that a pension plan that is purely voluntary on the part of the employer and to which the employee makes no contribution, is not an enforceable contract, but a mere gratuity, in which the employee has no vested right until he begins to receive benefits thereunder." *Id.* at 443, 104 A.2d at 861; Friedman v. Romaine, 77 Misc. 2d 134, 352 N.Y.S.2d 351 (Sup. Ct. 1974), where the court said: "It has long been the law with respect to pension plans . . . that the setting up of such a plan is entirely voluntary on the part of the employer and that the benefits conferred thereby are gratuities which the employer has the right to refuse or discontinue as circumstances warrant." *Id.* at 140, 352 N.Y.S.2d at 357; McNevin v. Solvay Process Co., 32 App. Div. 610, 53 N.Y.S. 98 (Sup. Ct. 1898), *aff'd*, 167 N.Y. 530, 60 N.E. 1115 (1901).

85. *See* Hunter v. Sparling, 87 Cal. App. 2d 711, 197 P.2d 807 (Dist. Ct. App. 1948).

86. *Id. Contra*, Hughes v. Encyclopaedia Britannica, Inc., 1 Ill. App. 2d 514, 521, 117 N.E.2d 880, 882 (1954).

87. Schofield v. Zions Co-op Mercantile Institution, 85 Utah 281, 287, 39 P.2d 342, 344 (1934) (emphasis added). *See also* Sheehy v. Seilon, 10 Ohio St. 2d 242, 227 N.E.2d 229 (1969); Jacoby v. Grays Harbor Chair Mfg. Co., 77 Wash. 2d 911, 468 P.2d 666 (1970).

88. See text accompanying notes 83-87 *supra*.

benefits.[89] The pension provisions of labor and tax law represented an implicit congressional acknowledgment of this principle but were inadequate to protect the employee's pension rights.[90] With private pension programs mushrooming in both number and complexity,[91] the need for a unified and comprehensive approach to federal regulation had become critical by 1974.

EMPLOYEE RETIREMENT INCOME SECURITY ACT

The Pension Reform Act is the most formidable legislative product of the 93d Congress.[92] While the Act does not require any employer to establish a retirement program, its regulatory provisions govern all private pension plans established or maintained by employers or groups of employees engaged in or affecting commerce.[93] Because of the PRA's omnibus nature, some general observations may serve to place in perspective its funding and coverage features.

Administration and Enforcement

Two facets of the Act's administrative and enforcement apparatus are immediately apparent. First, ministerial authority is apportioned among two executive departments, Labor and Treasury, and the newly formed Pension Benefit Guaranty Corporation.[94] Regulatory provisions are to be administered by the Secretary of Labor, tax provisions by the Secretary of the Treasury, and the insurance provisions by the Pension Benefit Guaranty Corporation.[95] Most requirements for pension plans are set out twice in the Act, once in Title I (Labor)[96] and again in Title II (Tax).[97] This overlap is understandable in view of the evolution of federal pension law. Since pre-1974 tax regulation alone was inadequate to assure employee protection,[98] and, since the Labor Department was clearly not geared to administer tax law, it was inevitable that any statutory scheme for bringing

89. M. BERNSTEIN, *supra* note 25, at 45. *See* R. NADER & K. BLACKWELL, *supra* note 15, at 17; *Hearings, supra* note 71, at 245.

90. See text accompanying notes 14-18, 70-71, and following note 82 *supra*.

91. See note 19 *supra*.

92. The Act is the direct culmination of 5 separate bills, Childs, *supra* note 7, at 865, respectively considered by four standing committees (Senate Finance, Senate Labor and Public Welfare, House Ways and Means, and House Education and Labor) as well as the conference committee. Divided into 5 titles, it includes 39 key definitions and adds, amends, or repeals 135 separate Internal Revenue Code provisions.

93. Act §4(a). Plans excluded from the coverage provisions of Title I include governmental plans, church plans, plans complying with workman's compensation, disability and unemployment laws, plans maintained outside the United States for the benefit of persons substantially all of whom are nonresident aliens, and excess benefit plans. Act §4(b).

94. Act §§3001-04; see text accompanying notes 135-143 *infra* for a discussion of the Pension Benefit Guaranty Corporation.

95. *Id.*

96. Act §202(a)(1)(A).

97. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410.

98. See text accompanying note 70 *supra*.

all pension law under a single umbrella would have to encompass both departments.

The second significant characteristic of the PRA is that it has teeth. Coercive interference with a participant's or beneficiary's rights under the Act constitutes a criminal offense,[99] as does a willful violation of any reporting or disclosure provision.[100] In addition, civil actions may be brought by the Secretary of Labor as well as by any participant, beneficiary, or fiduciary to recover benefits due or enforce rights under the terms of a plan, remedy fiduciary breaches, or enjoin or obtain other equitable relief for the violation of Title I of the Act.[101] Federal district courts have broad jurisdiction to hear these actions[102] and the Tax Court is granted jurisdiction to issue declaratory judgments for income tax qualification purposes.[103] While employees' remedies are enhanced through the creation of new rights under the Act, perhaps the most significant aspect of enforcement is that, for the first time, employers have the right to a judicial determination of the qualified status of their plans before committing substantial funds.[104]

The effectiveness of the employees' remedies will depend to a large extent on the reporting and disclosure provisions. The PRA substantially increases the amount of paperwork involved in maintaining a plan. Trust administrators must file reports in unprecedented numbers with participants, the Secretaries of Labor and the Treasury, and the Pension Benefit Guaranty Corporation.[105] Aside from the sheer volume, the most vexatious feature of reporting and disclosure is the unavoidable overlap among the various regulatory agencies. That Congress recognized this as a potential problem is evidenced by entreaties to the departments concerned to coordinate report-

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99. Act §§510-11. Violations are punishable by a fine of $10,000 or 1-year imprisonment or both.

100. Act §§501, 101-10. Violations are punishable by a $10,000 fine or 1-year imprisonment or both, for an individual, or by a fine of $100,000 for "a person not an individual." Act §501.

101. Act §502.

102. *Id.* District courts are granted original jurisdiction without regard to diversity of citizenship or the amount in controversy. Suits may be brought where the plan is administered, where the breach occurred, or where the defendant resides or may be found. *Id.* "State courts have concurrent jurisdiction in actions brought by a participant or beneficiary to recover benefits, enforce rights, or to clarify rights under the terms of a plan (as distinguished from an action involving a violation of the Act)." Overbeck, *Persons Upon Whom Duties and Obligations Are Imposed Under the Employee Retirement Income Security Act of 1974,* 52 TAXES 881, 893 (1974).

103. Act §1041(a), *to be codified as* INT. REV. CODE OF 1954, §7476.

104. Under prior law, employers had no effective appeal from an IRS determination, or refusal to make a determination, that a proposed plan failed to qualify for special tax benefits. The employer was allowed to go to court only after he had established a plan, contributed to it, made deductions and then had those deductions disallowed by the IRS. Because of the costly nature of this process, both in money and time, employers rarely disputed Service rulings even when they disagreed with the Service's position. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 106 (1974).

105. *See, e.g.,* Act §§101-09, 209, 302(c)(8), 1033, 4007, 4043, 6057(a), 6058(b).

ing wherever possible.[106] Nonetheless, one skeptical commentator has remarked:

> Perhaps this Congressional direction will have a salutary negative effect on the proliferation of forms and reporting requirements. However, based on experience, one has some apprehension that Congress may find it is in the same position as King Canute when he commanded the tides of the ocean not to roll in.[107]

As noted earlier, violation of the reporting and disclosure provisions may result in criminal penalties.[108]

Fiduciary Obligations

The PRA imposes a higher standard of care on fiduciaries than does the common law. Every plan fiduciary is required to act solely in the interests of the plan's participants and beneficiaries, for their "exclusive benefit, and with the care, skill, prudence and diligence under the circumstances that a prudent man acting in a like capacity and familiar with such matters would use in conducting an enterprise of like character and with like aims."[109] To minimize investment risks, the Act generally requires diversification of plan assets unless prudent to do otherwise[110] and places a 10 percent limit on investments in employer-issued securities and employer-used real estate.[111] With some exceptions,[112] fiduciaries may not engage in the following transactions between the plan and a party in interest:[113] the sale, exchange, or lease of property; the lending of money or any other extension of credit; and the furnishing of goods and services. In addition, the fiduciary is prohibited from transferring any plan income or assets to or for the use of a party in interest.[114] Violations result in a five percent excise tax on the amount involved,[115] with an additional 100 percent tax imposed on the party in interest if the transaction is not corrected after notice from the Internal Revenue Service.[116] Personal liability is imposed on a fiduciary for his own

106. *See, e.g.,* Act §§1033(e), 3004(a), 4065.

107. Overbeck, *supra* note 102, at 888.

108. See note 100 *supra.*

109. Act §404(a)(1).

110. Act §404(a)(1)(C).

111. Act §407.

112. Act §408. The Secretary of Labor, after consultation with the Secretary of the Treasury, is authorized to grant exceptions if he finds the transactions administratively feasible, in the interests of the plan and its participants and beneficiaries. Act §408(a). For the other numerous exceptions, see Act §408(b).

113. Act §3(14) defines "party in interest" broadly to include, *inter alia,* employers; unions with participating members, fiduciaries, and employees and officers of a plan.

114. Act §406(a); Act §2003(a), *to be codified as* INT. REV. CODE OF 1954, §4975(c)(1). Under prior tax law, such transactions had only to be fair and reasonable. INT. REV. CODE OF 1954, §§503(a)(1)(B), (b).

115. Act §2003(a), *to be codified as* INT. REV. CODE OF 1954, §§4975(a), (b).

116. *Id.* Thus, a total excise tax of 105% is possible. Payment of these taxes does not

breaches[117] although, where the trust instrument specifically allocates duties, he will generally not be liable for the dereliction of a co-fiduciary.[118] Bonding is required of most fiduciaries and other persons who handle plan assets.[119]

Contribution and Benefit Limitations

Because private pensions are considered supplementary retirement income and are subsidized by every other taxpayer,[120] the Act imposes ceiling limitations on contributions and benefit payments to assure that pension benefits are not "swollen completely out of proportion to the reasonable needs of individuals for a dignified level of retirement income."[121] In keeping with the distinctive character of each kind of plan, limits are placed on the contributions that may be made to a participant's account under a defined contribution plan and on the benefits that may be paid out under a defined benefit plan. For defined contribution plans,[122] annual additions[123] to a participant's account may not exceed the lesser of 25 percent of his compensation or $25,000.[124] For defined benefit plans,[125] the PRA limits yearly benefit payments to the lesser of 100 percent of the average annual compensation for the participant's highest three consecutive years, or $75,000.[126] Exceeding these ceilings will result in disqualification of the trust for tax

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relieve the party in interest of his obligation to repay to the plan the amount involved in the prohibited transaction.

117. Act §409.

118. Act §405.

119. Act §412. Persons other than fiduciaries who would handle plan assets would include, for instance, clerical personnel and the administrative staff of the pension plan. Exceptions to the bonding requirement include fiduciaries that are corporations organized and doing business under the laws of the United States or any state, persons authorized under state or federal law to exercise trust powers or to conduct an insurance business, persons subject to supervision or examination by federal or state authority, and persons with a combined capital and surplus in excess of at least $1 million. *Id.*

120. See text accompanying note 68 *supra.*

121. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 112 (1974).

122. See text accompanying note 33 *supra.*

123. "Annual additions" means the sum of the employer's contributions, the lesser of half the employee's contributions or the employee's contribution in excess of 6% of his compensation, and any other participants' forfeitures that are added to his account. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(c). It does not include tax-free transfers ("rollovers") between qualified plans or individual retirement accounts. *Id.*; see note 296 *infra* and accompanying text.

124. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(c).

125. See text accompanying notes 30-32 *supra.*

126. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(b). However, if benefits are to begin before age 55 (early retirement), the $75,000 ceiling shall be reduced to reflect the potential additional years during which the participant will be receiving benefits. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(b)(2)(C). In any event, his annual benefit can be as much as $10,000 notwithstanding the preceding limitations. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(b)(4). If a participant has less than 10 years of service with his employer, his defined benefits are reduced proportionately. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(b)(5).

purposes,[127] although all limitations are to be adjusted annually by the Secretary of the Treasury to reflect cost-of-living increases.[128]

Taxability of Lump Sum Distributions

While most plans are designed to pay the employee a supplemental retirement income, a number of defined contribution plans provide for a lump sum distribution of an employee's entire accrued benefit at retirement. Such distributions were taxed as capital gains[129] until 1969, when Congress began to phase out this provision, essentially continuing capital gains treatment for the portion of a distribution attributable to pre-1970 accumulations, while taxing the post-1969 employer contributions as ordinary income.[130] Since 1969 the phaseout has represented a Gordian knot for the authors of the Treasury's tax regulations, as well as the taxpayers themselves.[131] In fact, it is "frequently maintained that lump sum distributees are unable to compute their taxes, and that accountants and tax lawyers have been refusing to attempt the computations."[132] In an effort to cut the knot, the PRA, while retaining the concept of the 1969 amendment, simplifies the method of computing the tax.[133] The Act provides for capital gains treatment of that portion of the lump sum representing pre-1974 value. The post-1973 portion will be taxed as ordinary income, but the retiree may use a 10-year forward averaging in which for purposes of rate determination all other income is ignored. If the individual elects to use the averaging device, however, he may incur additional current liability if he has received any other lump sum distributions in the preceding five years.[134]

Insurance Against Plan Termination

Despite all its eloquent promises, requirements, and penalties, the Employee Retirement Income Security Act of 1974 would be meaningless without some assurance that retired employees will ultimately receive their expected benefits. Accordingly, the Act establishes the Pension Benefit Guaranty Corporation,[135] which will provide insurance against plan termination. It

127. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415; see text accompanying notes 57-60 *supra* for a discussion of the effects of disqualification.

128. Act §2004(a), *to be codified as* INT. REV. CODE OF 1954, §415(d).

129. INT. REV. CODE OF 1954, §402(a)(2).

130. Tax Reform Act of 1969, §515(a)(1) (now INT. REV. CODE OF 1954, §402(a)(5)).

131. *See* TREAS. REG. §1.402(a)-1; PROPOSED TREAS. REG. §1.402(a)-2.

132. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 147 (1974).

133. Act §2005(a), *to be codified as* INT. REV. CODE OF 1954, §402(e)(1)(C). The Act adds 5 years of capital gains treatment to lump sum distributions. *Id.*

134. Act §2005(a), *to be codified as* INT. REV. CODE OF 1954, §402(e)(2). This 6-year "look-back" provision requires that all lump sum distributions made in the 5-year period immediately preceding the recipient's current taxable year be added to the current distribution, and that a tax on the cumulative total be computed, thus pushing the present amount into a higher tax bracket. After deducting from the cumulative tax the amount already paid on the prior distributions, the resulting balance is the amount of current tax liability.

135. Act §4002(a).

will be administered by the Secretaries of Labor, Commerce, and the Treasury,[136] who will receive counsel from a seven-member advisory board appointed by the President.[137] Uniform premium rates will be prescribed for single-employer and for multi-employer plans respectively,[138] based on one of three figures — the number of plan participants, unfunded benefit liabilities, or total guaranteed benefits.[139] Generally, the Act provides that all nonforfeitable benefits are to be insured by the Corporation.[140] The Corporation may additionally insure such other nonbasic benefits as it deems appropriate.[141] In the event a plan does terminate, an employer must indemnify the Corporation for all amounts it pays his employees, up to 30 percent of his net worth.[142] The employer may, however, purchase additional insurance to cover these liabilities.[143]

THE PRA: A REACTION

A great deal of controversy has centered around the mandatory insurance provisions, which are seen by some employers as an unwarranted incursion into private business.[144] Few, however, would doubt the equity of the new provisions allowing aggrieved plan participants their day in court or assuring an employer his right to a determination of tax qualification status before his plan is implemented. Similarly, few would question the desirability of the high standards of care imposed on persons entrusted with pension funds. Furthermore, while some employers undoubtedly consider the increased

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136. Act §4002(d).

137. Act §4002(h). This board will consist of 2 members from employee organizations, 2 from management, and 3 representing the general public. *Id.*

138. Act §4006(a). A "multi-employer plan" is defined as a plan instituted pursuant to a collective bargaining agreement to which more than one employer is required to contribute and which pays benefits regardless of whether a participant's employer ceases to contribute. The amount of contributions made by any one employer during the first plan year must be less than 50% of the aggregated contributions for that year made by all the employers. In subsequent years, the 50% rule may be expanded to 75%. Act §§3(37), 1015(f).

139. Act §4006(a). For the first full year following enactment, single-employer plans are to pay $1 per plan participant, and multi-employer plans are to pay 50¢ per plan participant. *Id.*

140. Act §4022(a). Given the Act's funding provisions, see text accompanying notes 229-270 *infra*, insurance would seem unnecessary. Because of the slow amortization of past service costs, see note 242 *infra*, however, a possibility of inadequate funding still exists.

141. Act §4022(c). These might include, for example, death, disability and medical benefits. H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 368 (1974); S. REP. No. 93-383, 93d Cong., 1st Sess. 82 (1973).

142. Act §4062(b). Although the Act does not specify, the "30% rule" presumably applies to each plan maintained by an employer. Lindquist, *The Pension Remodeling Act of 1974*, 52 TAXES 873, 876 (1974). Liability can thus exceed net worth where 4 or more plans are terminated by a single employer.

143. Act §4023.

144. *Hearings, supra* note 71, pt. 1, at 399, 403-04. "NAM [National Association of Manufacturers] believes that the concept of plan termination insurance is unworkable, inequitable and undesirable." *Id.*

reporting and disclosure requirements unnecessarily burdensome,[145] few could seriously contend that employees should not be aware of the mechanics of their plan's operations. There is less agreement, however, with regard to the reports that must be made to the Government.[146] Nevertheless, these new standards would probably be palatable to most employers if more federal regulation of pensions were not imposed. But there is more – much more. The PRA is fundamentally a response to an extensive catalogue of much-publicized horrors involving the disenfranchisement of retired employees due to inequitable forfeiture and plan insolvency.[147]

Before the PRA, more than half the people who expected pensions never received them,[148] prompting Professor Merton C. Bernstein, the "Ralph Nader of pensions,"[149] to reflect: "The losses of many provide the funds with which the payoff is made to the lucky few – just as at any honest race track."[150] Still, employers and pension administrators contend that most plans worked: that their funding was adequate and that more people were receiving pension benefits than ever before.[151] They point to the fact that the phenomenal growth of pension plans has taken place in the private sector without governmental supervision. In addition to a basic, philosophical disagreement with the Act's increased federal regulation, these pension specialists view the PRA as "a bureaucratic nightmare."[152] One consultant has asserted that the Act represents "overkill":

> It will cost the U.S. economy a third of a billion dollars a year just to administer this act. It's like calling out the Army, Navy, and Air Force and searching every man on the street because one lady was mugged in Central Park.[153]

While it is true that the vast majority of pre-1974 plans operated as they were designed to – including the fine-print forfeiture clauses that employees generally were unaware of – still the benefits were available at retirement only to those employees with the winning tickets. Congressional reaction

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145. FORTUNE, Jan. 1975, at 81.

146. *Id.*

147. *See generally Hearings, supra* note 71; *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways and Means,* 92d Cong., 2d Sess. (1972); Childs, *supra* note 7. See R. NADER & K. BLACKWELL, *supra* note 15, for an illustration of the types of abuses involved.

Perhaps the most dramatic and publicized case of a plan insolvency that resulted in mass forfeiture of pension benefits was the closing of the Studebaker plant in South Bend, Indiana, in 1964. Of the 8,500 employees discharged, only those who were 60 years old or older and had at least 10 years of service received their full benefits. The rest either lost their entire pension or received a small fraction on every dollar. *Id.* at 9.

148. *See id.* at 1.

149. Jackson, *Comments,* in PRIVATE PENSIONS AND THE PUBLIC INTEREST 51, 54 (1970).

150. *Cited in* R. NADER & K. BLACKWELL, *supra* note 15, at 11.

151. *Hearings, supra* note 71, at 397.

152. FORTUNE, Jan. 1975, at 81.

153. *Id., citing* Preston C. Bassett, vice president of Towers, Perrin, Forster & Crosby, actuarial and consulting firm.

to this race track syndrome crystallized in the Act's comprehensive provisions for participation, vesting, and funding.

PARTICIPATION

CONGRESSIONAL FINDING: *It is therefore desirable in the interests of employees and their beneficiaries . . . that minimum standards be provided assuring the equitable character of such plans.*[154]

Although the PRA reflects societal abrogation of the theory that pensions are a "reward" for long and faithful service,[155] Congress has recognized employers' legitimate interest in limiting retirement protection to relatively stable employees. Thus, the Act's participation provisions effect a compromise between the employee's need to begin accruing pension rights as early as possible and the employer's desire to avoid the administrative headaches involved in granting coverage to immature and transient employees.[156] It will be recalled that participation, or membership, refers to the period during which the employer makes contributions for the employee's benefit.[157] An employee will be allowed to participate after he has met the plan's initial eligibility requirements. Before proceeding to a dissection of the new participation requirements, however, it should be emphasized that participation, vesting, and benefit accrual comprise a virtually seamless web. While diagrammatic isolation of these discrete elements is both possible and necessary at this point, ultimately they must be considered together. Moreover, it is vital that participation be recognized as the key to all of the other benefits attributable to the PRA's regulation of pension plans. Requirements for vesting and termination insurance, for instance, become completely worthless to an employee unless he is able to participate in his particular plan.

Under prior law there were few limits on the length of service or the age that could be required of employees before they were permitted to enter a pension plan.[158] Many plans, therefore, excluded great numbers of relatively young or mobile workers. The PRA changes such situations. As previously noted, most requirements, including those relating to participation, are set out twice in the Act, once in Title I (Labor) and again in Title II (Tax).[159] Under both sections the general participation requirement is that no pension plan may exclude, on account of age or service, an employee who has completed one year of service or attained the age of 25, whichever

154. Act §2(a).

155. See text accompanying notes 83-87 *supra* and accompanying note 192 *infra*.

156. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 15 (1974). Young employees as a group tend to change jobs and even industries more frequently than their more mature fellow workers. *Id.* at 44.

157. See text accompanying notes 38-39 *supra*.

158. *See, e.g.*, INT. REV. CODE OF 1954, §401(d)(3), requiring H.R. 10 plans (see note 64 *supra*) to benefit all employees with 3 or more years of service.

159. See text accompanying notes 97-98 *supra*.

occurs later;[160] nor may it exclude older employees solely on the basis of age.[161] This rule, like all requirements under Title I, is mandatory. Thus, while violations will merely disqualify a plan under Title II,[162] thereby insuring unfavorable tax treatment,[163] the same violations will render it illegal under Title I[164] and subject to civil sanction.[165] As with all general rules, however, the participation requirement has exceptions. The most notable is that if a plan provides for 100 percent vesting[166] after only three or fewer years of employment, it may restrict participation to employees who have completed three years of service.[167] Further, although the general participation rule bans age discrimination, a defined benefit plan[168] may exclude an employee who is within five years of the plan's normal retirement age at the time his employment commences.[169] Clearly, Congress recognized that the prohibitive costs of providing defined benefits to retired employees after short-term service would deter employers from hiring such older workers.[170] This exception does not apply to defined contribution plans because the contribution, being fixed by the terms of the plan, would be no higher for an older participant than for a young one.

For purposes of determining the participation apprenticeship periods set out above, the PRA generally defines a year of service as a 12-month period during which the employee worked not less than 1,000 hours.[171] This year is to be figured on the basis of the date on which the employee commenced work.[172] The Secretary of Labor is charged with defining an hour

160. Act §202(a)(1)(A); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(1)(A). A pension plan may, of course, exclude employees for reasons other than age and service. Supervisory personnel, for example, may be excluded from a plan designed to cover only the rank-and-file.

161. Act §202(a)(2); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(2).

162. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(1)(A).

163. See text accompanying notes 57-61 *supra.*

164. Act §202(a)(1)(A).

165. See text accompanying notes 101-102 *supra.*

166. For a discussion of vesting, see text accompanying notes 208-228 *infra.*

167. Act §202(a)(1)(B)(i); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(1)(B)(i). Additionally, if a plan is maintained exclusively for employees of a tax-exempt educational institution, INT. REV. CODE OF 1954, §§170(b)(1)(A)(ii), 501(a), and provides for immediate 100% vesting upon participation, it may limit participation to indivduals who have attained the age of 30, rather than 25. Act §202(a)(1)(B)(ii); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(1)(B)(ii). While these two exceptions appear capable of joint implementation, the Act specifically disallows such a plan provision. *Id.*

168. See text accompanying notes 30-32 *supra.*

169. Act §202(a)(2); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(2).

170. H.R. REP. No. 93-1380, 93d Cong., 2d Sess. 262 (1974); H.R. REP. No. 93-807, 93d Cong., 2d Sess. 17 (1974). Congressional pronouncements notwithstanding, this rationale is strained at best when applied to a pension formula that is based on years of service.

171. Act §202(a)(3)(A); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(3)(A). The employee would thus average a minimum of 20 hours a week for 50 weeks a year. This formula is admittedly arbitrary but represents an attempt by Congress to establish some degree of standardization, without which it would be easy to visualize employers requiring unfair, and perhaps outrageous, annual accumulations of working hours in order to achieve a "year of service."

172. Alternatively, where the employee has not completed 1,000 hours of service in the

of service.[173] To determine the apprenticeship period, all years of an employee's service are taken into account,[174] and after he has satisfied the eligibility requirements, he must be allowed to commence participation at the beginning of the next plan year.[175]

While the participation standards are repeated in Title II as part of the qualification requirements for favorable tax treatment,[176] Title II contains additional provisions[177] incorporating these standards into the anti-discrimination rules.[178] Under prior tax law, it will be remembered, a plan would not qualify unless it covered 70 percent of all employees, or 80 percent of those eligible if 70 percent were eligible,[179] or unless it covered those employees deemed eligible under a classification system that did not dis-

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first full calendar year of his employment, the year of service may be a plan year. Act §202(a)(3)(A); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(3)(A). In the case of a maritime industry, 125 days shall be substituted for 1,000 hours. Act §202(a)(3)(D), Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(3)(D). For seasonal industries in which the customary period of employment is less than 1,000 hours a calendar year, the Secretary of Labor is authorized to promulgate regulations defining a year of service. Act §202(a)(3)(B); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(3)(B). This is to provide sufficient flexibility to ensure that the varying circumstances of these industries are treated individually. H.R. REP. NO. 93-807, 93d Cong., 2d Sess. 15 (1974).

173. Act §202(a)(3)(C); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(3)(C).

174. Act §202(b)(1); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(5)(A). However, service prior to a 1-year break in service (a 1-year break in service is defined as less than 500 hours during any plan year, or other 12-consecutive-month period. Act §203(b)(3)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(6)(A)) need not be regarded for plans using the 100% vesting, 3-year participation option. Act §202(b)(2); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(5)(B). Moreover, employee service prior to a 1-year break in service need not be taken into account until such employee has completed a year of service upon his return. Act §202(b)(3); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(5)(C). Finally, where an employee's consecutive 1-year breaks in service equal or exceed the aggregate number of years of service prior to the break, pre-break service may be totally disregarded for purposes of determining the respective apprenticeship periods. Act §202(b)(4); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(5)(D). It is readily apparent that an employee who accumulates between 500 and 1,000 hours will occupy a "twilight zone," having neither a year of service nor a break in service.

The Act additionally requires that pre-participation service for a predecessor employer be treated as service for the new employer where the latter maintains the same plan as the former. Act §1015(a)(1), *to be codified as* INT. REV. CODE OF 1954, §414(a)(1). In the event that the new employer institutes another plan, the Secretary of the Treasury is authorized to treat such prior service as current service to the extent he deems appropriate. Act §1015(a)(2), *to be codified as* INT. REV. CODE OF 1954, §414(a)(2). If an employee works for a company that maintains a multiemployer plan, see note 130 *supra*, his apprenticeship service shall not be diminished in the event he changes employment but stays within the multi-employer unit. Act §1014(c)(1), *to be codified as* INT. REV. CODE OF 1954. §413(c)(1).

175. Act §202(a)(4); Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(a)(4). The Act allows this limited delay for administrative convenience. In any event, the employee must be permitted to enter the plan within 6 months after he has met the participation requirements, no matter when the next plan year begins. *Id.*

176. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410.

177. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b).

178. *Id.;* INT. REV. CODE OF 1954, §401(a); see text accompanying note 54 *supra*.

179. See note 54 *supra*.

criminate in favor of officers, shareholders, supervisory or highly paid employees.[180] The only change in these antidiscrimination rules is the exclusion of certain groups from consideration in applying the 70 percent test. Employees who have not yet satisfied the age or service requirements[181] are disregarded,[182] as are union members whose collective bargaining agents reject pension benefits after good-faith bargaining.[183] The purpose of this latter exclusion is to enable employers with both union and nonunion employees to offer pension coverage to their nonunion employees.[184] Before this amendment, many such employers were foreclosed from establishing qualified plans because union employees, without whom the 70 percent test could not be met, had chosen not to participate.[185] In view of the above exceptions, it may seem somewhat incongruous that older employees, who may be excluded from participation in defined benefit plans,[186] may not be disregarded for breadth-of-coverage determination.[187] Apparently Congress was reluctant to allow employers to take undue advantage of the maximum age exception by hiring primarily older persons, then denying them the benefits of pension plans.

The PRA's participation standards should thus prove effective as a means of "assuring the equitable character of [pension] plans."[188] Clearly, no pension plan can provide retirement security for an individual who is not a participant. It is equally clear that many plans will have to broaden their coverage to admit previously excluded employees; even those who would have eventually been covered may now participate sooner, thereby increasing potential retirement benefits. At the same time, employers' interests[189] have

180. INT. REV. CODE OF 1954, §401(a)(3). Prior law also included in the prohibited class employees "whose principal duties consist in supervising the work of other employees." *Id.* The PRA deletes this supervisory category, presumably on the assumption that such persons would also be considered "highly paid employees." Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b).

"The terms 'highly compensated' and 'lower compensated' are relative, and the distinction between them must be based upon the circumstances of each case." Rev. Rul. 56-497, 1956-2 CUM. BULL. 284, 286.

181. See text accompanying note 160 *supra.*

182. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b)(1)(A).

183. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b)(2)(A). Two other groups of employees are excluded from consideration in applying coverage standards. Any plan may disregard nonresident alien employees if none of their income is deemed to come from sources within the United States. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b)(2)(C). In addition, collectively bargained plans for airline pilots who are represented in accordance with the Railway Labor Act may exclude employees not covered by the agreement. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b)(2)(B). This latter exclusion may later be extended to other professional groups. Act §§3021-22; H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 264 (1974).

184. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 17 (1974).

185. *Id.*

186. See text accompanying notes 169-170 *supra.*

187. Act §1011, *to be codified as* INT. REV. CODE OF 1954, §410(b)(1)(A); H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 262 (1974).

188. Act §2(a).

189. See text accompanying notes 155-156 *supra.*

not been completely arrogated in the fever to right past wrongs. Congress had the power, after all, to decree that *all* employees would be allowed to participate immediately, without exception. The participation standards appear to effect an equitable compromise between the employers and employees. The right to participate, however, is only as valuable as the pension itself.

VESTING AND BENEFIT ACCRUAL

CONGRESSIONAL FINDING: *[D]espite the enormous growth in such plans many employees with long years of employment are losing anticipated retirement benefits owing to the lack of vesting provisions in such plans.*[190]

Although in a bygone era American workers remained at one job during most of their working lives, today's labor force must be responsive to the demands of a highly mobile economy. Society's need for a competitive labor market should not be frustrated by a 19th century pension philosophy. On the other hand, had it not been for employers' legitimate desire to retard costly employee turnover, private pensions, which themselves represent substantial employer expenditure, might never have evolved as a major factor in retirement planning. While not unmindful of employer costs, Congress' primary purpose in enacting guidelines for vesting and benefit accrual was to protect employees against inequitable forfeiture of retirement benefits.[191]

Vesting, like participation, is valuable only when the property in which one has a vested right is itself valuable. It becomes necessary, therefore, to explore the workings of benefit accrual before proceeding with vesting.

Benefit Accrual

Many pension plans formulated before the PRA provided that only minuscule benefits could accrue during the early years of an employee's participation while major portions accumulated in the years just preceding retirement. This practice, called "backloading," permitted employers to continue to treat pensions much like a "gold watch given at a retirement banquet: a reward for long and faithful service."[192] Under the PRA such practices are severely curbed.

For defined contribution, or money purchase, plans,[193] the accrued benefit is simply the balance in a participant's account.[194] It is considerably more

190. Act §2(a).

191. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 18-19 (1974). Basically, accrual (see text accompanying note 39 *supra*) refers to the rate at which retirement benefits accumulate, and vesting (see text accompanying note 40 *supra*) refers to the rate at which the accrued benefits become nonforfeitable.

192. L. Lokken, *supra* note 27, at 121.

193. See note 33 *supra* and accompanying text.

194. Act §204(c)(2)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(7).

difficult, however, to say what constitutes an accrued benefit in a defined benefit plan.[195] For this reason, the balance of this section deals with vesting and accrual in the context of a defined benefit plan.

Accrued benefits under a defined plan are expressed in terms of a "normal retirement benefit"[196] and, for administrative convenience, do not include such ancillary benefits as medical or life insurance.[197] In order to check excessive backloading,[198] the Act contains three alternative formulas for computing accrual rates: the three percent rule, the 133 1/3 percent rule, and the fractional rule.[199] Under the three percent formula, a plan may provide for accrual at three percent each year, with a maximum participation period of 33 1/3 years.[200] At this rate, an employee who leaves his job after 10 years of participation would have to be credited with 30 percent of the normal retirement benefit. If the normal benefit were $2,000 a year, the employee would have accrued $600 per year.[201]

The 133 1/3 percent rule[202] provides that the rate at which the normal retirement benefit accrues in any year must not be greater than 133 1/3 percent of the rate at which it accrued in any prior year.[203] Stated another way, the accrual rate in an early year must be at least three-fourths the rate in any later year. If the plan contemplates 33 1/3 years for full benefit accrual,

Separate accounts must be maintained for all participants in defined contribution plans; defined benefit plans that allow for employee contributions in addition to employer contributions must maintain separate accounts for each employee's contributions. Act §204(b)(2); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(2). See *XYZ* example in text following subheading A PENSION PRIMER.

195. See *ABC* example in text following subheading A PENSION PRIMER.

196. The normal retirement benefit is the annual amount a participant will receive when he reaches normal retirement age. Some plans provide pension incentives to retire early, where the trade or business might require physical agility or other characteristics associated with youth. Where the incentive is a larger pension benefit than would be paid if the employee continues to the normal retirement age, that greater amount will be considered the normal retirement benefit. Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(9). While a plan may set its own normal retirement age, it may not delay benefit receipt beyond a retiree's 65th birthday or the 10th anniversary of his entry into the plan, whichever comes later. Act §3(24).

197. Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(9).

198. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 61 (1974).

199. Act §204(b)(1); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(1). The three accrual rules described apply only to employees who quit before retirement. For retiring employees there is another, much simpler rule: at retirement an employee's accrued benefit must be 100% of the normal retirement benefit. *See* Act §203(a); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a).

200. Act §204(b)(1)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(1)(A).

201. Of course, if the employee were only 50% vested, he would receive only $300 a year at retirement. See note 41 *supra* and text accompanying notes 208-228 *infra*.

202. Act §204(b)(1)(B); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(1)(B).

203. *Id.* Plan amendments increasing the accrual rate for all participants, however, are to be considered as having been in effect for all plan years for the purposes of this rule. *Id.* Thus, if an amendment in 1980 increased the accrual rate from 1% to 3%, it would not violate the 133 1/3% rule, even though it would represent 300% of the earlier rate.

the average accrual rate would be three percent, as under the three percent rule,[204] but the actual rate would be both smaller and greater. Under the 133 1/3 percent rule, the plan could provide for lower accrual in the early years of an employee's service with a correspondingly higher accrual in the later years. This would allow the employer to reward those employees who stay with the company. Under this standard, for example, a plan might provide for a normal retirement benefit of 1.5 percent of compensation for each of the first 20 years and two percent each year thereafter.[205] In such a plan, the benefit formula would also define the accrual rate. Thus, where an employee's annual compensation is $12,000, after 10 years he would have accrued 1.5% x 10 years x $12,000, or $1,800 per year.

The third benefit accrual formula, the fractional or pro rata rule,[206] is far less complex than the other two, although this is not apparent upon a first reading of the statutory language. Stripped of obfuscatory verbiage, it simply provides that an employee's accrued benefit is a straight-line proportion of the normal retirement benefit based on his years of participation. If, for example, a plan contemplates a normal benefit of $2,000 after 33 1/3 years of participation, an employee with 10 years of participation has accrued $600.60 per year (10 x $2,000 ÷ 33⅓).[207]

Vesting

Once an accrual rate has been developed in compliance with the PRA, the provisions for nonforfeiture require that one of three vesting schedules be superimposed. Thus, in practice, vesting and accrual are complements, although they are to be treated separately during the initial stages of plan formulation. In every instance vesting assumes the presence of an accrued benefit.

While exceptions and alternatives permeate the vesting provisions of the Act, certain requirements are categorical. Every plan must provide that an employee's normal retirement benefit shall become nonforfeitable (100 percent vested) upon attainment of the normal retirement age.[208] Moreover, each plan must also provide that an employee's right to that portion of his

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204. See text accompanying notes 200-201 *supra*.

205. The Act provides that where benefits are based on average compensation during any period, that average figure may not include more years than the 10-consecutive-year period when the employee's compensation was highest. Act §204(b)(1)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(1)(A). The effect of this provision will generally be beneficial to employees, since the average salary over an entire career is usually considerably less than a high-10-year average.

206. Act §204(b)(1)(C); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(b)(1)(C).

207. The discussions of all 3 basic accrual rules are premised on a plan's being noncontributory, *i.e.*, derived from employer contributions with no contributions by the employee. Where any part of a pension fund is derived from employee contributions, accrued benefits are allocated under §204(c) and §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(c). It should be noted that these rules set only minimum standards; plans may provide for more rapid accrual.

208. Act §203(a); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a).

accrued benefit derived from his own contributions shall at all times be nonforfeitable.[209] And finally, every plan must provide that upon full or partial plan termination, an employee's accrued benefits shall become fully vested.[210] It is interesting to note, however, that the substance of the vesting provisions is expressed in terms of alternatives. In plain words, every employer is given the opportunity to choose — but choose he must — which of three vesting schedules his plan will implement.

Certainly the simplest option is the "10-year vesting" rule by which a plan is obliged to provide 100 percent vesting of accrued benefits after 10 years of employee service.[211] The merit of this alternative from the employer's standpoint is that it avoids some of the recordkeeping and other administrative costs inherent in the partial vesting provisions of the other two schedules.[212] Of the three schedules, it provides the greatest amount of protection to those employees who have the requisite 10 years of service; for those with fewer than 10 years, however, it provides for no vesting at all.[213]

Not quite so simple is the second option, or "graded vesting" schedule.[214] While this option requires some vesting relatively early in the employee's career, it delays full vesting longer than the 10-year schedule. Plans using the graded alternative must vest accrued benefits at the following rates:[215]

Years of Service	Nonforfeitable Percentage
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15	100

209. Act §203(a)(1); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(1).

210. Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(d)(3). This will ensure that a participant will not forfeit his accrued benefit because of events over which he has no control.

211. Act §203(a)(2)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(2)(A).

212. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 55 (1974).

213. *Id.* This "notch effect," from no vesting in year 9 to full vesting after year 10, might induce an employer to dismiss an employee just before he completed his 10th year. Where there has been a pattern of such abuse or where there is reason to believe there will be such abuse leading to forfeitures that would discriminate in favor of the prohibited class, see text accompanying note 54 *supra*, the Treasury Department may disqualify the plan even though it meets the vesting standards of the Act. Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(d)(1).

214. Act §203(a)(2)(B); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(2)(B).

215. *Id.*

Because vesting occurs gradually, this alternative avoids the so-called "notch" effect, whereby an employee becomes entitled to too great a proportion of his vested rights in a single year, thus giving the employer an incentive to dismiss him prior to that point in order to avoid increased costs.[216] A major assumption of this schedule is that at least a part of the obligation to provide retirement benefits should be shifted from the employee's last employer to those who employ him early in his working career.[217]

The final option is the "Rule of 45,"[218] designed primarily to protect older workers.[219] This age-weighted approach provides that after five years of service, an employee whose age and years of service total 45 must have a nonforfeitable right to the following percentage of accrued benefits derived from employer contributions:[220]

If years of service equal or exceed —	and sum of age and service equals or exceeds —	nonforfeitable percentage is —
5	45	50
6	47	60
7	49	70
8	51	80
9	53	90
10	55	100

Notwithstanding the above table, this rule also provides that if an employee has completed 10 years of service, he must have a nonforfeitable right to 50 percent of his accrued benefits with a vested right to an additional 10 percent for each year after the tenth. Therefore, regardless of which vesting schedule his employer chooses, the latest any employee can be granted a 100 percent vested right to his accrued benefits is 15 years after he begins participation. These new vesting requirements, together with the liberalized provisions for participation, will increase pension costs by somewhere between 5 and 10 percent, depending upon the plan's pre-Act schedules and eligibility requirements, according to the president of one actuarial consulting firm.[221]

216. Compare the 10-year vesting rule discussed in text accompanying notes 211-213 *supra*.

217. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 55 (1974). For example, an employer for whom an employee worked for only 5 years early in his career would pay 25% of his accrued benefit at retirement. It should be noted, however, that this does not mean the employee will receive 25% of his normal pension. Rather, he will receive 25% of the amount accrued, which could be as little as 15% of the normal pension. Twenty-five percent of 15% is less than 4% of the normal retirement benefit. See note 41 *supra*.

218. Act §203(a)(2)(C); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(2)(C).

219. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 55 (1974).

220. Act §203(a)(2)(C); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(2)(C).

221. FORTUNE, Jan. 1975, at 81, *citing* Leonard Mactas, president of the consulting actuaries division of Kwasha Lipton, Inc., of Englewood Cliffs, N.J. It must be noted, however, that there are extreme discrepancies between the estimated cost increases attributable to the PRA's vesting requirements. For instance, projected increased costs for vesting under

While a pension plan may, of course, allow for more rapid vesting than is required by the Act,[222] generally no rights, once they are vested under a plan, may be forfeited by the employee under any circumstances.[223] In determining an employee's position on the vesting schedules, all service, including pre-participation service, must normally be taken into account.[224]

Recognizing that there will be bona fide hardship cases during the transitional periods after the PRA becomes effective, Congress has provided a means by which a variance of up to seven years may be granted. Upon a finding that (1) the application of the vesting requirements would increase the cost of the plan so as to jeopardize the voluntary continuation of the plan or result in a substantial curtailment of benefits, *and* (2) the application of such requirements or discontinuance of the plan would be adverse to the interests of plan participants in the aggregate, *and* (3) a variance from the minimum funding standards or an extension of amortization periods[225] would

S.4, not too dissimilar from the vesting provisions of the PRA, were placed at 0.1% to 0.2% for prior plans having "moderate vesting" schedules. *Hearings*, pt. 2, *supra* note 26, at 1035.

222. Act §203(d).

223. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 60 (1974). There are exceptions to this rule, however. A plan may provide that an employee's benefit may be forfeited upon his death. Act §203(a)(3)(A); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(3)(A). The plan may also provide that payment of benefits be halted for a period during which the employee returns to work for the employer maintaining the plan under which the benefits are being paid. Act §203(a)(3)(B); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(3)(B). Further, plan amendments having the effect of limited forfeiture may be given retroactive effect if expressly authorized by the Secretary of Labor. Act §203(a)(3)(C); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(3)(C). Finally, a plan may provide that if an employee withdraws his own mandatory contributions and is vested with less than 50% of his accrued benefits, such accrued benefits may be forfeited. Act §203(a)(3)(D); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(3)(D). If a plan has this provision, however, it must also provide that the forfeited right shall be restored upon repayment of the employee's own contributions, with interest. *Id.*

224. Act §203(b)(1); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(4); H.R. REP. No. 93-807, 93d Cong., 2d Sess. 56 (1974). Limited exceptions to this rule include service prior to age 22 in certain circumstances, service during which an employee declined to contribute to a plan requiring employee contributions, service with an employer during any period for which the employer did not maintain a plan, service prior to a 1-year break in service under specified conditions, and years of service prior to Jan. 1, 1971, unless the employee has had at least 3 years of service after Dec. 31, 1970. Act §203(b)(1); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(4). The computation of years and hours of service is essentially the same for vesting purposes as for participation. Act §203(b)(2); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(5); see text accompanying notes 171-174 *supra*.

Although plan amendments are allowed by the Act, a participant's nonforfeitable right to his accrued benefits must not be diminished thereby. Moreover, if a plan is amended, all employees with 5 or more years of service must be given the option to have their vested percentage of accrued benefits computed as if the amendment had not been adopted. Act §203(c)(1); Act §1012(a), *to be codified as* INT. REV. CODE OF 1954, §411(a)(10).

225. See Act §§303-04; Act 1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(d), (e). The Act's funding standards require the retirement of unfunded obligations by equal annual amortization payments. The amortization periods differ according to the source of the unfunded liability. Such periods may be extended up to 10 additional years by the Secretary of Labor on a case-by-case basis. Act §304(a); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(e). See text accompanying notes 258-260 *infra* for a discussion of funding variances.

be inadequate, the Secretary of Labor may prescribe alternative methods of vesting.[226] It should be noted that petitions for a variance must be filed no later than two years after the PRA's enactment.[227]

Because the vesting schedules required by the Act are not designed to allow highly mobile employees such as engineers and defense industry workers to achieve parity with their more stable counterparts, a special provision was enacted to allow a means of faster vesting without violating the prohibition against discrimination. This section permits highly mobile employees who participate in defined benefit plans to take reduced benefits in exchange for more rapid vesting.[228]

All in all, the vesting and accrual provisions of the Act should help to assure that "employees with long years of employment [will not lose] anticipated retirement benefits." Certainly, the vesting and accrual rules disallow the dubious practice of delaying tangible pension rights so as to avoid granting them altogether should a worker be dismissed or quit at 60 rather than 65. Even a 100 percent vested right to the maximum accrued benefit, however, will not make for a secure retirement if the pension fund is insolvent when the employee retires.

FUNDING

CONGRESSIONAL FINDING: *[O]wing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered.*[229]

While private pensions are now widely regarded as deferred compensation, there is no assurance that employers will be able to satisfy pension obligations on a pay-as-you-go basis.[230] Sound policy, as well as tax incentives, would dictate the establishment of a trust fund as a pool for the gradual accretion of assets to meet these debts. Unfortunately, the accretion rates have not always kept pace with increasing and often unforeseen liabilities.[231] In some cases, the unfunded obligations[232] of pension plans represent 40 or 50 percent, or even more, of the employer's net worth.[233] Congress

226. Act §§207, 1012(c).

227. *Id.*

228. Act §1012(b), *amending* INT. REV. CODE OF 1954, §401(a)(5).

229. Act §2(a).

230. See note 37 *supra* and accompanying text.

231. Liabilities may increase if amendments to a plan provide for larger pensions or for more rapid vesting or accrual. Where such amendments come about through union demands in collective bargaining, the increased liabilities would be unexpected. Similarly, an increase in the number of employees covered under the plan, an unexpected number of early retirements, or other increases in employee turnover could render the plan less than adequately funded. In addition, declining stock and other security values can decrease the plan's assets, thereby effecting an increase in its liabilities.

232. These obligations would include, for example, past service costs (see note 30 *supra*, ¶2), increased liabilities (see note 243 *infra*) and experience losses (see note 244 *infra*).

233. Western Union's unfunded pension obligations equal 46% of the company's net

recognized the threat this situation posed to retirement security. Consequently, both Title I and Title II now require that every defined benefit plan satisfy certain funding standards calculated to amortize past unfunded liabilities as well as to defray current costs. Even if a plan should later lose its tax-qualified status, it must still meet the funding standards.[234]

It is through these standards that the other provisions of the Act are translated into dollars. The PRA's minimum funding requirements represent a significant cost increase to many employers whose plans are subject to the standard.[235] An employer must now begin to amortize the portion of his plan that, under prior law, was allowed to be unfunded. Also, the current costs that he must satisfy each year will be higher, for the plan will have to cover more employees. In addition, employee benefits will accrue and become nonforfeitable more rapidly than before. The Act's impact on defined benefit plans will in many cases be dramatic.[236]

One example of this impact on most employers is larger service costs. The normal service cost for any particular year is the portion of future pension benefits and administrative expenses assigned to that year under the plan's actuarial cost method.[237] This amount must be contributed currently by the employer. Past service costs, on the other hand, are the amounts of liability in excess of plan assets existing at the time the plan was established, plus any other unfunded prior costs.[238] For example, if at a plan's inception an employee were deemed to have already accrued a certain percentage of his eventual benefit, that amount would be a past service cost.[239] Before the PRA, the minimum contribution an employer could make to a qualified plan in any year was an amount sufficient to cover the portion of eventual pension obligations arising from employees' service in that year plus interest on the unfunded past service costs.[240] Now, under the PRA's general rule,[241] he must contribute the year's normal service costs, plus an amortized portion of past service costs,[242] increased liabilities,[243] and "ex-

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worth. The figure for Bethlehem Steel is 53% and for Uniroyal, "an astounding 86%." FORTUNE, Jan. 1975, at 78.

234. Act §302; Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412.

235. Plans excepted from the Act's minimum funding standards include the following under Title I: employee welfare (as opposed to pension) plans; insurance contract plans; plans to which employers make no contributions; plans providing payments to retired partners under §736 of the Internal Revenue Code; individual retirement accounts or retirement bonds; defined benefit plans to the extent they are treated as individual account plans; and excess benefit plans. Act §§301(a), (b). Under Title II, all plans other than qualified pension trusts, qualified annuity plans, and qualified bond purchase plans are excluded from coverage, in addition to those listed above. Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(a), (h), (i).

236. *See generally* Lindquist, *supra* note 5, at 875.

237. Act §3(28); see note 36 *supra*.

238. Act §3(30).

239. *Id.*

240. TREAS. REG. §1.401-6(c)(2)(iii).

241. Act §302; Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(a), (b).

242. Past service costs are unfunded past service liabilities. Act §3(30). For plans in existence on Jan. 1, 1974, the amortization period is 40 years. For new plans, the amortiza-

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perience losses,"[244] reduced by an amortized portion of decreased pension liabilities[245] and "experience gains."[246] To facilitate accounting for these contributions by the employer and enforcement of the requirements by the Government, the plan must establish a funding standard account.[247] If at the end of any plan year the balance in the account falls below zero — in other words, if the employer's contribution, when added to all other credits[248] for that year, is less than the charges against the account[249] — the account has an accumulated funding deficiency[250] on which a five percent excise tax is imposed.[251] If the employer fails to correct the deficiency within the correc-

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tion period is 30 years (40 for multi-employer plans). Act §§302(b)(2)(B)(i), (ii); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(b)(2)(B)(i), (ii). A plan's initial past service cost is the excess of pension liabilities arising from employees' service prior to adoption of the plan (or to imposition of the funding standard) over the fair market value of the plan's assets. Act §3(30).

243. An increase in liabilities may result from a current plan amendment increasing unfunded past service liability, and is amortizable over 30 years (40 years for multi-employer plans). Act §302(b)(2)(B)(iii); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(b)(2)(B)(iii); see note 231 *supra*.

244. An experience gain or loss is the difference between anticipated experience, *e.g.*, return on investments, and the actual experience. The amortization period for these gains and losses is 15 years (20 years for multi-employer plans). Act §§302(b)(2)(B)(iv), (3)(B)(ii); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(b)(2)(B)(iv), (3)(B)(ii). Net gains or losses resulting from changes in actuarial assumptions are amortizable over 30 years. Act §302(b)(2)(B)(v); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(b)(2)(B)(v), (3)(B)(iii).

245. A decrease in plan liability may result from the adoption of an amendment reducing pension benefits and is amortizable over 30 years (40 for multi-employer plans). Act §302(b)(3)(B)(i); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(b)(3)(B)(i).

246. See note 244 *supra*.

247. Act §302(a)(1); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(a).

248. Other credits include equal amortization installments of decreases in plan liabilities, of net experience gains, and of gains resulting from changes in actuarial assumptions; any waived funding deficiency; and the excess of any debit balance in the funding standard account over any debit balance in the alternative funding standard account, if in the preceding year the accumulated funding deficiency was computed under the alternative standard. Act §302(b)(3); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(b)(3); see text accompanying notes 255-257 *infra*.

249. Charges against the funding standard account include the normal cost for the plan year, equal installments of the amortized liabilities (see notes 242-244 *supra*), installments on a 15-year amortization of each waived funding deficiency, and on a 5-year amortization of any excess debit balance. Act §302(b)(2); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(b)(2).

250. Act §302(a)(1); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(a). An employer contribution made within 2½ months after the end of a plan year relates back to the plan year. This period may be extended up to 6 additional months under regulations to be prescribed by the Secretary of the Treasury. Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(c)(10).

251. Act §1013(b), *to be codified as* INT. REV. CODE OF 1954, §4971(a). If the tax is not paid, before a deficiency notice may be issued the Secretary of the Treasury must notify the Secretary of Labor and give him a reasonable opportunity either to require the employer to correct the deficiency or to comment on the imposition of the tax. Act §1013(b), *to be codified as* INT. REV. CODE OF 1954, §4971(d).

tion period,[252] he is assessed an additional tax equal to 100 percent of the accumulated funding deficiency.[253] In addition to this penalty tax of 105 percent, he may also be subject to civil liability under Title I for violation of the minimum funding standards.[254]

Plans that use funding methods that provide for a relatively fast accretion of plan assets in the early plan years may use an alternative minimum funding standard.[255] Under this provision, a plan would continue to maintain the regular funding standard account but would also establish an alternative minimum funding standard account, which would be charged and credited on a somewhat different basis, not involving amortization.[256] For any plan year, the accumulated funding deficiency would be the lesser of the deficit in the regular account or that in the alternative account.[257]

Congressional concern about the impact on employers of the PRA's funding standards, and the concomitant threat to the voluntary continuance of pension plans, is evident in the provisions granting the Secretaries of Labor and the Treasury authority to waive or to vary certain requirements.[258] There are, however, limitations on the discretion they may use in the exercise

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252. The "correction period" is the period beginning with the end of a plan year in which there is an accumulated funding deficiency and ending 90 days after a deficiency notice with respect to the additional (100%) tax has been mailed. Under certain circumstances the period may be extended. Act §1013(b), *to be codified as* INT. REV. CODE OF 1954, §4971(c)(3).

253. Act §1013(b), *to be codified as* INT. REV. CODE OF 1954, §4971(b). If this additional tax is unpaid, the Secretary of the Treasury must again notify the Secretary of Labor. See note 251 *supra*. If the Secretary of the Treasury finds that the collection is in jeopardy, however, he may proceed without prior notice to the Labor Department. Act §3002(b).

254. Act §502(b).

255. Act §305; Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(g). Plans allowed to use the alternative standard are those utilizing projected benefit cost methods rather than accrued benefit cost methods. The accrued benefit or unit credit method recognizes pension costs only when they have accrued; that is, when the employee service on which the benefits are based has been rendered. Under the unit credit method, the normal cost is the present value of the units of future benefits credited to employees for service in that year. Thus, for an individual employee, the cost (present value) of a unit of benefit increases each year because the length of time the contribution will earn interest becomes shorter. Projected benefit cost methods, in contrast, look forward and assign the entire cost of an employee's projected, or future, benefit to past, present, and future periods not directly related to the time when the service is rendered, or when the benefits accrue to the employee. Projected benefit cost methods include, *inter alia*, the entry age normal method and the individual level premium method. For a description of the operation of these methods, see *Op. No. 8, supra* note 31, at 6551-53.

256. The alternative account would be credited with the amount considered to be contributed by the employer and charged with the sum of the following amounts: the lesser of the normal cost computed under the plan's funding method or the normal cost figured under the unit credit method (see note 255 *supra*); the excess of the present value of accrued benefits over the fair market value of the plan assets; and the cumulative excess of credits over charges to the alternative standard account for all prior plan years. Act §305; Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(g).

257. Act §302(a)(2); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(a).

258. Act §§303(a), (c), 304(a); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §§412(b), (c).

of that authority. Waivers are to be granted only where necessary because of substantial business hardship[259] and where application of the minimum funding standard would be "adverse to the interests of plan participants in the aggregate."[260]

In line with the funding requirements, the PRA increases the deduction limits for employer contributions. Before 1974, deductible contributions were limited to the greater of the following: five percent of the compensation of participating employees,[261] or that amount plus a level amount of unfunded past liabilities amortized over the remaining future service of the employees whose benefits comprise the liabilities[262] ("level cost" limit); or the normal cost of the plan plus 10 percent of the unfunded past liabilities[263] ("normal cost" limit). The PRA repeals the five percent limitation and provides instead a deduction for any amount an employer must contribute to meet the minimum funding standards.[264] In addition, the Act retains the "level cost" limit[265] and alters the "normal cost" limit to provide for 10-year amortization of unfunded liabilities[266] rather than the 10 percent interest payment, which, of course, would never retire the unfunded portion.

The PRA's funding provisions will create the most critical hardship for plans that were already severely underfunded.[267] To be sure, it will be somewhat more expensive to fund any pension plan that comes within the purview of the Act. One may ask, then, whether the PRA, with its increased coverage and strict funding requirements, may prove to be the straw that will break the back of the private pension. Even Professor Bernstein[268] has been quoted recently as voicing reservations:

> Private pensions had a terrific vogue during the Fifties and Sixties because they were built on the bull market. . . . Lacking that kind of fuel, I doubt whether prefunded pensions are viable in a period of double-digit inflation.[269]

It would appear certain that the PRA's funding standards will assure solvent pension plans when the time comes for retirement benefits to be

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259. Act §303(b); Act §1013(a), *to be codified as* INT. REV. CODE OF 1954, §412(d)(2). Factors to be considered in determining substantial business hardship include but are not limited to whether the employer is operating at an economic loss, whether there is substantial unemployment or underemployment in the trade or business and in the industry concerned, whether the sales and profits of the industry concerned are depressed or declining, and whether it is reasonable to expect that the plan will be continued only if the waiver is granted. *Id.*

260. Act §303(a); Act §1013(a), *to be codified as* INT. REV. ACT OF 1954, §412(d)(1).

261. INT. REV. CODE OF 1954, §404(a)(1)(A).

262. INT. REV. CODE OF 1954, §404(a)(1)(B).

263. INT. REV. CODE OF 1954, §404(a)(1)(C).

264. Act §1013(c), *to be codified as* INT. REV. CODE OF 1954, §404(a)(1)(A)(i).

265. Act §1013(c), *to be codified as* INT. REV. CODE OF 1954, §404(a)(1)(A)(ii).

266. Act §1013(c), *to be codified as* INT. REV. CODE OF 1954, §404(a)(1)(A)(iii).

267. See note 233 *supra* and accompanying text.

268. See text accompanying note 149 *supra.*

269. FORTUNE, Jan. 1975, at 79.

paid. If a fund is able to accumulate sufficient assets to meet accumulated liabilities, it is by definition solvent. The fundamental question, therefore, is whether employers will be able to satisfy these standards or whether section 302 of the PRA sounds the beginning of the end for defined benefit plans. Although the answer would require clairvoyance, at least one commentator has suggested that, where the employer has any choice in the matter, it would be imprudent to elect a defined benefit plan.[270] But assuming defined benefit plans are able to withstand these onerous funding requirements, the participation, accrual, and vesting standards should become meaningful bulwarks of retirement security.

INDIVIDUAL RETIREMENT ACCOUNTS[271]

Although a private pension plan is an essential component in the retirement scheme for millions of American workers, many others must depend solely on Social Security and personal savings for old-age stability. For these individuals, pre-Act tax law was simply a stumbling block on the unmarked road to a comfortable senescence.[272] While their tax dollars may have in-

270. Lindquist, *supra* note 5, at 875.

271. The reader should be aware that, although not specifically treated by this section, individual retirement annuities and retirement bonds each offer viable alternatives for retirement planning. Like individual retirement accounts, retirement annuities and retirement bonds operate on the assumption that the participant is not presently covered by a qualified plan but is nevertheless interested in providing for old-age security with before-tax dollars. Individual retirement annuities and retirement bonds basically offer the same favorable tax features as retirement accounts and must meet most of the same requirements. Their single substantive difference, therefore, would appear to be the conduit through which retirement funds are invested, involving the use of either a trust, an annuity, or a governmental bond, and the participant's views with respect to the relative merits of each as an investment medium. *See generally* Act §§2002(a), (b), (c), *to be codified as* INT. REV. CODE OF 1954, §§219, 408, 409 respectively, for regulation of individual retirement annuities and retirement bonds.

272. For members of this class, there were few avenues to retirement security. Limited to investment of *after-tax dollars*, usually in low-interest savings accounts, they were then taxed on the interest as it was earned. Such individuals were thus doubly disadvantaged. The following figures may help to illustrate.

Assume that *A* and *B* have the same amount of taxable income with a top marginal rate of 40%; that *A* participates in a qualified plan and that *B*'s employer has no such plan; that both *A*'s qualified pension trust and *B*'s savings account are able to earn at an annual rate of 5%; and finally that at retirement, the taxable income of each will be reduced to an amount with a top marginal rate of 25%.

Year 1	*A*	*B*
Annual contribution	$1,000	$1,000
Less tax at 40%	0	400
Available for investment	1,000	600
Earnings at 5%	50	30
Less tax at 40%	0	12
Net gain on investment	50	18
Total value of fund	1,050	618
Total tax paid year 1	$ 0	$ 412

directly aided the retirement incomes of individuals covered by qualified plans, they reaped none of the benefits attributable to the extraordinary taxing principles of qualified trusts.[273] To assuage this inequity, Congress developed the individual retirement account (IRA).[274] In effect, the IRA allows for substantially the same tax treatment of private savings as a qualified trust provides for pension funds.

In contrast to a qualified trust, however, contributions to an IRA must normally be filtered through the participant's own tax form before becoming available for investment. Payments to an IRA will result in an above-the-line deduction from gross income,[275] provided the account is established in compliance with the Act. The initial requirement of an IRA is that it must be a trust created for the exclusive benefit of the participant or his beneficiaries[276] with a bank serving as trustee.[277] Annual contributions (except in the case of rollovers)[278] must be in cash and are strictly limited to the lesser of $1,500 or 15 percent of yearly income.[279] An identical ceiling is placed on

Year 2		
Annual contribution	$1,000	$1,000
Less tax at 40%	0	400
Net current contribution	1,000	600
Previous balance in fund	1,050	618
Available for investment	2,050	1,218
Earnings at 5%	102.50	60.90
Less tax at 40%	0	24.36
Net gain on investment	102.50	36.54
Total value of fund	2,152.50	1,254.54
Total tax paid year 2	$ 0	$ 424.36
Tax on distribution, Year N, at 25%	$ 538.13	$ 0
Total tax paid	538.13	836.36
Total contributions	2,000.00	2,000.00
Total available at retirement	$1,614.37	$1,254.54

273. See text accompanying notes 47-49 *supra.*

274. Act §§2002(a), (b), *to be codified as* INT. REV. CODE OF 1954, §§219, 408.

275. Act §2002(a)(2), *to be codified as* INT. REV. CODE OF 1954, §219(a)(2).

276. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a).

277. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(2). The Act provides that the Secretary of the Treasury may authorize a person other than a bank to serve as trustee if he can demonstrate a capability to administer the trust in compliance with the rules governing an IRA. *Id.*

278. See note 296 *infra* and accompanying text.

279. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(1). *Compare* $7,500 or 15% of income ceiling placed on contributions to H.R. 10 plans. See note 64 *supra.* No apparent justification exists for this discrepancy other than a congressional effort to encourage the establishment of a Keogh plan where an owner-employee might be considering excluding his employees and adopting an IRA for his sole benefit. Nonetheless, this is a rather spurious reason for penalizing the many individuals unable to participate in a qualified plan and who are not even in a proprietary status. Clearly, the IRA's $1,500 or 15% of income ceiling should be raised so as to more nearly reflect the similarity between an owner-employee and a potential IRA participant.

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annual deductions.[280] Should the participant exceed these yearly limitations, either inadvertently or by design, such excess contributions will be subject to a six percent penalty tax to be paid by the participant.[281] An individual may avoid this tax, however, by withdrawing both the excess payments and corresponding investment yields prior to the timely filing of his income tax return for the year in which they were made.[282] No deductions will be allowed for contributions to an IRA if during the same year an individual was covered by and participated in any other qualified pension plan.[283] Further, to ensure that such accounts are used for retirement purposes, no deductions will be allowed for payments by an individual who has attained the age of 70½[284] and, correspondingly, the entire interest in the account must be distributed by that age or, in accordance with regulations prescribed by the Secretary of the Treasury, over the life or lives (or for a term certain not exceeding the lives) of the participant and his or her spouse.[285] Special provision is made for the death of the participant or spouse prior to final distribution of the account assets.[286] Finally, while distribution may commence at any time following the participant's attainment of age 59½, regardless of whether he continues to work, if account funds are distributed prior to that point, a 10 percent excise tax will be levied on such amounts.[287]

The Act provides that no part of an IRA may be invested in a life insurance contract[288] or commingled with other property, except in a common trust or investment fund.[289] Otherwise, account assets may be invested in much the same way as assets of a qualified trust including, but not limited to, the purchase of annuity contracts, savings accounts, or stocks of a mutual fund.[290]

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280. Act §2002(a), *to be codified as* INT. REV. CODE OF 1954, §219(b)(1). Of course, the $1,500 or 15% of yearly income limit on deductions for and contributions to an IRA is merely a ceiling. Participants may deduct and contribute lesser amounts at their discretion. *See id.;* Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(1).

281. Act §2002(d), *to be codified as* INT. REV. CODE OF 1954, §§4973(a), (b).

282. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(d)(4). Reclaimed excess contributions will not be includible in gross income for the subsequent year although, of course, they will be disallowed as deductions in the year when made. Any net income attributable to and distributed with the excess contributions is to be included in the participant's income for the year in which it was received. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 130 (1974).

283. Act §2002(a), *to be codified as* INT. REV. CODE OF 1954, §219(b)(2).

284. Act §2002(a), *to be codified as* INT. REV. CODE OF 1954, §219(b)(3).

285. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(6).

286. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(7).

287. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(f). This penalty tax will be in addition to the normal income tax assessed on such amounts as the result of its inclusion in gross income for the year received. *Id.*

288. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(3). This prohibition is to ensure that contributions to an IRA are, in fact, for the purpose of creating a pension. "The individual retirement account is to be used to provide retirement income and life insurance is an asset designed for a different purpose — to provide funds for survivors." H.R. REP. No. 93-807, 93d Cong., 2d Sess. 133 (1974).

289. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(a)(5).

290. H.R. REP. No. 93-807, 93d Cong., 2d Sess. 132 (1974).

Generally, the investment earnings of an IRA will be exempt from taxation.[291] Should the account engage in a prohibited transaction,[292] however, the Act presumes a constructive distribution of all account assets, with a corresponding tax on an amount equal to their fair market value.[293] An employer may establish an IRA for his employees if the trust satisfies all the requirements for such accounts and if the employer maintains a separate account for the interests of each employee or member.[294] Employer contributions to such accounts must be included in the employees' gross income, although they are then subject to subsequent deduction.[295]

A significant feature of the PRA's treatment of individual retirement accounts is the rollover provisions for tax-free transfers from an IRA or qualified trust into a different account. Congress recognized that, from time to time, an employee will move and wish to establish a new IRA in a different locale. Therefore, distributions out of an IRA to the participant will not be considered gross income if, within 60 days following distribution, the entire amount received (both money and property) is transferred to another IRA.[296]

The Act's provisions for individual retirement accounts clearly represent a long-awaited and badly needed tax break for individuals not covered by qualified plans.[297] Through a relatively uncomplicated process, these people may now save for retirement with before-tax dollars. Unfortunately, these novel benefits do not now seem to be widely known. It would therefore be helpful if interested banks not currently publicizing the plans and the Government itself would engage in an educational campaign to acquaint

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291. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(c).

292. See text accompanying notes 112-114 *supra*.

293. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(c).

294. *Id.*

295. Act §2002(a), *to be codified as* INT. REV. CODE OF 1954, §219(a).

296. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(d)(3). This provision shall apply only once every 3 years. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(d)(3)(B).

Alternatively, if the entire amount received from the IRA is attributable solely to an earlier rollover from a qualified trust or annuity and such amount represents the total assets of the account, the funds so received may be transferred to a qualified trust or annuity without including them in gross income. Act §2002(b), *to be codified as* INT. REV. CODE OF 1954, §408(d)(3). Once again, the entire transaction must take place within 60 days. *Id.* Moreover, lump sum distributions from qualified trusts and annuities need not be included as gross income if transferred into an IRA or qualified trust within 60 days of receipt. Act §2002(g)(5), *to be codified as* INT. REV. CODE OF 1954, §402(a)(5).

297. For instance, assuming a 6% return on investment, contributions to an IRA of $1,500 a year for 30 years would result in a net retirement fund of $118,587. In contrast, and because earnings of normal savings accounts are taxable, the same $1,500 a year payments into a savings account earning 6% interest would, after 30 years, result only in retirement savings of $68,633 if the contributing individual were in a 25% tax bracket. More dramatic still would be the case of an individual who follows the same procedure of saving in a normal account but who is in a 50% tax bracket. For him, a contribution of $1,500 a year for 30 years would net only $35,682. See Orlando (Fla.) Sentinel, Feb. 16, 1975, §A at 25, col. 1. An IRA will certainly enhance retirement income for those individuals participating in one.

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potential IRA participants with the substantial gains to be derived from this type of investment.

CONCLUSION

The PRA is a noble piece of legislation. It is the product of an American compassion for the often-forgotten victims of the fear, isolation, and poverty attendant upon old age. Its taxing provisions are for the protection of people, not just revenue. Its regulatory provisions are not punitive, but preventive. And its insurance provisions are not a penalty, but a pledge of retirement security.

Unfortunately, for all its good intentions, the PRA may be a white elephant: it looks big and strong, but will it work? The prohibitive cost factors may be insurmountable. The avalanche of paperwork, the threat of excise taxes, the rigor of funding standards, and the possibility, however remote, of corporate liquidation may converge and backfire, discouraging employers from ever establishing or maintaining pension plans. It has been suggested, therefore, that private pensions are not the ultimate answer; rather, it is said, retirement income should be provided through a system of public pensions such as Social Security, based on the federal taxing power.[298] Perhaps this would be a viable alternative, considering the duplication of efforts involved in maintaining both public and private systems. Still, the Pension Reform Act may remedy the current inequities existing in private pension plans. And, perhaps most importantly, for the first time all private pension law has been pulled together into a unified whole — the Employee Retirement Income Security Act of 1974.

KAY G. FINLEY
MERRITT A. GARDNER

298. R. NADER & K. BLACKWELL, *supra* note 15, at 122-23; FORTUNE, Jan. 1975, at 78.