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ABSTRACT

This report examines legislation proposed by the Nixon administration to (1) make available to employed workers a new type of personal retirement plan having tax-deferral advantages, (2) apply pre-retirement vesting requirements to the private pension system, and (3) broaden tax-deferred retirement plans presently available to the self-employed and their employees. The legislation would permit all wage and salary earners to set up their own individual retirement plans under the same tax-deferral arrangement now available for group-type pension plans and for retirement plans of the self-employed. Alternative retirement plans and pension vesting proposals are discussed. (JS)

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THE ADMINISTRATION'S PRIVATE PENSION PROPOSAL

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THE ADMINISTRATION'S PRIVATE PENSION PROPOSAL

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INTRODUCTION

This analysis deals primarily with legislation proposed by the Nixon administration to (1) make available to employed workers a new type of personal retirement plan having tax-deferral advantages, (2) apply pre-retirement vesting requirements to the private pension system, and (3) broaden tax-deferred retirement plans presently available to the self-employed and their employees.

The proposed legislation is embodied in H.R. 12272, introduced by Rep. Wilbur Mills, D-Ark., for himself and Rep. John Byrnes, R-Wisc. Identical measures (H.R. 12302; S. 3012) have been introduced by Rep. Gerald D. Ford, R-Mich., and Senator Carl T. Curtis, R-Neb. The House bills were referred to the House Committee on Ways and Means. The Curtis bill is pending before the Senate Committee on Finance.

President Nixon recommended the proposed pension legislation in a message to the Congress on December 8, 1971.

The administration's new proposals have now further expanded the broad array of pending legislative issues affecting the private pension system. Other pending proposals range from expansion of pension-plan disclosure requirements to federal direction of private-pension vesting and funding and federal insurance of pension-plan solvency.

A unique feature of the administration bill is that it would permit all wage and salary earners to set up their own individual retirement plans under broadly the same tax-deferral arrangement now available for group-type pension plans and for retirement plans of the self-employed. This opportunity would be open both to employees already covered by a group retirement plan financed in whole or part by the employer and to workers not covered by any pension or other retirement plan.

A second feature of the administration-proposed legislation, also absent from other major pension proposals, is that it would increase substantially the limits on tax-deductible contributions that may be made to retirement plans of self-employed persons and their employees.

But the third feature of the administration measure is similar to other pending proposals in that it would create a new federal standard requiring, as a condition of tax qualification, that benefit rights under private pension and profit-sharing retirement plans be vested after specified periods of employment service. Details of the proposed vesting requirements, however, differ among the pending bills.

Pre-retirement vesting of pension benefits means generally the conferring on pension plan members separated from employment before pensionable age of rights to receive all or part of their pensions when they reach the plan's retirement age. Such pre-retirement vesting of pension rights is not now required (except to the extent of available assets when pension plans are terminated) by law or regulation--although, in practice, the great majority of pension plans have some form of pre-retirement vesting. (Deferred profit-sharing plans, as distinguished from pension plans, are required by the Internal Revenue Service to provide for vesting of rights.)

Dent and Javits Bills

In addition to the administration's new measure, major pension bills pending in Congress include H.R. 1269 by Rep. John H. Dent, D-Penn., and S. 2 by Senator Jacob K. Javits, R-N.Y.

Both are comprehensive measures that would (1) establish new federal standards governing benefit-vesting and funding of private pension plans, (2) create a program for federal insurance of such plans, and (3) rewrite the Welfare and Pension Plans Disclosure Act, adding fiduciary responsibility standards and materially expanding its present requirements. Additionally, the Javits bill would institute a voluntary pension-portability arrangement and would create a new pension commission to administer federal laws affecting private pension and other employee benefit plans.1/

The Dent and Javits bills are assigned to the committee with jurisdiction over labor legislation (the House Committee on Education and Labor and the Senate Committee on Labor and Public Welfare). The administration's bill was referred to the House committee having jurisdiction over tax legislation because it would amend directly the Internal Revenue Code under which the greater part of present federal legislation relating to private pension plans and other employee benefit plans is administered.

Griffin Measure

Another pension proposal that would require pre-retirement vesting and newly instituted federal insurance of pension plans as qualification conditions is a bill (S. 2485) introduced by Senator Robert P. Griffin, R-Mich. This measure would require, following a phase-in period, full vesting of pension rights after ten years of employee participation. The insurance program would apply to plans in existence for five or more years. It would undertake to insure against losses of benefits from involuntary terminations of pension plans and in instances of voluntary termination it would make the employer liable for payment of unfunded, vested liabilities.

Fiduciary Responsibility Proposals

Also involved in the array of pending legislation affecting the private pension system are the Nixon administration's legislative proposals of 1970--now incorporated in large part in the Dent and Javits bills--encompassing fiduciary responsibility criteria and disclosure requirements for employee benefit plans. A slightly revised version (H.R. 12337) of the administration bill has been introduced by Rep. John N. Erlenborn, R-Ill.2/ A similar measure (S. 2486) has been introduced in the Senate by Senator Griffin.

Study Initiated by the President

Although the pension legislation proposed by the administration is silent on pension funding standards, federal insurance of pension plans, and pension portability--subjects involved in the "pension debate"--the President announced in his Message on Pension Reform a "major study project which could lead to further legislation."

He has directed the departments of labor and the treasury, he said, to undertake a one-year study to determine the extent of benefit losses under pension plans which are terminated. This information is needed, he added, "in order to determine what Federal policy should be on questions such as funding, the nature of the employer's liability, and termination insurance."

The President, in the course of his message, also urged the Congress to act promptly on the Employee Benefits Protection Act originally proposed by him in March of 1970. This is the proposed legislation, now incorporated in H.R. 12337, to set up federal fiduciary responsibility criteria for persons administering pension funds. It also would rewrite the existing Welfare and Pension Plans Disclosure Act to broaden reporting and disclosure requirements to which employee benefit plans are subject.

Tax Treatment of Private Pension Plans

All three major features of the new pension legislation proposed by the administration are keyed directly to the use of federal taxing statutes to encourage the establishment and growth of privately financed plans providing pensions and savings for retirement.

The great bulk of today's private pension plans are tax-qualified under conditions of the Internal Revenue Code which affect certain aspects of a plan's makeup and its funding. The plans must meet these conditions if they are to avoid tax disadvantages decreed for nonqualified plans.

Under present rules applying to tax-qualified pension plans:

1. Employer contributions to pension funds are deductible from the employer's gross income as business expenses.

2. Such contributions are not taxable to employees until received by them as pension benefits--normally during retirement when their tax rates are likely to be lower than during much of the pre-retirement period.

3. Investment income of a pension fund is not taxable to either the fund or the employer--and is not taxable to employees until received by them as part of their benefits.

On the other hand, if a funded pension plan fails to meet the requirements of the Internal Revenue Code for tax qualification the results are as follows: (1) the employer is currently taxable on the amount of his contributions if benefit rights are not vested in the year of the contribution; (2) employees are currently taxable for the contributions if the rights are vested; and (3) investment earnings of the plan are currently taxable to the trust or other media holding them.3/

Conditions attached by statute or rule to tax qualification of pension plans include certain minimum funding standards and a nondiversion-of-funds rule making pension trusts irrevocable, and requiring that pension funds be used exclusively for the benefit of employees. They also include a basic statutory prohibition against discrimination in favor of supervisory and highly compensated employees or employees who are officers or stockholders. Many regulatory rules are attached to this prohibition. Numerous other rules, stipulated chiefly through an extensive body of administrative law developed by the Pension Trust Branch of the Internal Revenue Service, relate to matters such as completeness and definiteness of the pension plans, showings of permanence of the plans, limits on employee contributions, and conditions applying to terminations of plans.

With respect to the newly proposed authorization of tax qualification for a personal retirement plan set up by an employed individual, his contributions to his plan would be currently deductible, within prescribed limits, for tax purposes. Investment income earned by his individual plan would be currently untaxed. Both the contributions and investment earnings would become income taxable to him only when subsequently withdrawn.

Another aspect of the proposal is that employee contributions to a qualified pension plan calling for such contributions would be deductible within prescribed limits, from the employee's currently taxable income. Under present law such contributions are made out of after-tax income of the employee.

In the case of the proposed new vesting standard, compliance with the standard would be a condition of tax qualification for a pension or profit-sharing retirement plan.

Proposed changes affecting retirement plans for the self-employed and their employees would continue, as now, to be tied to the Internal Revenue Code, but the amounts of tax deductible contributions to such plans for the benefit of the self-employed would be larger.

Although the administration measure as represented by the Mills-Byrnes bill would depend for enforcement on tax qualification of retirement plans, that is not the case with the Dent and Javits measures. They would depend, instead, on regulatory actions by administrative agencies and actions by the courts.

Under the Dent bill, the administrative agency would be the U.S. Department of Labor. Under the Javits bill it would be a newly created, national pension commission. In the latter instance the Internal Revenue Code would be amended to provide that any pension or profit-sharing retirement plan subject to the measure would be treated as meeting tax qualification conditions only if the plan held (or had applied for) a registration certificate issued by the pension commission. Denial or withdrawal of registration would result in denial of tax qualification.

Growth of Private Pension Plans

By the end of 1969, the latest year for which detailed data are available, private retirement plans (pension and deferred profit-sharing plans) covered 29.3 million wage and salary workers and had reserves of $125.1 billion to finance future benefit payments. During 1969 employers deposited $11.1 billion and employees $1.3 billion of contributions toward the funding of benefits. The plans paid out that year $5.9 billion in benefits to 4.2 million retirees and other beneficiaries. By the end of the year, an estimated 200,000 of such plans maintained by corporations and having tax qualification were in operation. Approximately 14,700 new pension plans and 13,300 profit-sharing plans of corporations had been approved by the Internal Revenue Service during 1969.4/

Significant growth of the private retirement plans has been a relatively recent development. In 1950 such plans covered only 9.8 million workers and had reserves totaling only $12.1 billion. In that year the contributions were $2.1 billion and payments were $370 million to 450,000 beneficiaries.5/ The growth during the 1950-1969 period in the number of workers covered by retirement plans was 199 percent--as compared with a 36 percent growth of the employed civilian labor force.

As to future growth of private retirement plans, a 1966 study forecasts coverage of approximately 42 million workers by 1981 as the "most reasonable"

projection. And, by this time, assets of the plans "most likely" will be in a range of $188 to $214 billion and annual benefit payments probably will exceed $10 billion.6/

The data provided above on retirement plans for wage and salary workers do not include figures for retirement plans for the self-employed. The number of such plans qualified under the Self-Employed Individuals Tax Retirement Act rose in 1969 to a total of approximately 250,000, involving an estimated 400,000 participants.7/

Similarly, the data do not cover private employee benefit plans other than the retirement-plan category.

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Individual retirement plans for employed persons that would qualify for tax-deferral treatment under the Nixon proposal would be generally of the same character as the tax-qualified retirement plans now authorized for professional people, owners of unincorporated businesses, and other self-employed persons. Such plans are known popularly as "Keogh" or "H.R. 10" plans.8/

The principal difference would be that under Keogh plans, self-employed people must include their employees, if any, and finance benefits for them; whereas, an employee setting up an individual plan would not be involved with employees of his own. Also, the employed person would be more restricted than the self-employed in the annual amount of his earned income that he would be permitted to set aside in his retirement fund on a tax-deferral basis.

However, as in the case of Keogh plans, the individual retirement plan would permit, subject to certain specified conditions, investments in a broad range of assets. These could include stocks, bonds, mutual fund shares, annuity and other life insurance contracts, face-amount certificates, and savings accounts with financial institutions.

Self-employed persons, as well as employed individuals, would be eligible to set up individual retirement plans under the proposed tax deferral arrangement.

Details of Proposed Legislation

Details of the proposed legislation relating to individual retirement plans are outlined below.

Limits on Deductible Investments. For an employed person not covered by a retirement plan of his employer (or a self-employed person), the amounts of annual payments into his individual retirement account that would be deductible from federally taxable income (for the taxable year in which payments were made) would be limited to 20 percent of his earned income of up to $7,500 annually.9/ Hence the limit on such a payment would be $1,500. Or he could opt to set aside less than 20 percent of earned income. In the case of a married couple, the privilege of deductibility would be available to each spouse, within these limits, based upon his or her earned income.

If an employed person already were a participant in a retirement plan financed by his employer, he still could set up his own individual retirement plan--but the 20 percent ($1,500 maximum) limitation on the tax-deductible payment into his own retirement account would be reduced to reflect the employer's contributions in his behalf under the group plan. For this purpose, he could assume, at his option, that the employer's contribution is seven percent of his (the employee's) wages or salary. In that case the employee could invest annually a maximum of 13 percent of his earnings (but not more than $975) in his own retirement account. (Since the seven percent offset would apply to all earned income from performance of personal services for the employer, the opportunity to make such investments would phase out completely at an annual earnings level of $21,428.) Or if he could show that the employer contribution in his behalf was less than seven percent, the reduction of the 20 percent allowance would be by the lesser amount as determined under treasury department regulations.

Should the employee be a participant in a qualified pension or other group retirement plan which provided for employee as well as employer contributions, his contributions to the group plan would become deductible from his taxable income, as previously noted, under the proposed legislation. However, if he elected to establish an individual retirement account, all three types of contributions (his into his own account, his into the group plan, and the employer's) would have to fit within the overall limitations of 20 percent of the first $7,500 of wages or salary.

The proposed legislation contains a special provision applying to employed persons, such as certain public employees, who are not covered by social security or the federal railroad retirement program. In such a circumstance, an individual's overall deductible allowance for investments in his own retirement account would be reduced not only by any employer's contribution in his behalf (subject to the seven percent option), but also by the amount of the social security tax that would be payable if his employment were subject to social security tax. This additional reduction in the allowance is described as reflecting the fact that social security taxes paid by employees are not deductible from their taxable income.

Rules Applying to Individual Plans. Principal conditions to be met for an individual retirement plan to qualify for tax-deferral treatment under the proposed bill would include the following:

(1) Contributions by an individual would have to be held in a separate trust, custodial account, or other approved arrangement maintained for the purpose of subsequently distributing to the individual, his spouse, or his beneficiaries such contributions and their investment earnings. Assets so held could not be commingled with other property of the individual or his spouse.10/

The custodial accounts or trusts could be maintained by banks, credit unions, and other institutions approved by the treasury department.

(2) With certain exceptions, funds could not be withdrawn without penalty by the person establishing the plan until he or his spouse attained age 59 1/2 years. The principal exceptions are that there could be withdrawals without penalty before that age was reached (a) in the event of the disability or death of the individual, and (b) if the amount withdrawn were deposited in another qualified, individual retirement plan within 60 days. Otherwise, early withdrawals would result in a 30 percent (of the amount withdrawn) penalty tax and, additionally, would not qualify for general averaging permitted under present tax law.

(3) The plan must provide that the entire interest of an individual in it will be distributed to him by his age 70 1/2 years 11/ or, commencing not later than that, the withdrawals will be sufficiently large to exhaust the entire accumulation of assets over his or his and his spouse's life expectancy. The annual penalty imposed for failure to meet these distribution rules after the individual reached age 70 1/2 years would be 10 percent of the excess accumulation.

(4) Prior to the start of withdrawals, any investment earnings of a plan must be held as part of its assets. Refunds of premiums, dividends, or similar distributions in the case of an annuity contract purchased from an insurance company must be held by the issuer of the contract and may be applied only toward payment of future premiums or the purchase of additional benefits similar to those provided in the contract.

Rules contained in the proposed legislation governing the tax qualification of individual retirement plans appear to be complex. Experience with the (Keogh) retirement plans for the self-employed, however, indicates that plans meeting the qualifying conditions would become readily available to the public from sources such as banks and other financial institutions, insurance companies, credit unions, and mutual stock funds.

The institutions or persons acting as custodians or trustees for the plans, rather than the individuals establishing them, would be responsible for the submission to the Internal Revenue Service of reports required for federal administrative purposes.

Tax Position of Individual with Personal Retirement Plan

As previously noted, an employed person who established an individual retirement plan, under terms of the legislation now proposed, would be

in essentially the same position tax-wise as a participant in a tax-qualified group pension plan. To summarize:

1. As long as his investments through his plan did not exceed the allowable annual limits, that portion of his earned income so invested would be free of federal income taxation for the year in which it was earned. In this instance the amounts invested would be deductible from his own taxable income rather than, in the case of employer contributions to a group plan, being deductible as a business expense from taxable income of the employer.

2. Investment earnings of the plan would not be currently taxable.

3. Moneys subsequently withdrawn from the plan would be income taxable to the individual in the years in which the withdrawals were made. Such income received during retirement normally would be taxable at lower rates than "off-the-top" income of pre-retirement years.

The proposed bill specifically prohibits withdrawals from individual retirement plans from being taxed on a capital gains basis. Income averaging permitted by the federal tax code, however, could be applied to withdrawals from the plan if such withdrawals were not premature (before age 59 1/2 years).

General income averaging for tax purposes may be applied to most forms of taxable income. Its use ordinarily is advantageous to a taxpayer in a year in which he has an unusually large amount of taxable income as compared with such income during the immediately preceding four years. In substance, the income averaging method operates to tax a part--the so-called averageable income--of the unusually large income in the peak year at the same lower effective tax rate that applies to the first one-fifth of this averageable income. In the case of an individual retirement account, the person who established it could use the income averaging method of computing his taxes if after his age 59 1/2 he elected, for example, to withdraw in a lump sum all or a large part of his plan's accumulated assets.

Larger Savings Possible Under Tax-Deferral Treatment

Certain advantages to an individual of being permitted to accumulate savings for retirement on a tax-deferred basis are obvious.

In the first place, his investments cost less than in the instance of after-tax investments. Or, to put it another way, larger investments may be made at the same initial cost.

For example, under the proposal for tax-deductibility of payments into an individual retirement account, the tax savings at the outset on a maximum $1,500 investment for a person in a 25 percent income tax bracket would be $375 (25 percent of $1,500). If he continued to invest $1,500 annually through his plan for 30 years, the principal amounts of his investments would total $45,000 and his tax savings (assuming he remained in the 25 percent tax rate bracket) would have totaled $11,250. Thus the initial tax savings, in effect, would reduce the net cost of his $45,000 set-asides, taking into account the after-tax status of personal savings under present law, to $33,750. (The initial tax savings obviously are not the "ultimate" savings, since the initial savings will be reduced later by tax liability for withdrawals.)

In the case of a person in a 20 percent rate bracket the initial tax savings on $1,500 annual investments through a retirement plan would be, of course, $300 per year. If he had an annual income of $7,500, was married and claimed two exemptions, his tax saving on a $1,500 investment (in the improbable event that he could "afford" such an investment) would be $268 under 1971 tax rates.

The second obvious advantage to an individual of privileges accorded in the proposed legislation would be deferral of federal income taxation of his retirement plan's investment earnings.

When an individual commenced, after retiring (or before if he chose, provided he was beyond age 59 1/2), to cash in the assets of a retirement plan set up under the proposed legislation, he still would be liable, of course, for payment of income taxes on his withdrawals. In contrast, the person who had set aside personal savings under present law already would have settled all his federal income tax charges, except for taxes on continuing investment earnings, against the savings. In most instances, however, the aggregate tax liability on withdrawals from the retirement account can be expected to be substantially less than the taxes that would have been paid in the process of setting aside a like amount of savings on an after-tax basis.

Reasons for this usually lower tax liability lie chiefly in the lowered tax rate brackets into which taxpayers normally fall when retirement brings reduced income, and attainment of age 65 brings an additional personal exemption. Absence of current taxation of accumulating investment earnings would be a major factor. The availability of income averaging in computing tax liability for withdrawals from retirement accounts would be an added factor in some instances.

According to a "Fact Sheet" distributed in conjunction with the President's Pension Message of December 8, 1971, annual pensions beginning at the recipient's age 65 that would be produced, under given assumptions, by payments of $1,500 annually into individual retirement plans, in accordance

with the proposed legislation, would be as follows:

Age when $1,500 contributions begin	Annual pension beginning at age 65
40	$7,500
45	4,750
50	3,375
55	1,950
60	900

Stated assumptions are that the pensions are striaght-life for males, payable in monthly installments, with investment earnings computed at a five percent rate.

It is to be noted again that such pensions would be taxable as they were received.

Arguments Supporting Individual-Plan Proposal

The basic arguments in support of the proposed tax treatment of individual retirement plans are that additional encouragement of private savings is needed and that the present law discriminates against employed people who want to set aside savings for retirement. Wherever it can be achieved, self-reliance is better than social welfare, it is argued.

Encouragement of Savings--Public Policy. The conclusion that public policy should encourage personal savings was expressed by President Nixon as follows:

> Self-reliance, prudence and independence are qualities which our Government should work to encourage among our people. These are also the qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have greater security tomorrow. In this respect, pension plans are a direct expression of some of the finest elements in the American character. Public policy should be designed to reward and reinforce these qualities.12/

The great length to which the United States has gone in setting up tax-supported social welfare programs for the benefit of the aged and other groups, it generally is argued, tends to drain away self-reliance as a dominant quality of the American people. Hence, regardless of the need for and merits of the public programs, they have effects that seem to call for the counterbalance of public action that will encourage rather than discourage individual responsibility. With respect to income maintenance for the aged, few people will deny the superiority of private

savings over public support--but there must be enough opportunity and incentive to make the private-savings approach work significantly.

It has been pointed out, furthermore, that the income tax system itself tends to discourage and penalize savings. That is, it taxes interest earnings from savings but allows expenses of indebtedness to be deducted for tax purposes.

Pension Equity for the "Forgotten Man." Need for equity for the "forgotten man" in the tax treatment of savings for retirement is the principal specific argument in support of the current proposal relating to individual retirement plans.

The "forgotten man" in this instance primarily is the person working for an employer who does not have a pension plan for his employees. Or, in a slightly different context, he may be an employee participating in a pension plan with benefits he considers as inadequate. In either circumstance, any savings personally set aside for retirement must be out of income already taxed, and any subsequent investment earnings of such savings are subject to annual income taxation.

In contrast, of course, both the group pension plans financed by corporate employers and retirement plans for the self-employed (and their employees, if any) function, both as to contributions and investment earnings, under the shelter of tax deferment if they meet qualifying conditions.

A spokesman for the Nixon administration describes the "discriminatory" situation as follows:

> The effect of existing law relating to saving for retirement purposes is to discriminate substantially against individuals who do not participate in qualified private retirement plans or who participate in plans providing inadequate benefits. Frequently, this situation is the result of a unilateral decision of the employer not to establish a private retirement plan for its employees or not to improve benefits under an existing plan.13/

The point also is made that, in addition to persons working for employers without pension plans, there are many other employed individuals who, because of the nature of their occupations, never have a sufficient period of service with any one employer to accrue adequate retirement benefits.

Advocates of the proposed legislation estimate that approximately half of the nonagricultural labor force does not now participate in private retirement plans and "that coverage is not likely to expand significantly

under existing conditions."14/ But adoption of the proposal, they believe, would bring about a significant expansion of private retirement plans. The administration's estimate is that 14 million taxpayers would be expected to claim tax deductions for retirement contributions under the proposal, with some 70 percent of the tax benefits going to persons with annual incomes below $15,000.15/

It is to be noted that the professed inequities the proposal would seek to cure would include the present inability of employees to deduct their contributions to pension plans. Since employer contributions to qualified plans are deductible as business expenses, the after-tax status of employee contributions often is criticized. The proposed change to deductibility of the employee contributions to group plans is consistent with proposed changes relating to individual retirement plans.

Individual Control of Investments. Individual retirement plans would hold certain advantages even over qualified plans financed by employers, it is argued. An individual setting up his own plan would be free to choose, within broad limits, the kind of investments he wished to make. For example, he could choose bonds or savings accounts or opt for equity investments through mutual funds. Or he could purchase annuity contracts from insurance companies. Also, the assets of his plan would be wholly his own, assured to him or his beneficiaries irrespective of changes in his employment or the timing of his death.

In contrast, an individual employee does not have control over the type of investments made by a group plan in which he participates. Depending on vesting provisions of his group plan (if there are no employee contributions under the plan) and the length of his service with an employer, termination of his employment may result in lack of qualification for any benefits. Or, his death before retirement age may preclude, again depending on provisions of the group plan, receipt of any benefits by him or his beneficiaries even though the rights are vested.

Advocates of the proposed individual retirement plans contend that advantages peculiar to such plans (and to present plans for the self-employed) would invite wide usage of the plans and promote the quality of self-reliance.

Alternative to Social Welfare Programs. Students of government who are alarmed over the current trend toward what they believe to be unhealthy over-reliance on social security and other public programs to support the aged, generally look upon added encouragement of personal savings as a practical, desirable alternative to "runaway" social welfare. Public policy embodied in the original establishment of social security programs for the aged (insurance and assistance programs plus the subsequent medicare and medical assistance programs) was that they would provide the foundation layer of income maintenance, with personal savings and private

pensions serving as additional layers. Rapid expansion of social welfare in recent years, however, has invited a conclusion that its continued expansion could lead to virtual elimination of the private pension system and to substantial diminution of opportunities for personal savings.

For example, Robert J. Myers, chief actuary of the federal Social Security Administration from 1947 to 1970, states that "expansionists" among social welfare planners "would have the social security program be predominant or virtually monopolistic in the economic-security field" and "essentially... would eliminate the private pension system, except for persons with the highest earnings."16/

The tax incentive now proposed to encourage personal savings for retirement offers, many people believe, at least the possibility of capturing enthusiastic public acceptance. Such a rekindling of the popularity of personal savings, it is reasoned, would lessen public pressures for over-expansion of social welfare programs.

The very least that the proposal would accomplish, it is further argued, would be finally to give a tax "break" to the ordinary, steadily employed worker who is both industrious and self-reliant. Income, social security, and property tax laws for the most part are structured against the personal interest of this type of worker. The industrious are the ones called upon to bear much of the brunt of financing social welfare for those who, because of indolence, profligacy, or force of uncontrollable circumstances are not self-supporting. There is a strong body of thought holding that the former are now entitled to a break in their favor.

Arguments Against Individual-Plan Proposal

The main arguments made against the proposed tax treatment of individual retirement plans are that the proposal would violate sound principles of taxation and would be of benefit chiefly to people in higher-income brackets. These and certain other arguments are examined below.

Violation of Taxing Principles. Whereas the present tax treatment of qualified, group pension plans is considered by many legal authorities as being substantially consistent with general principles of tax law, it is argued that the proposed tax treatment of individual retirement plans would be an outright tax subsidy. It would represent still another step in the use of tax incentives to accomplish social objectives. Hence, in the opinion of some authorities, it would be violative of what they consider to be a sound rule that the purpose of taxation should be limited basically to raising the revenues needed to finance governmental operations.

The view that the present tax treatment of qualified pension plans financed by corporate employers is consistent with basic tax principles is

as follows: employers' contributions to the plans are a form of deferred compensation properly deductible from income under general rules as business expenses; that under general tax rules employees would not be taxed on such contributions until they received the pension benefits. A further conclusion is that while general rules of trust taxation might impose some current tax on pension-fund income, the amount would be small and its impact erratic.17/

Special legislation such as that now proposed is required, however, to permit contributions to an individual retirement plan to be treated as deductible from income for tax purposes. Such contributions would come from ordinary income taxable to the individual under present law. In the case of retirement plans for the self-employed, of course, the privilege of deducting the contributions from income otherwise taxable and of deferring taxation of investment earnings of such plans, already has been granted by special legislation.

It is argued that the trend toward proliferation of tax incentives to accomplish social or related objectives constitute a distinct threat to the taxing structure. Some tax incentives of this nature already exist. Varied others outside of the pension field, such as for pollution control and the education of children, have been proposed. It can be argued that the list of good things which might be accomplished by use of tax incentives is virtually endless--but that in accomplishing these good things the taxing structure would be severely eroded.

Greater Benefits for Higher-Income Workers. An argument that the proposed tax shelter for the individual retirement plans would be of greater benefit to higher-paid workers is based chiefly on two considerations. In the first place, amounts of deferred taxes otherwise payable on income contributed to the plans would be larger for persons in higher-income tax brackets than for those in the lower brackets. Secondly, the proportion of lower-paid workers taking advantage of the opportunity for tax-sheltered savings could be expected to be smaller than in the case of higher-paid employees.

As previously noted, the initial tax "saving" on a $1,500 annual investment in an individual retirement plan would be $375 per person in a 25 percent tax bracket, as compared with $268 for a person (married, claiming two exemptions) with an annual income of $7,500. Comparable differentials would exist, depending on differentials in applicable tax rates, with respect to savings from the lack of current taxation of investment earnings. It is pointed out, however, that an offsetting factor would come into play when, during such individuals' retirement, withdrawals were made from the plans. The worker with the higher earnings during his working lifetime normally would continue during retirement to be taxed in a higher rate bracket than the worker who had had lower earnings. Hence, in normal circumstances, tax bills paid during retirement by the former

on income from the withdrawals would be larger than those paid by the latter.

The proportion of employed people who would take advantage of the proposed legislation, if it is enacted, is conjectural at this point. While the administration's prediction is that some 70 percent of the tax benefits would go to persons with annual incomes below $15,000, this prediction does not include estimates of what the breaks would be for persons with incomes under, for example, $10,000 or $7,000. The proposal has been criticized on the grounds that most people with incomes under $10,000 probably would not have enough disposable income to avail themselves of the tax-sheltered investment opportunities open to them.

Loss of Federal Revenues. The cost to the government of any proposed legislation that would reduce revenues or increase expenditures must always be taken into account when considering the merits of such legislation. In this instance the administration's estimates are that the cost in lost revenues would grow, as more people took advantage of the retirement plan privileges, from $300 million in the first year to $480 million in the fourth year. It can thus be argued that the proposal would add still another complexity to the already overly complex problem of bringing the federal budget back into balance. Such an argument would carry greater weight if it were assumed that possibilities of long-range savings in social welfare costs resulting from the proposal are too conjectural to be taken into account.

Tax Impact on Retiree. A question may be raised, by way of argument against the retirement-plan proposal, as to whether deferment of tax liability until an individual's retirement is in itself desirable. Even though the aggregate tax liability normally would be less and the net savings larger under the tax-deferment route, nevertheless retirement usually is a period of reduced income during which any tax liability seems overly burdensome to an individual. Would it be better for him to have settled the involved tax bills during his working years when his personal budget probably was more flexible? The current tax treatment of social security benefits, under which employees' social security taxes are not deductible for income tax purposes but benefits are tax-free, implies that present public policy gives an affirmative answer to that question.

Under the Nixon administration proposal, vesting of an individual employee's rights to benefits from a qualified private pension plan of a corporate employer would start when the employee's age plus his years of participation in the plan totaled 50. At that time at least half of his benefits earned after 1973 would have to be vested. Attainment of full vesting after another five years of employment service would be required.

Thus the principal impact of the administration proposal would be, as in the case of other major pending legislative proposals of a similar nature, to establish new federal standards of pre-retirement vesting, in accordance with specified criteria, for private pension plans. The standards also would apply to profit-sharing retirement plans.

As contrasted with the so-called "rule of 50"--the combination of employee age and his years of service--used in the administration measure, the requirement of the Dent bill (H.R. 1269) basically is full vesting of benefit rights after ten years of employment under a pension plan. The Javits bill (S. 2) would require vesting to start after six years and be completed after 15 years of an employee's service.

Proposals for compulsory vesting in private pension plans stem from discontent arising out of experiences of some individuals who lost jobs they held for a number of years before their pension rights, under terms of their pension plans, were vested. Or the discontent may arise because in some cases loss of pension credits may be the price that an employee must pay to quit his job--either to take another job or for some other reason.

The great bulk of private pension plans already have some form of pre-retirement vesting, instituted through either voluntary actions by employers or collective bargaining between employers and labor unions. Such vesting ranges from immediate to commonly described "late" vesting. The trend of the last two decades has been strongly toward earlier vesting. Some plans, however, still withhold vesting of benefit rights until the time of employees' retirement.

Background of Vesting Controversy

Lack of early vesting in many pension plans often is due principally to deliberate choices made, when the plans were established or their benefits liberalized, as to how available pension resources should be used. Or it may be due to a desire on the employer's part to use a pension plan as

the means of retaining experienced workers.

Cost Consideration. Early vesting, as contrasted with late vesting or no vesting prior to retirement age, materially increases costs of pension programs. This comes from the fact that, in the absence of pre-retirement vesting, pensions become payable only to employees who continue to work for the employer until retirement age. Normal employee turnover eliminates as prospective pensioners all the employees who do not, for a variety of reasons, continue in employment to the point of retirement. Had pension rights of such employees been vested when the separations occurred, however, they would have carried the rights with them and, on reaching retirement age, would have been eligible for benefits earned during the earlier spell of employment. Hence each step taken toward early vesting provisions in a pension plan increases its costs by, in effect, the amount of the "carry-away" benefits subsequently becoming payable as the result of the vesting change.

Significance of Past Service Credits. Choices made with respect to pension vesting often are affected directly by the practice of retroactive granting of pension credits for employees' periods of past employment. Granting of such credits normally is strongly sought by unions when they are negotiating for a new pension plan or for larger benefits under an existing one. The employer also has a definite interest in granting past service credits because generally his most immediate concern, when he sets up a pension plan, is to provide pensions for long-service employees at or near retirement age. Use of the past service credit accomplishes this objective. Ordinarily, however, it increases costs of the pension plan materially.

Resources available for pensions usually are limited. Therefore, decisions about the total "pension package" necessarily involve tradeoffs among the alternative uses of these limited resources. Often the choice--whether made in management-labor negotiations or by management unilaterally--is to sacrifice early vesting in favor of past service credits or larger pensions. Or, the parties involved may decide in favor of pay raises absorbing resources that otherwise would be available for early vesting of the pensions.

Employee-Retention Factor. The concept held by employers of pension plans serving as means of retaining experienced workers--or simply as means of rewarding long-service employees--also has been a factor militating against early vesting of pension rights. This concept was especially prevalent in the early stages of the private pension movement but is considered by authorities in the pension field as being now of declining significance.

Research has shown that lack of vesting is not peculiar to pension plans established unilaterally by employers. Rather, as one authority finds, pension vesting "is no more prevalent in collectively bargained plans than in those installed by employers on their own initiative."[18]

Current Status of Pension Vesting. Responsible studies of recent years attest to the substantial progress that has been made toward earlier vesting of pension rights.

In 1962-63, an average of two out of three private pension plans contained provisions for pre-retirement vesting of pension rights and the plans with such provisions accounted for three out of five workers covered by all plans, according to data reported in a 1965 study commonly known as the Cabinet Committee Report.19/ At the end of the 1960s, a study emanating from the Bureau of Labor Statistics reported that more than three-fourths of all workers covered by pension plans were in plans with vesting provisions, and more than nine-tenths were in plans with vesting, early retirement, or both.20/

A second recent study, by the Pension Research Council (Wharton School of Finance and Commerce), showed that (as of 1966) 47 percent of the participants in sampled pension plans were under plans with "early" vesting, 34 percent under plans with "intermediate" vesting, and 19 percent under plans with "late" vesting.21/ Under classifications utilized in the study, "early" vesting was full vesting in ten or fewer years of service, "intermediate" vesting was full vesting after 11 to 20 years, and "late" vesting was full vesting after 21 or more years.22/ The latter category included plans providing for vesting only when an employee qualified for normal retirement.

Still another study, based on a random sample of pension plans drawn in mid-1969, reports findings as to vesting provisions closely comparable to those of the Pension Research Council's study. Also reported in this third study were findings that 2.2 percent of the sampled plans provided for immediate vesting and 7.5 percent of them provided for no pre-retirement vesting. The smallest degree of vesting was found to occur in multi-employer plans, 41 percent of which had late pre-retirement vesting and 15.4 percent of which had no vesting prior to retirement age.23/

The gist of all the findings, in general terms is that a great deal of change has occurred toward reasonably early vesting of private pension rights. Substantial numbers of the pension plans, however, still defer vesting for individual employees until they have worked for the same employer for nearly half or more of lifetime working spans--with a small percentage providing for no vesting prior to retirement age.

Details of Administration's Proposal

Legislation proposed by the administration contains certain new minimum standards affecting eligibility of employees for pension coverage, as well as the "rule of 50" relating to vesting, which must be met by pension and profit-sharing retirement plans as conditions of tax qualification.

The eligibility and vesting proposals described here would apply to retirement plans wholly or partially financed by corporate employers--not to the so-called Keogh plans for the self-employed and their employees.

Eligibility Standards. Under the bill, a plan may not require, as conditions of participation by employees, that an employee (1) have been employed by the involved employer longer than three years, (2) is older than 30 years, or (3) is not older (at the first time he is otherwise eligible to participate) than five years less than normal retirement age under the plan.

In other words, eligibility to participate in a plan would be required if an employee has at least three years of employment service, is at least 30 years old, and is not older than five years less than retirement age. The last requirement relates to the situation of a new employee who is near retirement age when hired, wherein the high cost of pension coverage under some plans may act as an impediment to his being hired. His pension coverage could be waived under the proposal only if, after having been employed for the time specified in the plan to establish eligibility, he was less than five years away from retirement age.

The Revenue Code does not now contain specific requirements as to length of service and age for employee participation in retirement plans of corporate employers, although any eligibility rules in a plan must be nondiscriminatory. (A Keogh plan, however, may not exclude employees with three years or more of service.)

Vesting Standards. The proposed "rule of 50" vesting standard basically is (1) that at least half of an employee's accrued benefits be vested when (at the close of a plan year) his age plus years of participation total 50 years and (2) that at least one-fifth of the balance of his accrued benefits be vested in each of the next five years.

This vesting requirement (with certain exceptions described later) would apply to all pension and profit-sharing retirement plans as a condition of their tax qualification. In the case of presently existing plans (specifically those established on or before November 30, 1971), however, the vesting standard would apply only to benefits accrued or contributions made, with certain exceptions, after 1973. However, all participation in the plans by individual employees, whether before or after the end of 1973, would be counted in determining whether combinations of age and participation added to 50 years.

A modification of the basic standard would apply to workers near or beyond age 50 when hired--those for whom the "rule of 50" would be satisfied soon after the time of hiring. In that situation, the employee's initial 50 percent vesting could be delayed for three years after the hiring date, regardless of whether the plan called for participation in it in less than

three years. For example, if a plan permitted participation in one year, instead of the maximum three years, a person hired at age 50 would satisfy the "rule of 50" at age 51, when he became a participant--but under the modification the 50 percent vesting could be delayed for another two years, until his age 53. In this example, he then would attain full vesting at age 58. The purpose of the modification is to minimize a disincentive against the hiring of older workers.

The bill would permit the vesting requirement to be set aside entirely under certain circumstances of unfavorable financial condition of a plan. The vesting standard would not be required to apply, in the case of a plan existing on November 30, 1971, to benefits accrued for any year for which (1) benefit payments to retirees exceed benefit accruals by active participants and (2) the present value of accured liabilities exceeds the actuarial value of plan assets. This exception would not apply, however, if the plan were amended during that year or the next five years to increase benefits.

The measure specifically stipulates that the vesting standard shall not be applied to prohibit a plan, to which employees make contributions, from providing for forfeiture of benefit rights if an employee voluntarily withdraws his own contributions upon the termination of his employment or active participation in the plan.

Effective Dates. The proposed new eligibility requirements would apply to newly established plans from the outset and, for plans existing on November 30, 1971, generally to plan years beginning on or after January 1, 1974. As already noted, the vesting standards would apply to new plans and, as to those existing at the end of November, 1971, generally to benefits accrued or contributions made after 1973. An exception applies to any already existing, union-negotiated plan, however. For such a plan, the effective dates in both instances would be the plan year beginning after the termination of the collective bargaining agreement in effect on November 30, 1971.

Vesting Under Dent and Javits Bills

To provide a means of comparing pension vesting proposals of pending measures introduced by Representative Dent and Senator Javits with proposals of the administration bill, details of the Dent and Javits proposals are outlined below.24/

Dent Proposals. As represented by H.R. 1269, the proposal is for a basic requirement that rights to regular retirement benefits be fully vested after not more than ten years of employment service under a pension plan. This basic requirement could be satisfied during a transitional period, however, by any of several permissible vesting alternatives. It also

would be subject to certain other rules and definitions. The latter include:

(1) Age and service requirements for admitting employees to participation in a pension plan could not exceed age 25 and three years of employment.

(2) For vesting purposes, an employees' entire service with the employer would have to be counted except (a) service prior to age 25, (b) service during which the employee refused to contribute to a plan requiring employee contributions, (c) service with a predecessor of the employer (with certain exceptions), and (d) service broken by suspensions of employment, provided rules governing breaks in service are not unreasonable or arbitrary as determined by the secretary of labor.

(3) The vesting requirement would apply to the accrued (earned) portion of a retirement benefit payable not later than an employee's age 65. In the event of pre-retirement termination of employment under a stated benefit plan, the vested benefit would be that portion of a regular retirement benefit computed through use of the ratio of the employee's years of credited service to his total possible years of service to age 65. If a fixed contribution plan were involved, vesting would apply to the amount credited to the employee's account at the time of his termination.

(4) Plans to which employees contribute could not provide for forfeiture of benefits attributable to employer contributions solely because an employee withdrew his own contributions.

Pension plans already in existence (on enactment date of proposed legislation) could satisfy vesting requirements of the Dent bill by providing nonforfeitable benefit rights to plan participants under any of the following alternatives:

(1) Vest only benefits accrued on service after the effective date of the standard (two years after enactment) for employees with ten years' service after age 25. (Service before and after the effective date would count toward the ten-year requirement.)

(2) Vest all accrued benefits (for service before and after effective date) of employees with ten or more years of service at a rate (not less than ten percent per year) that will result in 100 percent vesting not later than nine years after the effective date.

(3) Vest the accrued benefits for all 20-year-service employees in the first year after the effective date, thereafter annually reducing the service requirement at least one year so that, ten years after the effective date, the service requirement would not exceed ten years.

(4) Vest accrued benefits by a method approved by the secretary of labor as being substantially consistent with 2 or 3 above.

For new plans established after enactment of the legislation the transitional alternatives would be, starting in the sixth year of the plan's operation: (1) to vest accrued benefits of employees with 15 years of service and then reduce the service period year-for-year until the ten-year service standard prevails in the eleventh year, or (2) to vest initially 50 percent of accrued benefits for employees with ten or more years of service and then amortize vesting of the remainder of such benefits over the next five years.

Javits Proposals. The Javits bill (S. 2) would establish a basic minimum standard of graded vesting that would mature to full vesting after 15 years of an employee's service. The vesting would start after six years of an employee's service. Ten percent of accrued benefits would vest at that time with an additional ten percent for each year thereafter until full vesting occurred after 15 years.

The Javits bill provides that an employee shall be deemed to be a member of a pension plan beginning with the start of contributions to the plan in his behalf--and that in no event may the "probationary" period of employment establishing eligibility for participation in the plan be longer than six months. It also provides that for vesting purposes an employee's aggregate period of time as a plan member shall be treated as if it were a period of continuous service, without regard to temporary suspensions of employment.

In the event of loss of employment by an individual with vested pension rights prior to his retirement age, he would be entitled under the bill to a deferred life annuity commencing at his attainment of the normal retirement age under his employer's pension plan (but not later than age 70). The commuted value of this annuity would be computed on the basis of interest rates and mortality tables approved by the newly created pension commission.

Enforcement of Vesting Proposals. Under the Dent bill, enforcement of the vesting requirements would be through making unlawful the operation of a pension plan lacking approval of its vesting provisions by the secretary of labor. Denial of a certificate of approval would be subject to court review. The secretary also could bring civil actions to enjoin acts in violation of law, regulations, or orders. Criminal penalties are provided for willful violations.

Enforcement of vesting and other provisions of the Javits bill would be through a requirement of qualification for registration of a pension plan with a central pension commission. The commission would be empowered to deny or cancel registration of a plan found not to conform in its provisions

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or administration, to requirements of the proposed legislation. In such event, the commission could petition a federal court to order compliance with requirements. The court also would be empowered to appoint a receiver to take over assets of a pension plan. An administrator of a plan could sue for court review of a final order or other action by the pension commission.

Coverage and Miscellaneous Aspects. Vesting standards of both bills would apply to virtually all private pension and profit-sharing retirement plans (including multi-employer plans) except (1) those established outside the United States for noncitizens and (2) self-employment plans covering only a proprietor or partners. The Javits bill also specifically exempts plans with not more than 25 participants and unfunded plans lacking tax qualification. Under the Dent bill, pension plans established by an existing collective bargaining agreement due to expire within one year after the effective date of the vesting requirements would not have to comply earlier than such agreement's expiration date.

Supporting Arguments for Vesting Standards

Advocates of federal vesting standards for private pension plans generally take the position that such standards are necessary (1) as a matter of equity and fair treatment for individual workers and (2) to ensure that private plans achieve their pension function. Earlier vesting of pension rights, advocates argue, is needed especially to protect innocent victims of permanent layoffs resulting from an employer's economic misfortune, as well as to protect low-wage workers who ordinarily move from job to job during their working careers.

Spokesmen for the administration contend that older workers are the ones for which the need for vesting of pension rights is most acute. The "rule of 50" proposed through H.R. 12272 and S. 3012 is designed, they assert, especially to protect workers over age 45 without increasing pension costs to an extent that would retard expansion of pension benefits.

Protection if Jobs Terminate. The need for protection of workers against loss of pension credits in the event of employment separations is described by President Nixon as follows:

> A basic problem in our present pension system is the situation of the worker who loses his pension when he is discharged, laid off, resigns or moves to another job. A person who is discharged just before retirement, for example, sometimes finds that the retirement income on which he has been relying--and which has been accumulating for many years--simply is no longer due him.

Preservation of the pension rights of employees who leave their jobs--vesting--is essential to a growing and healthy private pension system.25/

The often-cited Cabinet Committee Report of 1965 stated its premise about the need for vesting of pensions to protect individual workers as follows:

> As a matter of equity and fair treatment, an employee covered by a pension plan is entitled, after a reasonable period of service, to protection of his future retirement benefit against any termination of his employment. Vesting validates the accepted concept that employer contributions to pension plans represent "deferred compensation," which the individual worker earns through service with his employer.
>
> Without vesting, a worker displaced after long years of service is denied all of his accrued pension protection. A worker in a similar position who voluntarily changes his employment has to forfeit his right to a future pension. Both circumstances are charged with inequity.26/

The individual equity argument has been expressed by Senator Javits, in comments on the vesting requirements of an earlier bill similar to S. 2, in these words:

> ...A man who has devoted 15 years of his life to working under a plan in the expectation of pension has earned something, he has paid for it, and he ought not to be told in his later years, after devoting much of his working life to service with one company, that his rights have been forfeited because of the "small print" in the pension contract.27/

Fulfillment of Pension Function. The proper function of private pensions cannot be fulfilled unless there is protection against loss of pension equities when workers move from one job to another, some advocates of vesting standards argue. This position was expressed by an AFL-CIO spokesman during 1970 congressional hearings as follows:

> Very few employees work for just one employer all their lives. In fact, very few work for one employer as long as 30 years, or even 20. The Monthly Labor Review of September 1968 reported that the median number of years of the men aged 60 to 64--that is, those approaching retirement age--who had been with the same employer was only 15.1 years. In other words, one-half

> of those aged 60 to 64 had less than 15.1 years of continuous service with the same employer. For women in the same age bracket, one-half had less than 9.4 years of continuous service with the same employer.
>
> Clearly, if private pension plans are to fulfill the function of providing retirement benefits for a substantial proportion of workers, a vesting requirement is necessary for all single-employer plans.28/

Another spokesman for organized labor has expressed this viewpoint in support of federal pension-vesting standards:

> ...a pension plan that says to a worker, "As long as you work in this company, your equity is protected," that is no protection. That is no freedom. Or, "As long as you work in this area, your equity is protected."
>
> We want to provide the freedom that a worker needs and has a right to exercise...so we do not want a worker chained to a job as the only means of protecting his pension equity.29/

Contribution to Labor Force Mobility. Advocates of pension-vesting standards argue generally that vesting enhances mobility of the work force and therefore is desirable from the standpoint of manpower utilization. This is particularly true, they contend, with respect to important segments of the labor force such as highly skilled professional, technical, and other white collar workers, as well as some manual workers. Critics of mandatory vesting, however, discount this argument as being, at the best, of minor significance. They point to factors such as job seniority rules as being more significant deterrents to worker mobility than lack of vesting.

Superiority Claims for Administration Proposal. Advocates of the administration's proposed vesting standard contend it is superior to other proposed standards primarily because it concentrates on protecting pension rights of older workers, where the need is the greatest, while avoiding excessive cost increases that might lead to reduction of benefit levels or general retardation of growth of the private pension system.

Required vesting of pension rights earned in the future would start more quickly under the "rule-of-50" formula for an employee at or near age 50 than it would for a younger employee. Under terms of the proposed legislation, for example, vesting for a participant in a pension plan who is age 47 or more (but still more than five years away from retirement age) would have to start in not less than three years. But for a person becoming a participant at age 20, the wait until vesting was required would

be 15 years. Under a straight 10-year vesting requirement applied to pension credits earned in the future, however, the 10-year wait until the start of mandatory vesting would apply to both the 47-year-old and 20-year-old participants.

Data supplied in support of the administration proposal include estimates that the vesting requirement would cause the share of aged-45-and-over participants in private pension plans with vested rights to rise from 60 percent to 92 percent. For participants of all ages, the increase for those with vested benefits would be from 31 to 46 percent. The average cost increase for pension plans now providing no pre-retirement vesting, it was predicted, would be eight percent or 1.8 cents per hour for each covered employee.30/

Both the "rule-of-50" formula and the absence of mandatory vesting of pension benefits accrued before 1974 are factors tending to hold down additional pension costs attributable to the proposed vesting requirements.

Arguments Against Compulsory Vesting

Opposition to legislated pension vesting standards generally is centered not on the merits of vesting as such, but on expected effects of governmental compulsion and standardization.

Proposed vesting requirements, opponents contend, would reduce the flexibility needed by private pension plans, would retard rather than encourage development of new plans, and would tend to deprive both employers and employees of freedom of choice in developing the kinds of pension plans they want.

Vesting Progress and Pension Priorities. Progress that has occurred in the building of vesting provisions into pension plans generally is regarded as indicating widespread acceptance of the desirability of vesting. Where pension plans provide no pre-retirement vesting, or something less than early vesting, it is contended that in most instances deliberate choices have been made in favor of other uses to which pension resources may be put. That is, early vesting has been traded off for larger pension benefits, for other fringe benefits such as disability and widows' benefits, or even for larger wage increases.

This line of reasoning is pursued in one statement, presented in 1970 congressional hearings, which first pointed to the Pension Research Council study as showing that approximately half of present pension coverage is under plans with early vesting that already essentially meet vesting standards of major legislative proposals. The statement continues:

The [proposed] statutory establishment of minimum vesting criteria suggests that it is possible to define "the" minimum vesting requirements which should be universally applicable to all private pension plans. Seemingly, the justification for this is based on the notion that early vested benefits are some sort of inalienable right. If this philosophy were valid, one would expect that Taft-Hartley plans [which are to a large extent dominated by unions] would feature a high degree of vesting. However, the Pension Research Council study shows that precisely the opposite is the case, and that Taft-Hartley funds are distinctly less liberal in vesting conditions than are other private pension plans, on the average. This does not mean that Taft-Hartley pension boards of trustees are short-changing their constituents but, rather, that they have elected to apply available pension contributions and investment income toward meeting higher priority objectives....31/

Equity Problem in Trade-off of Past Service Credits. Critics of compulsory vesting standards challenge the claim of advocates that workers are entitled in all situations to early vesting of pensions as a matter of equity and fair treatment. In many situations, they point out, a choice must be made between early vesting and the granting of past service credits to long-service employees. They argue there often is more equity, especially when new pension plans are being established, in protecting long-term employees at or near retirement age--providing adequate pensions for them--than in vesting pension rights to the credit of younger, shorter-term employees. A steel company executive expresses an opinion on this point:

> Company contributions for pensions are rarely allocated to specific individuals, and current levels of pension benefits could not be provided if that were the case, any more than group life insurance premiums could be allocated and paid to each employee upon termination. The primary purpose of a private pension plan is to provide adequate pension benefits for longer service employees. If there is a desire to set aside funds as savings for each employee and funds are available to do so, that purpose can be accomplished through the establishment of a savings plan, either in conjunction with a pension plan or separately at the choice of the parties involved. (Emphasis supplied.)32/

The point also is made that the great majority of job terminations result from voluntary quitting of work by employees, rather than from permanent layoffs. Usually the employee who quits is in the younger age group and

still will have an opportunity to earn pension rights when he "settles down" to a steady working career, it is said.

Cost Implications of Vesting Standards. There is general agreement that the added cost to existing pension plans of currently proposed vesting requirements would vary widely from none (for plans already satisfying the requirements) or modest costs to substantial costs. Controlling factors in individual instances would include existing vesting provisions of a plan, rate of turnover of the employees involved, and age distribution of the employees.

One witness in 1970 hearings spoke to the cost problem illustratively, using the example of a four-year-old pension plan of an employer who had 237 employees when the plan was established. The plan provided a lifetime retirement income at age 65 with disability or early retirement benefits allowed after 15 years of service at age 55. The witness showed that, within limits of the employer contributions required for the plan, adding provisions to the plan for ten-year vesting of benefits accrued after age 25 would have reduced a $100 monthly normal retirement benefit to $82 monthly. He added:

> Notice specifically that in order to provide benefits to employees who have served 10 years and then left the company, we have to take benefits away from other employees--those who remain with the company until retirement.... For this employer...the effect of adding vesting would amount to only an 18 percent reduction in pension--a modest amount, we might say. But...more importantly, for another employer engaged in another economic activity, the cost of vesting might not be so modest. The committee is no doubt familiar with a study published in the "Transactions of the Society of Actuaries" in 1966 which shows vesting costs ranging up to double, and even triple the basic pension cost in some cases.33/

Discouragement of New Plans. The planning stage preceding the establishment of a new pension plan--or a negotiation between an employer and a union for a new plan--ordinarily is the point at which greatest consideration is given to an initial choice between early vesting for all employees and larger pensions for long-term employees nearing retirement age. The same problem recurs when an existing plan is being liberalized. Opponents of legislated vesting standards contend that, in this circumstance, such standards would tend especially to discourage development of new plans. For example:

> To the extent that mandatory vesting discourages the establishment of the new pension plans and the improvement of existing plans, as we believe it would, the long

range result would be to make private retirement benefits less widely available and more restrictive in scope and amounts, thus denying benefits to employees who might otherwise enjoy them.34/

PROPOSALS AFFECTING PLANS FOR THE SELF-EMPLOYED

Principal effects of the administration's pension bill on retirement plans for self-employed persons and their employees would be to (1) increase to $7,500, but not more than 15 percent of earned income, the maximum annual contribution to such plans that is allowable as a deduction for tax purposes, (2) require such plans to provide earlier participation by older employees than is now required, and (3) relax present vesting requirements applicable to the plans.

Pension legislation proposed through the pending Dent and Javits bills does not contain comparable provisions relating to the so-called Keogh plans. (The term, "Keogh plans," will be used in the remainder of this section in referring to retirement plans established under terms of the Self-Employed Individuals Retirement Act of 1962.)

Background of Keogh Plan Proposals

Legislation under which Keogh plans function was enacted in order to give self-employed individuals an opportunity to defer tax liability on a portion of their income set aside for retirement purposes in much the same way as they and others already could do for their employees under then-existing law. The avowed purpose was to remove what was considered to be discrimination in tax treatment against self-employed people who wanted to accumulate savings for retirement.

The Keogh plans may be utilized by self-employed individuals such as professional people, farmers, owners of unincorporated businesses, and partners in partnerships regardless of whether they have common-law (regular) employees. If such a plan covers a partner owning more than a 10 percent income or capital interest--referred to by statutory definition as an "owner-employee"--all common-law employees with more than three years of service also must be covered under the plan.

Within the limits allowed, and provided all qualification conditions under the Revenue Code are met, contributions made to Keogh plans on behalf of both the self-employed individual and his employees are deductible in computing taxable income. As in the case of qualified pension plans maintained by corporations, investment earnings of the Keogh plans are currently nontaxable. When assets and earnings are withdrawn as retirement income, of course, such income is taxable to the individual receiving it.

A variety of types of investments are available for Keogh plans, much as would be the case for the newly proposed individual retirement plans. The major methods of funding available to Keogh plans are direct purchases of annuity or other insurance contracts from insurance companies and funding through trusts, special custodial accounts with banks, and purchases of special U.S. Government retirement bonds. In addition to banks and insurance companies, sponsors include mutual funds and professional and trade associations. Essentially preapproved, standardized plans are offered by most sponsors.

Under present law, a self-employed person may contribute annually to his Keogh account, on a deductible basis, up to 10 percent of earned income or $2,500, whichever is less.35/ In addition, he may contribute for himself, on a nondeductible basis, an additional amount of up to 10 percent of earned income, subject to the $2,500 limit--provided employees also are permitted to make voluntary contributions. However, if the plan covers only one or more owner-employees, the additional voluntary contribution is not permitted. Although the additional contribution would be from after-tax dollars, earnings accumulations from it are tax-sheltered.

Contributions required to be made by the self-employed person for his fulltime employees with three years or more of service must be at the same percentage of compensation as he contributes for himself. Keogh plans may extend to employees the privilege of making voluntary contributions to their accounts from their own after-tax dollars.

For the self-employed person, earned income from which deductible contributions may be made generally includes professional fees and other compensation received for personal services. For a proprietor or partner who performs substantial personal services in the operation of a business in which he has a capital investment, the earned income includes the profits of the business. However, investment income not involving substantial performance of personal services cannot be included in earned income for purposes of participation in a Keogh retirement plan.

Penalty-free benefits may not be withdrawn from a Keogh plan by an owner-employee, except in the event of his disability or death, prior to his age 59 1/2 years. He must start withdrawing them by at least the year in which he attains age 70 1/2, regardless of whether he has retired. Restrictions are different for employees covered by a plan, but distributions to them begin at the time of their retirement.

Premature distributions of a Keogh plan assets result in tax penalties. For a premature withdrawal by an owner-employee, the penalty is income tax liability on 110 percent of the amount withdrawn. If the withdrawal is less than $2,500, the tax liability is the increase, plus 10 percent, which results from adding the withdrawal to taxable income. If the withdrawal is $2,500 or more, an averaging formula involving the 10 percent penalty is utilized.

As an additional penalty for a premature withdrawal, the owner-employee is disqualified for five years from participating in his Keogh plan.

Details of Legislative Proposals

Provisions of H.R. 12272 affecting Keogh plans are summarized below.

Increased Limits on Contributions. The maximum rate at which deductible contributions might be made annually to a plan by a self-employed person in his own behalf would be increased to 15 percent (up from 10 percent) of a maximum of $50,000 of earned income. Also, if there were employees, the rate would have to be the rate at which contributions were made for the employees. As a result, a self-employed individual would be permitted a deduction of as much as $7,500 contributed for himself to his plan, but only if he contributed 15 percent of compensation for his employees. The maximum rate at which additional nondeductible contributions could be made would be 10 percent of the first $50,000 of earned income.

The limitation on deductible contributions for a shareholder-employee of an electing small business corporation would be, as in the case of the self-employed, the product of the rate at which contributions are made for other employees (not more than 15 percent) and his compensation up to a $50,000 limit.

Earlier Participation for Older Employees. The proposed legislation would forbid a Keogh plan to require, as a condition of participation, that an employee have completed more than one year of service with the employer if the employee's age at the time is 35 years or more, more than two years of service if his age is at least 30 but less than 35 years, or more than three years of service if his age is less than 30 years. This contrasts with the present three-years-of-service standard applicable to all employees. An "employee" is defined so as not to include a part-time worker whose customary employment is for less than 20 hours per week or for not more than five months in a year.

Relaxation of Vesting Requirement. As contrasted with the present requirement for Keogh plans of vesting of employee rights when contributions are paid, the proposed change is to a "rule of 35" which combines age and years of service. That is, an employee's interest in at least 50 percent of his rights under a plan would be required to be nonforfeitable when his age and years of participation totaled 35 years. The balance of his rights then would have to be vested not less rapidly than ratably over the next five years of participation.

The effective date for amendments affecting Keogh plans would be taxable years beginning after 1972 unless the taxpayer elected to apply them to a taxable year ending after December 31, 1971.

Policy Questions Raised by Proposals

Purposes of the proposal to permit larger contributions to Keogh plans on a deductible basis, according to the President, are to achieve greater equity for such plans and to "encourage and enable the self-employed to provide more adequate benefits for themselves and for their workers."36/

Referring to the fact that there are no limits on deductible contributions by corporations on their employees' behalf that are comparable to the present limits for Keogh plans of the lesser of $2,500 or 10 percent of earned income, the President states:

> This distinction in treatment is not based on any difference in reality, since self-employed persons and corporate employees often engage in substantially the same economic activities. One result of this distinction has been to create an artificial incentive for the self-employed to incorporate; another result has been to deny benefits to the employees of those self-employed persons who do not wish to incorporate which are comparable to those of corporate employees.37/

Present limits on contributions to Keogh plans and the fact that contribution rates on behalf of employees must be the same as for the business owner have been found to result often in unduly low rates of contributions made for the employees. This happens especially in the case of an owner anticipating relatively high levels of earned income from his business or professional pursuits.

For example, if the owner anticipates annual earned income of $100,000, a contribution rate of 2 1/2 percent written into his Keogh plan will permit him to set aside to his account, on a deductible basis, the present maximum of $2,500 per year. However, the same rate of 2 1/2 percent of employees' wages and salaries would apply to contributions made by him for his employees. In the case of an employee earning $10,000, consequently, the contributed amount for him would be $250.

The proposed changes in the limits on contributions, it is argued, would both achieve greater equity and encourage and enable self-employed persons to provide more adequate retirement benefits for themselves and their employees. Under the proposed legislation, the owner could set aside through his Keogh plan tax-deductible savings of as much as 15 percent of the first $50,000 of earned income. Thus with earned income of $50,000 or more he could achieve the maximum deductible contribution of $7,500, but to do this he would have to make 15 percent contributions for his employees.

The proposed change with respect to participation of employees in Keogh plans would assure earlier participation than under present law for employees who are 30 or more years of age. This change is supported by its

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advocates on the grounds of desirability of improving the position of older workers.

While the proposed change in vesting requirements for Keogh plans--from immediate vesting to a "rule of 35"--represents a relaxation of present requirements, it is regarded as being more consistent with the new vesting requirements proposed for retirement plans of corporate employers. Furthermore, the relaxation will tend to encourage more self-employed persons to set up Keogh plans for themselves and their employees, it is argued.

Generally, the proposal to increase limits on contributions to Keogh plans is subject to much the same "con" arguments as the proposed tax deferment for individual retirement plans. That is, it may be argued, it would tend to further erode the tax base in violation of sound principles of taxation, would offer greater benefits to higher-income people, and would further complicate federal budget balancing problems.

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SPECIAL ELIGIBILITY AND VESTING REGULATIONS

H.R. 12272 contains amendments, affecting in certain circumstances both retirement plans of corporate employers and the Keogh plans, which would authorize the issuance of regulations relating to nondiscrimination requirements of the Revenue Code.

The purpose and nature of the proposed amendments are described as follows:

> Present Law. While the Internal Revenue Code does not provide any specific and generally applicable requirements on the age and service conditions for participation in a qualified plan and does not contain any specific and generally applicable requirement that a participant in a qualified plan have at any time before retirement age a nonforfeitable right to receive his accrued benefit, the age and service conditions for participation in a plan and the extent of pre-retirement vesting under the plan are considered by the Internal Revenue Service in determining whether the plan satisfies the nondiscrimination requirements of the Code. However, neither the circumstances under which less restrictive age and service conditions for participation and pre-retirement vesting will be required to satisfy the nondiscrimination test, nor the substance of satisfactory provisions in cases where they are required, are well defined. As a result, considerable variation and uncertainty has arisen.
>
> Proposal. The proposed bill would authorize the promulgation of regulations setting forth (1) the circumstances under which a plan will satisfy the nondiscrimination requirements only if the conditions of participation in the plan are less restrictive than those which would be generally applicable under the proposed bill and the conditions for vesting of benefits under the plan are less restrictive than those of general application under the proposed bill, and (2) the provisions which will be required in order to insure that a plan will satisfy the nondiscrimination requirements in light of the particular circumstances. Failure to include such conditions in a plan would result in the disqualification of the plan. Such provisions could not however, be required

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to be more restrictive than those which would be imposed by the bill on plans benefiting self-employed individuals who are owner-employees. The proposed bill in this respect would apply only to plans covering--

(1) a partner having (a) more than a 5 percent interest in capital or income, or (b) more than a 1 percent, but not more than a 5 percent, interest in capital or income if all such partners have more than 50 percent of the interests in capital or income; or

(2) an employee owning (or considered as owning within the meaning of section 318(a)(1) of the Code) (a) more than 5 percent in value of the outstanding stock of the corporation or (b) more than 1 percent, but not more than 5 percent, in value of the outstanding stock if all such employees together own more than 50 percent in value of the outstanding stock.

Effective Date. These rules would apply to plan years to which the proposals relating to eligibility and vesting would apply.38/

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NOTES TO TEXT

Notes to Chapter 1

1/ For a detailed analysis of these bills, as well as general information about the private pension system, see Issues Affecting Private Pensions, published in April 1971 by the American Enterprise Institute for Public Policy Research. For additional background information, see also The Debate on Private Pensions, published in 1968 by the American Enterprise Institute.

2/ One change of some significance concerns the exemption of profit sharing, stock bonus, thrift and savings, and similar plans from a proposed limitation (applicable to pension plans) of 10 percent of a fund's assets that may be invested in an involved employer's securities. Under the revised bill, such plans would be exempt from the limitation if they explicitly permit--rather than require--investments of this character. The administration's original proposals and similar proposals of the Dent and Javits bills are analyzed in Issues Affecting Private Pensions, op. cit.

3/ As a practical matter, most nonqualified pension plans are unfunded, pay-as-you-go arrangements under which benefits are paid to retirees out of the general assets of the employer. In this circumstance the payments to retirees are currently deductible by the employer, the retirees are taxable for the benefits they receive, and there are no investment earnings of a fund to be taxed. However, such nonqualified, unfunded plans have disadvantages which make them undesirable except under special circumstances.

4/ Source of data: Walter W. Kolodrubetz, "Trends in Employee-Benefit Plans in the Sixties," Social Security Bulletin (Washington: U.S. Department of Health, Education and Welfare), April 1971, pp. 21-34.

5/ Ibid.

6/ Daniel M. Holland, Private Pension Funds: Projected Growth (New York: National Bureau of Economic Research, 1966), p. 2.

7/ Social Security Bulletin, op. cit.

Notes to Chapter 2

8/ So named because the Self-Employed Individuals Tax Retirement Act of 1962 started its legislative course as H.R. 10 and was authored by Rep. Eugene J. Keogh.

9/ The limitation is expressed in the bill as not to exceed "20 percent of so much of his earned income for such taxable year as does not exceed $7,500."

10/ With an exception as to investments in a common trust fund.

11/ More precisely, "by not later than his taxable year in which he attains the age of 70 1/2 years."

12/ President's Message on Pension Reform, December 8, 1971, hereinafter referred to as President's Pension Message.

13/ Acting Treasury Secretary Charles E. Walker in explanation submitted to the Congress of the proposed Individual Retirement Benefits Act of 1971, 117 Congressional Record S21591 (daily ed., December 14, 1971).

14/ Ibid.

15/ Estimates from Fact Sheet distributed in conjunction with the President's Pension Message, op. cit.

16/ Robert J. Myers, "Government and Pensions," Private Pensions and the Public Interest (Washington: American Enterprise Institute for Public Policy Research, 1970), p. 36.

17/ These conclusions, in substance, are expressed by Raymond Goetz, Professor of Law at the University of Kansas, in Tax Treatment of Pension Plans--Preferential or Normal? (Washington: American Enterprise Institute for Public Policy Research, 1969).

Notes to Chapter 3

18/ James H. Schulz, Pension Aspects of the Economics of Aging: Present Future Roles of Private Pensions, a working paper prepared for the Special Committee on Aging, United States Senate (Washington: U.S. Government Printing Office, 1970), p. 36.

19/ Public Policy and Private Pension Programs, A Report to the President on Private Employee Retirement Plans (Washington: U.S. Government Printing Office, 1965), hereinafter referred to as Cabinet Committee Report.

20/ Harry E. Davis and Arnold Strasser, "Private Pension Plans, 1960 to 1969--An Overview," Monthly Labor Review, July 1970 (Washington: U.S. Department of Labor), p. 45.

21/ Frank L. Griffin, Jr., and Charles L. Trowbridge, Status of Funding Under Private Pension Plans (Homewood, Ill.: Richard D. Irwin, Inc., 1969), p. 40.

22/ Certain reasonable assumptions, explained in the study, were used to classify vesting that depended on age only, that was conditioned on a combination of age and years of service, or that was of the "graded" type.

23/ Carl H. Fischer, Vesting and Termination Provisions in Private Pension Plans (Washington: American Enterprise Institute for Public Policy Research, 1970), pp. 14-15.

24/ Repeated in this analysis from Issues Affecting Private Pensions, op. cit.

25/ President's Pension Message, op. cit.

26/ Cabinet Committee Report, op. cit., p. 39.

27/ 113 Congressional Record S2689 (daily ed., February 28, 1967).

28/ Andrew J. Biemiller, director of legislation, AFL-CIO, Private Welfare and Pension Plan Legislation, Hearings, General Subcommittee on Labor, Committee on Education and Labor, House of Representatives, 91st Cong., 1st and 2d sessions (Washington: U.S. Government Printing Office, 1970), p. 105. (Hereinafter referred to as House Pension Hearings.)

29/ From statement by the late Walter Reuther, president of United Automobile Workers of America, ibid., pp. 174, 185.

30/ Data from President's Pension Message and accompanying fact sheet, op. cit.

31/ John Moore, of the Wyatt Company (consulting pension actuaries), House Pension Hearings, op. cit., p. 329.

32/ H. C. Lumb, then vice president of Republic Steel Corporation, representing the National Association of Manufacturers, ibid., p. 296.

33/ Eldon Nyhart, president of Howard E. Nyhart Company (employee benefit consultants and actuaries, Indianapolis, Indiana), ibid., p. 684.

34/ H. C. Lumb, ibid.

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Notes to Chapter 4

35/ There is no limit on earned income to which the contribution rate applies. For example, if earned income is $100,000, a rate of 2 1/2 percent will produce the dollar-amount maximum of $2,500.

36/ President's Pension Message, op. cit.

37/ Ibid.

38/ Walker explanatory statement submitted to the Congress, op. cit.

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