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1974 pension reform: A special report on the Employee Retirement Income Security Act of 1974

Touche Ross & Co.

1974 PENSION REFORM

a special report on

The Employee Retirement Income Security Act of 1974

TOUCHE ROSS

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INTRODUCTION

The Employee Retirement Income Security Act of 1974 that recently became law contains major reforms of our private retirement system. These affect every company that has or will have a retirement program of any type, including plans set up through collective bargaining. Practically every pension and profit-sharing plan will have to be amended and, presumably, the Internal Revenue Service will eventually requalify all existing plans.

The overall purpose of this legislation, as revealed by Congressional statements and the legislation itself, is to assure that pension plans are financed and operated in such a manner that employees ultimately receive promised benefits. The Act does not require any company to establish a pension plan. But it does set federal standards for established plans, and probably is the prelude to further legislation.

The cost of providing retirement benefits will increase as will the cost of administering them. In some cases, the added costs will be minor, but in other cases the cost will be sufficiently high that employers may consider making substantial modifications to their existing plans, beyond those required for mere compliance with the Act.

The initial legislative proposals and the final compromise legislation received huge majorities in Congress. One of the larger stumbling blocks had been whether the Department of Labor or the Internal Revenue Service would be responsible for administering and implementing the legislation. This issue was finally worked out on the basis of split jurisdictions. The Department of Labor has primary jurisdiction in the areas of individual benefits and fiduciary standards. Tax matters and funding standards are the responsibility of the Internal Revenue Service.

The purpose of this Report is to point out those areas in which important changes have been mandated, and to indicate how to measure their effect on your company.

Because many technical terms are used in pension matters, the glossary should be reviewed before reading the full Report.

This Report is limited to the highlights of this legislation; it should not be used as a definitive interpretation.

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HIGHLIGHTS OF THE NEW PENSION LAW

Eligibility Requirements – One year's employment or attainment of age 25, whichever is later.

Vesting Standards – One of three alternative standards must be adopted and followed. In all cases, employees must be at least 50% vested after 10 years of employment and 100% vested after 15 years.

Funding Standards – Each year's current costs must be funded in full. Past service costs must be funded over 30 to 40 years.

Plan Termination Insurance – Insurance against loss of benefits is compulsory.

Fiduciary Standards – Plan administrators, trustees, and other fiduciaries will be held to much stricter standards than in the past.

Disclosure and Reporting – Much more of both.

Individual Retirement Accounts – An employee not covered by a qualified retirement plan or a government plan can set up his own retirement account. His contributions are tax deductible and any investment earnings are not taxed currently.

H.R. 10 Plans – Annual contribution limits have been increased to the lesser of $7,500 or 15% of earned income. Also, a minimum deduction is available of up to $750, but not in excess of earned income.

GLOSSARY

The following definitions of key terms are necessary because the language of pensions is replete with jargon.

Eligibility Requirements – The conditions an employee must satisfy to become a participant in the plan.

Defined Benefit Plan – A pension plan in which employees receive a benefit at retirement predetermined by formula. The employer contribution is determined by actuarial calculations.

Defined Contribution Plan – A plan in which the employer contribution rate is fixed and the retirement benefit is whatever the accumulated contributions provide. Most plans of this type are called money purchase pension plans or profit-sharing plans.

Vesting – The employee's right to benefits whether he leaves or loses his job.

Qualified Pension and Profit-Sharing Plans – Plans that have met the requirements of the Internal Revenue Code and, accordingly, the employer's contributions are tax deductible within limits and employees are not immediately taxed on either the employer's contributions or the investment income earned by the plan's assets. These plans must meet numerous requirements such as not discriminating in eligibility or benefits in favor of certain groups.

Prior Service Costs (Accrued Liabilities) – The pension costs assigned under an actuarial cost method for retirement benefits accrued prior to the current year.

Plan Year – The plan's accounting year, which need not coincide with the employer's financial accounting year.

THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

GENERAL COMMENTS

If your retirement plan has been approved or is in the process of being approved by the Internal Revenue Service as a qualified plan, regardless of whether it is a pension or a profit-sharing plan, you are subject to the provisions of the law outlined in this Report. Certain nonqualified plans are not subject to the provisions of this law, including a nonqualified plan maintained for a "select group of management or highly compensated employees." As a consequence, such a plan may receive more attention in the future as a means of providing higher benefits for higher-income executives than is allowed for qualified plans (see page 16). Among other plans excluded from the provisions of this law are government (federal, state, and local) plans, church plans, union plans that do not provide for employer contributions and non-U.S. plans maintained for non-U.S. citizens.

The new legislation is primarily directed toward qualified private pension and profit-sharing plans. Other employee welfare plans whose benefits are communicated orally or in writing are also subject to the Act but it appears that they are affected in relatively minor ways.

In applying many of the provisions of this law, all employees of affiliated corporations are treated as employees of one corporation.

Keep in mind that the law has only recently been enacted and many of its provisions will not be entirely clear until the usual regulations and explanations are issued.

ELIGIBILITY REQUIREMENTS

A key issue in pension and profit-sharing plans is when are employees eligible to participate in the plan. Under prior law, eligibility was determined by the provisions of each plan. Under the new law, with minor exceptions, employees must participate after one year of employment or attainment of age 25, whichever is later. For plans that provide 100% vesting on eligibility, the one-year requirement may be increased to three years. In a 12-month period, 1,000 hours of employment generally constitute a year of service for eligibility and vesting purposes, but there are various provisions for special cases.

Defined benefit plans (see glossary) may exclude employees who are within five years of retirement age when hired. This exclusion protects older workers whose required participation in the plan might be so costly as to reduce their opportunities for employment. This exclusion does not apply to profit-sharing or money purchase plans (defined contribution plans).

Whatever the eligibility requirements, once an employee is eligible to participate in a plan, all years of employment after age 22 generally are counted for vesting purposes, including employment before this new legislation. But, the accrual of pension benefits starts in the year an employee meets the eligibility tests. Thus, an individual who works from age 22 to age 32 would have ten years of service for vesting purposes. He would be vested only in the pension benefits obtained during the seven years he was a participant in the plan (assuming eligibility at age 25). The only services for which a participant need not receive vesting credit are for years of employment prior to the establishment of a plan, prior to age 22, years in which he declined to make a mandatory contribution, and service prior to 1971 unless the employee worked at least three years after December 31, 1970.

These provisions are effective immediately for new plans. Most established single and multi-employer plans are fully subject to the new eligibility requirements in plan years beginning after December 31, 1975. (A multi-employer plan is any plan subject to collective bargaining to which a substantial number of employers contribute.) Multi-employer plans based on collective bargaining agreements currently in force may obtain delays if compliance would be an economic hardship.

Eligibility for H.R. 10 Plans. The 1962 "Self-Employed Individual's Tax Retirement Act," popularly known as H.R. 10, permitted self-employed individuals to establish qualified pension and profit-sharing plans for themselves and their employees.

Under the prior law, the eligibility requirement for persons employed by an owner-employee (an individual owning more than a 10% interest) could not exceed three years' employment, and the plans had to provide full and immediate vesting upon eligibility. These provisions have not been changed.

Eligibility of Unionized Employees. If a retirement plan for unionized employees exists under a collective bargaining agreement, an employer can set up a plan for other employees and exclude those already covered under the plan set up through collective bargaining. Similarly, if a union has rejected a retirement plan, the employer may set up a plan excluding unionized employees.

Service with a Predecessor Employer. If a new employer takes over the plan of a predecessor, service with the predecessor must be counted for purposes of the plan. The new employer is bound by the terms of the predecessor's plan unless the plan is amended or terminated.

VESTING PROVISIONS

Vesting is an important element in the cost of a plan. Under prior law, many plans granted full vesting only upon retirement age; however, a few I.R.S. offices had been requiring plans to have rapid vesting schedules before granting qualification. The new vesting provisions offer three alternative minimum vesting standards with respect to employer contributions, and require adoption of one. Under all three, an employee must be 100% vested after 15 years of service. The least costly vesting standard may be selected. The alternatives are:

- 10-Year Rule – 100% vesting in plan benefits after ten years of employment.
- Graded Vesting – 25% vesting after five years, then 5% additional vesting for each of the next five years, then 10% for each of the next five years. Thus 100% vesting after 15 years.
- Rule of 45 – This standard requires 50% vesting when an employee has at least five years of service and his age plus years of service add to 45. Additional vesting must be at least 10% for each year thereafter. To protect younger workers, an ancillary rule provides that if the rule of 45 is adopted, anyone who has been in a plan for ten years must be at least 50% vested.

If a plan changes its vesting schedule, the vesting percentage for each participant in his accrued benefit at the date of amendment cannot be reduced as a result of the amendment. In addition, as a further protection for long service employees, any participant with at least five years of service may elect to remain under the preamendment vesting schedule with respect to all of his benefits accrued both before and after the plan amendment.

These new vesting standards mean that many employees will obtain vested (nonforfeitable) rights to benefits in fewer years than previously. But more rapid vesting may still mean little to those, such as engineers, employed on projects of short duration. To accommodate such special cases, the Act allows an employer to establish a separate plan that provides for faster vesting in exchange for lower benefits, without altering the regular plan established for longer-term employees.

Effect of Employee Contributions on Vesting Provisions. In plans where both employers and employees contribute, it is necessary to separate employer and employee derived benefits. This separation is necessary because an employee is always fully vested in his own contributions but not necessarily in the employer contributions. The separation will also be necessary if an employee leaves the plan and decides to withdraw his own contribution. Such separation presents no problems in other than defined benefit plans because the employee-contributed portion of the total benefit is normally the amount in his own account, or can be determined from the ratio of total employee contributions to total contributions.

In defined benefit plans, an interest factor and conversion factor of 10% must be used to determine the portion of the vested benefit attributable to employee contributions. The new law sets the interest rate at 5% annually. Both the interest rate and the conversion factor are to be adjusted in future years on the basis of criteria set out in the law.

The new law provides that an employee who withdraws his own contributed funds from a plan loses the employer contributions if he is less than 50% vested, but retains all employer contributions if he is 50% or more vested. Any forfeited benefits will be restored if the employee repays the withdrawn funds within one year with interest at 5%.

When Do the New Vesting Provisions Become Operative? The new vesting provisions apply to all new plans once established. For existing single and multi-employer plans, the effective date is plan years beginning after December 31, 1975. Delays are authorized for collectively bargained plans if compliance would be an economic hardship or if present benefits are substantially above the minimum requirements. Delays may not extend beyond the expiration of the agreement or plan years beginning after December 31, 1980, whichever is first.

When Retirement Benefits Must Be Paid. Vested benefits under corporate plans are payable at the plan's normal retirement age but not later than age 65 unless the requirement of ten years participation extends past age 65. Retirement payments must start within 60 days after the end of the plan year in which the participant retires (usually age 65 or earlier retirement age).

Form of Payment. The Act requires plans providing retirement benefits in the form of an annuity to provide at least 50% of the benefit in the form of a joint and survivor annuity. This rule applies to all participants married at least one year prior to the annuity starting date. The added cost is borne by the participant whose periodic payments will be reduced to reflect the additional cost of providing benefits to a surviving spouse. A retiree may decline the joint and survivor annuity in writing. Otherwise, at normal or deferred retirement age, a participant will automatically receive at least 50% of his benefits in the form of a joint and survivor annuity.

A participant eligible for early retirement is in a different position. He must elect a joint and survivor annuity, if he does not opt for early retirement. Thus, if he does not take early retirement, and does not elect a joint and survivor annuity, and dies before normal retirement age, his wife will get nothing. If he lives until normal retirement age, he will automatically receive the joint and survivor annuity unless he exercises his right to make a written refusal.

Vested benefits may be used as collateral for reasonable loans from the plan provided the loans do not violate the fiduciary requirements imposed by the law.

To avoid complicated record keeping for minor pension amounts, a participant may be given his full vested benefits in cash, without his consent, when he leaves his job if the value of his vested benefits does not exceed $1,750.

The Rate of Benefit Accrual. The Act limits the methods used to calculate a participant's accumulated benefits on which vesting is based. Plans must structure the accumulation to minimize "back-loading" (providing minimal benefits in early years to minimize the vested amount and increasing the benefits in later years). Each plan must satisfy one of three accrued benefit tests incorporated in the Act.

Vesting in Multi-Employer Plans. In multi-employer plans governed by a collective bargaining agreement, the years of employment for vesting purposes are to be determined as if all parties to the plan constitute a single employer. For example, five years of employment with Company A and five with Company B are counted together if both companies are in the same plan.

Interrupted Employment. What happens to an employee who is laid off for six months after five years of employment and is then rehired? Does his prior service count for vesting purposes? The general rule is that an employee is considered to have a one-year break in continuity of employment. The Act contains detailed rules about this matter and, in some cases, the answer depends on the nature of the industry and on future regulations.

Special Vesting Standard for Plans Found to Discriminate. A plan might be in compliance with the vesting provisions and still be found to be discriminatory by the I.R.S. This might occur, for example, where a plan adopted the vesting standard providing for 100% vesting after ten years, but engaged in a pattern of discharging employees before they obtained vested rights. In handling such cases, the I.R.S. has been directed to institute a uniform standard requiring such plans to provide 40%

vesting after four years, 45% in the fifth year, 50% in the sixth, and an additional 10% each year thereafter until 100% vesting is obtained.

Plan Terminations. The new Act does not change the prior laws regarding full vesting when plans are terminated. When a plan is terminated, all participants become 100% vested.

FUNDING REQUIREMENTS

Under prior law, the annual tax deductible contribution to a qualified pension plan need only cover the liabilities created during the current year (normal cost) and the interest on any unfunded accrued pension liabilities (prior service costs). These deductions and the flexibility allowed in funding and investing requirements probably accounted for the rapid growth of pension plans, although excess profits taxes and wage stabilization programs were also factors.

The new stricter minimum funding requirements are the crux of the new law. Faster eligibility and earlier vesting mean little unless dollars are available to pay for them, and funding provides the dollars. The new funding requirements apply to all plans subject to the Act's vesting and participation requirements except profit-sharing or savings plans, plans maintained solely by employee contributions, and pension plans funded exclusively by individual insurance contracts.

Some multi-employer plans are funded on the basis of a percentage of payroll. Such plans can continue funding on the basis of a uniform percentage of payroll, provided they meet the minimum funding standards. Thus, future years, when wages are likely to be higher, will bear a larger share of the funding burden.

The annual maximum contribution permitted to a profit-sharing plan has been changed, and the allowable tax deductible contribution to H.R. 10 plans has increased.

These matters are discussed in the section MAXIMUM RETIREMENT BENEFITS AND CONTRIBUTIONS FOR INDIVIDUALS. This section covers only the minimum and maximum funding requirements of pension plans. The aggregate contributions for all plan years beginning after December 31, 1975 must cover at least the following:

- 100% of the liabilities created during the current year (normal cost), plus
- For plans in existence on January 1, 1974, unfunded liabilities for prior services must be funded in equal installments over no more than forty years, including principal and interest.

  For plans established after January 1, 1974, unfunded liabilities for prior services must be funded over no more than thirty years (forty years for multi-employer plans).
- The increase in the unfunded liabilities for prior services that arise from amending a plan must be funded over no more than thirty years (forty years for multi-employer plans).
- If actual experience differs from actuarial assumptions so that a net experience gain or loss results, such gain or loss must be amortized over no more than fifteen years from the date of each gain or loss for single employer plans and over no more than twenty years for multi-employer plans.

Alternative Funding Standard. An alternative funding standard is available which gives employers some leeway between the minimum required contribution and the maximum deductible contribution. Under this alternative standard, the minimum permitted contribution for any year is the amount needed to fully fund the plan (plan assets equal to plan liabilities), with plan assets valued at fair market value.

Actuarial Assumptions Used For Funding. An enrolled actuary (one qualified to practice before the Departments of Labor and Treasury) must certify that the actuarial assumptions and methods used for determining contributions are reasonably related to the plan's experience.

Assets must be valued by an approved method that takes fair market value into account, except that bonds and other forms of indebtedness may be valued at amortized cost.

The determination of experience gains and losses and the valuation of plan liabilities must be made at least once every three years. If not made, a penalty of $1,000 will be assessed against the plan administrator, unless reasonable cause exists.

Funding Relief in Hardship Cases. In a year that funding requirements create substantial financial difficulties, the Treasury Department is authorized to waive the funding requirements. Such waivers may not be given for more than five years of any fifteen consecutive plan years.

A waived annual contribution must be funded in equal annual installments over the next fifteen years. During a waiver period, the plan cannot be amended to increase benefits.

Funding Penalties. If funding relief is not authorized on the basis of hardship, and the minimum required funding contribution is not made, a penalty of 5% of the required contribution will be imposed. If the required contribution is not made after prescribed notice, an additional penalty of 100% will be imposed. These penalties are imposed on the employer and are not deductible for income tax purposes.

Maximum Tax Deductible Contribution. The minimum funding requirements do not prohibit the sponsor of a qualified pension plan from increasing its contribution in any year it wishes to decrease the unfunded prior service liability and, by so doing, obtain a larger tax deduction, within certain limits.

The former maximum limitation of 5% of covered employees' annual compensation has been repealed. In addition, the maximum deductible under the 10% rule has been changed to permit higher deductions.

In general, the Act provides that deductions are to be allowed to the extent of contributions required to meet the minimum funding standards. In many instances, the maximum contribution deductible for tax purposes will be the normal cost plus 10% of an unfunded past service base. The 10% includes principal and interest and, therefore, is not the same as the 10-year amortization permitted under prior law. Previously the maximum tax deduction had been normal cost plus 10% of an unfunded past service base which meant that more than 10 years were needed because of the interest accruing on the unfunded costs. Increases in prior service cost resulting from amendments to the plan or from experience losses can also be amortized over 10 years.

The deductible amounts must be based on the same actuarial funding methods and assumptions as were used to determine the minimum funding requirements. Also, under the Act, contributions by cash basis taxpayers (and accrual basis taxpayers as under prior law) which are made by the time the tax return is filed for the year in question may be treated as paid in that year.

The Act prescribes new limitations on contributions and benefits with respect to any individual, and these are described below.

MAXIMUM RETIREMENT BENEFITS AND CONTRIBUTIONS FOR INDIVIDUALS

Because qualified retirement plans enjoy considerable tax benefits, the legislators incorporated specific provisions in the Act to limit the retirement benefits that any one participant can obtain. Previously, there were no specified limits. While the maximum retirement benefits are fairly high, some highly-paid executives may find their retirement benefits less than anticipated.

The method used to set maximum retirement benefits varies with the type of plan and, consequently, each type of plan will be discussed separately.

Defined Benefit Plan. The maximum annual benefit in this type of qualified plan is 100% of a participant's average pay during his three highest-paid consecutive calendar years, or $75,000, whichever is less. This maximum benefit is adjustable up or down in minor ways to take into account such factors as changes in the cost of living, voluntary contributions of the employee, retirement benefits paid prior to age 55 or for less than ten years of employment, and special forms of payment. A grandfather clause allows higher benefits to participants in a plan in existence on October 2, 1973, if the benefits were in excess of the maximums and were not changed after that date. There seems to be nothing in the Act that would prohibit an employee from earning the maximum pension from one employer and then working for an unrelated employer to earn a second pension.

Defined Contribution Plans (Profit-Sharing or Money Purchase). For these plans, the limitation on retirement benefits is imposed by limiting the annual employer contribution to the plan. The maximum "annual addition" to a participant's account cannot exceed 25% of his compensation or $25,000, whichever is less. The term annual addition includes the employer contribution, forfeitures of other participants, and the lesser of one-half of all employee contributions or employee contributions in excess of 6% of compensation. The $25,000 limitation will be adjusted annually for changes in the cost of living. The overall limitation on corporate contributions to profit sharing plans remains at 15% of employee compensation.

Two or More Plans by the Same Employer. If the same employer has two or more plans of the same type, all the plans will have to be considered as one for the purpose of applying the above limits. However, some companies have both a pension and a profit-sharing plan (defined benefit and defined contribution plan). For participants in two such plans, the maximum retirement benefits are governed by a formula that essentially limits the combined retirement benefits to 140% of the individual plan limitations.

H.R. 10 Plans. The retirement benefits that can be obtained by self-employed persons under H.R. 10 plans have been significantly increased. The prior maximum annual tax deductible contribution of $2,500 has been increased to $7,500 or 15% of earned income, whichever is less. The law also establishes a minimum contribution level of up to $750 a year out of earned income, without regard to the percentage limitation. As under prior law, the annual contribution is tax deductible and any income earned by invested contributions is not currently taxable.

Under prior law, most H.R. 10 plans were defined contribution plans because the uncertain amount of the annual contribution seemed to preclude defined benefit plans. The new law allows self-employed persons the option of setting up defined benefit plans. How the $7,500 – 15% limitation will be translated into tax deductible contributions to a pension plan is left to future regulations, although the Act contains guidelines for determining maximum benefit limits. If this option is selected, however, similar benefits under an owner-employee plan must be provided to employees, and the plan cannot be integrated with Social Security benefits.

As under prior law, a penalty is imposed on a premature distribution of funds to an owner-employee. Any withdrawal of funds before age 59 1/2 is considered a premature distribution except when due to death or disability. The penalty, a flat 10% of the premature distribution, is in addition to the regular income taxes payable on the withdrawn funds. However, voluntary contributions may be withdrawn, if permitted by the plan, without penalty.

Earned Income Limitation on Contributions. A self-employed person may take only $100,000 of his earned income into account when determining his annual contribution, no matter how many plans he may establish. The effect of this $100,000 earned income contribution base limitation is that a self-employed person whose earned income is over $100,000 can obtain the $7,500 maximum deductible contribution only if his overall contribution rate for covered employees is at least 7 1/2%.

Subchapter S Plans. The shareholders of Subchapter S corporations are treated generally as self-employed partners. Thus, many of the provisions for H.R. 10 plans contained in the new law also apply to them, including the annual contribution limit of $7,500 - 15%.

Employee Individual Retirement Plans. For the first time, employees not participating in employer retirement plans can set up their own retirement plans. Since at least 50% of nonagricultural employees are not currently included in the private pension system, this should prove popular even though the benefits available to individual employees are much less than for H.R. 10 plans.

The maximum annual tax deductible amount that employees can contribute to their own plans is the lesser of $1,500 or 15% of earned income. Any income earned on the contributed funds is not taxed until distributed. The amounts contributed and earnings of the contributed funds will generally become taxable as the funds are withdrawn by the individual, starting when he reaches retirement age but no later than age 70 1/2. Generally, all withdrawals from individual plans will be taxable as ordinary income.

The employee plans are known as Individual Retirement Accounts and will undoubtedly be popularly referred to as an IRA. An IRA can be established as a mutual fund, bond account, savings account with a bank or savings and loan institution, or an individual annuity contract.

The IRAs are available only to individuals not actively participating in an employer plan. This means that an individual not yet eligible for an employer plan can establish his own IRA as can an individual who has left an employer plan and is no longer accruing benefits. Even though an employer has a qualified plan, an individual who can opt not to join the plan may set up his own IRA. If both husband and wife are not active participants in an employer plan, both can form IRAs, and obtain a combined maximum deduction of $3,000 per year. The tax deduction is from gross income, so employees who take a standard deduction will still benefit from the deduction for retirement contributions.

Premature distributions from an IRA, before age 59 1/2, will be subject to a penalty of 10% of the distribution, in addition to the regular income tax payable on the distributed funds. This does not apply in cases of death or disability.

To provide investment flexibility, assets can be withdrawn from one IRA account and reinvested in another type of IRA account within 60 days without penalty.

Companies, labor unions, or other groups can sponsor IRAs for employees or members. The effective date of the IRA provisions is plan years beginning after December 31, 1974.

Integration with Social Security. Under prior law, some qualified plans tied in the retirement benefits payable with Social Security benefits, and some reduced the benefits payable as Social Security benefits increased. Such plans are known as integrated plans. The new Act provides that in limited cases a qualified plan may not adjust its retirement benefits in accordance with increases in Social Security benefits after a benefit level has been set. Specifically, when a retired employee is receiving benefits or once a terminated employee has nonforfeitable rights to future benefits, his benefits cannot be changed by reason of subsequent Social Security increases. But the pension benefits of active participants can be adjusted for increases in Social Security.

PORTABILITY

Portability refers to a participant being able to transfer his retirement benefits from one plan to another and, ultimately, to get one check at retirement that represents the benefits accumulated in his various employments. The new law does not establish a central portability fund as had been proposed. However, the new law does provide for tax-free transfers or rollovers from one IRA to another and from the qualfied plan of an employer to an IRA, or vice versa, with the consent of both employer and employee. Also, a Social Security clearing house will be established to keep track of each individual's benefits that are vested after termination of employment.

FIDUCIARY RESPONSIBILITIES (Investment Limitations)

The fiduciary responsibilities imposed by the Act are very specific and have teeth in them. They include a new federal "prudent man" rule that overrides state statutes – the fiduciary's handling of the plan's affairs will be judged by the yardstick of the care and diligence a prudent man would use. The Act goes beyond this general rule. A fiduciary can be held responsible for the breach of a colleague if his failure to exercise reasonable care enabled the breach to be committed. Persons considered fiduciaries include officers and directors of a plan, the plan's investment committee and persons who select them, investment advisors, and may include outside consultants and advisors who exercise discretionary authority over the management of the plan. Fiduciaries of pension funds must act solely in the interest of the participants and beneficiaries and all fiduciaries must be bonded. A list of prohibited transactions is included in the Act. Employees and beneficiaries can institute civil court action if they believe their plans are not being administered in accordance with the law or that their contractual rights are being violated. Fines and other penalties can be imposed for these and other violations. These provisions generally become effective on January 1, 1975.

Investment Limitations. The investment of accumulated pension funds must be diversified to minimize the risk of large losses. No direct percentage limitation is imposed except for the requirement of adequate diversification. However, plans will not be permitted to invest more than 10% of their assets in employer securities. If this requirement is difficult to accomplish, a 10–year phase-out period is provided. The 10% investment limitation does not apply to profit-sharing or other defined contribution plans.

A transaction with a party in interest (for example, purchase of the employer's securities, leasebacks) is permitted but only for adequate consideration.

REPORTING AND DISCLOSURE REQUIREMENTS

The new Act significantly increases the reporting and disclosure requirements for employee benefit plans over those prescribed by the *Welfare and Pension Plans Disclosure Act of 1958.* While the main thrust of the new Act is employee pension reform, the reporting and disclosure requirements apply to employee welfare plans as well. Exempted from these requirements are governmental plans, certain church plans, workmen's compensation and unemployment compensation plans, and certain other special situation plans. The reporting and disclosure requirements are to take effect on January 1, 1975, although this date may be later for plans on fiscal years.

Annual Reporting Requirements. All plans subject to the reporting requirements are required to file an annual report with the Secretary of Labor within 210 days of the end of the plan year. The Secretary of Labor has authority to simplify the reporting requirements for plans with less than 100 participants. It is important to note that, for this purpose, participants include not only current employees but former employees who are receiving or may receive benefits in the future, as well as beneficiaries. In the case of employee welfare plans, the Secretary has authority to eliminate all reporting requirements.

Reporting and disclosure requirements for both employee welfare plans and pension plans fall within the following general framework:

Reporting To the Secretary of Labor

- A detailed plan description and a summary plan description that will also be furnished to participants.
- Comprehensive annual financial statements.

Disclosures to Plan Participants

- The summary plan description noted above.
- Simplified annual financial statements.

Reports Filed With the Secretary of Labor. The detailed plan description must be filed on prescribed forms and contain such details as names and addresses of trustees and legal counsel and plan administrator, relevant provisions from a collective bargaining agreement, eligibility requirements, vesting and funding provisions, procedures for claiming benefits, and remedies available to participants in case of disputes. The initial plan description is due within 120 days after a plan is subject to the reporting provisions, and material modifications must be filed within 60 days. The Secretary of Labor may require updated filings but not more often than once every five years.

The basic annual financial statements that must be filed include a statement of assets and liabilities, a statement of changes in fund balance, which includes revenues and expenses, and a statement of changes in net assets. The financial statements must also include notes disclosing the nature and impact of any significant plan changes, material lease commitments, tax status of the plan, and several other disclosures.

The annual report also includes supplementary schedules such as: a schedule of assets held for investment purposes, a schedule of loans and leases in default, a schedule of transactions involving 3% or more of the plan's assets, a schedule of any transactions involving a person known to be a party-in-interest, and information about any person receiving other than minimal compensation from the plan.

Certifications Required With Annual Reports. Annual reports of pension plans subject to the funding requirements must include an actuarial statement by an enrolled actuary. The actuarial statement must include the minimum required contribution, normal cost, accrued liabilities, number of participants, vested benefits by termination categories, the actuarial assumptions and methods used to determine costs, and the actuary's opinion on the reasonableness of the actuarial assumptions, among other matters.

The annual report also must include the opinion of a qualified, independent public accountant as to whether the financial statements conform with generally accepted accounting principles. Such opinion must be based upon an examination made in accordance with generally accepted auditing standards. The accountant may rely on the correctness of the actuarial matters contained in the actuary's report, provided he indicates such reliance.

The above audit requirements do not apply to financial statements prepared by a bank, insurance carrier, or similar regulated institution that rendered trust and other services to the plan if such institution certifies that the statements are accurate. In addition, all certification requirements may be waived for plans not subject to the filing of comprehensive annual reports.

Filings with the Secretary of Labor will be made available for public inspection.

Disclosures to Plan Particpants. A booklet describing the plan must be given to each participant within 90 days after he joins the plan. The booklet must contain a comprehensive detailed plan description and be written so that it is understandable by the average participant. The plan booklet must be filed with the Secretary of Labor, who has authority to reject it or authorize its distribution to plan participants. A new booklet must be issued every ten years (five years if important amendments have been adopted). These and the other reporting requirements that follow are imposed on plan administrators, which essentially means the company or union providing the benefits.

In addition, the plan administrator must give each participant summarized copies of the annual report within 210 days of the end of the fiscal year. Written descriptions of any material change in the plan must also be provided within the same time limit.

The new law gives participants, in effect, the same status as corporate shareholders in permitting them to inspect financial statements of a plan. The complete financial statements and other plan documents (trust agreement, bargaining agreement, actuarial report) must be available for examination by participants at the principal office of the plan, and be furnished to participants at their written request for a reasonable charge.

The plan administrator must give each person leaving the plan a statement of his rights to benefits. In addition, a plan participant or beneficiary can request information about his accrued and vested benefits.

Although these requirements may seem burdensome, they may have a positive employee relations effect, especially for employers who in the past have not fully informed employees of the benefits being accumulated for their retirement, the circumstances under which employees might lose their benefits, the persons responsible for managing the funds, how to apply for benefits, and the employer cost of these benefits.

Other Requirements. Special reports must be filed with the Pension Benefit Guaranty Corporation in the event of a plan termination (see Plan Termination Insurance). The Act requires that certain "reportable events," typically of a nature that threatens the existence of the plan, also be reported.

Information about vested benefits due to terminated participants must be sent to the Department of Health, Education, and Welfare where it will be recorded in the individual's Social Security file. Thus, participants will be notified of their vested pension benefits when they apply for Social Security benefits.

PLAN TERMINATION INSURANCE

An important way the new Act attempts to insure that retirement benefits are ultimately received is by an insurance program to guarantee the payment of vested benefits. Such insurance is mandatory for all plans subject to the minimum funding requirements, except for plans of professional corporations that will be the subject of a special study, profit-sharing and stock bonus plans, money purchase pension plans, plans funded by qualified individual insurance contracts or similar group contracts, and unfunded plans providing benefits in excess of the IRS maximums.

Cost of Insurance. Insurance premiums are payable by the pension plan and started on the date of enactment of this legislation. The initial premiums are $1 per plan participant per year (50¢ for multi-employer plans). Premiums are collected by the Pension Benefit Guaranty Corporation (PBGC), a new tax-free entity within the

Department of Labor. A discretionary penalty of 100% may be imposed on the plan if the premium is not paid within the 60–day grace period.

Extent of Insurance Benefits. If a pension plan cannot pay the benefits due to participants, the PBGC will assume the plan's obligations to the extent of the lesser of $750 per month per participant or 100% of the participant's average wages during his highest paid five years as a plan participant. A participant in two or more insolvent plans can obtain only one insurance recovery and special rules apply to owner-employees.

Insurance benefits are available immediately for single-employer plans that have been qualified with IRS, or have met the minimum funding standards of the new Act, for five prior years. Insurance benefits for multi-employer plans start January 1, 1978, but the PBGC is authorized to cover such plans before then on a voluntary basis.

New pension plans and amendments to existing plans will be phased in for potential insurance benefits at 20% per year. This means no benefits are paid if a plan defaults in its first year, 20% benefits in the second year, and so on. Pension benefits that accrue after a plan has been disqualified for tax purposes are not insurable.

Employer's Contingent Liability. Employers are contingently liable for up to 30% of net worth for insurance benefits paid to participants in an insolvent plan. This liability can be extremely large in plans with many vested participants and the challenging issue presented to lenders is obvious. Employers must insure against this contingent liability. The insurance coverage can be obtained from the PBGC or private insurers – the PBGC is obligated to provide this insurance if private insurance companies do not.

Insurance coverage of this contingent liability becomes effective after premiums have been paid to the PBGC for five years. This delayed insurance protection may not apply when insurance is obtained from other sources.

The cost of insuring the potential employer liability is borne by the employer.

Employers contributing to a multi-employer plan maintained in connection with a labor contract are also subject to the potential 30% liability. The liability applies to each employer who was a contributor to a multi-employer plan at any time during the five years prior to termination or default of the plan. The mandatory insurance coverage also applies to such employers.

The Act provides for a government lien against the property of employers who become subject to this 30% liability, and also contains a priority schedule governing the distribution of a plan's assets in the event of insolvency.

Effect of Mergers on Insured Retirement Plans. Proposed mergers, consolidations, and similar transfers of an employer's assets and liabilities must take into account the effect of such action on any insured plans involved. In such cases, the plan administrator must file an actuarial statement at least 30 days prior to the merger. The merger will be approved only if each participant's benefits immediately after the merger at least equal the benefit he would have received immediately before the merger, assuming in both cases that the plans were to be terminated.

TAXATION OF LUMP SUM DISTRIBUTIONS

Lump sum distributions from qualified plans may be made when participants retire, when plans terminate, and in other cases. Such distributions are now subject to new tax treatment. The taxable portion of such a distribution representing 1973 and prior years' benefits is treated as a long-term capital gain. That portion representing 1974 and subsequent years' benefits is taxable as ordinary income. To alleviate the effects of graduated income tax rates on a one-time distribution, special ten-year averaging provisions can be applied. This, in effect, taxes the lump sum in the year of distribution as if the income were received over the longer period. A separate tax schedule is applied to smaller distributions to avoid higher taxes than were previously imposed.

Rollovers from qualified pension or profit-sharing plans to an IRA are not eligible for capital gains treatment or the special 10–year averaging provisions when ultimately distributed.

One of the requirements for obtaining such beneficial tax treatment on lump sum distributions from qualified plans had been a strict separation from service rule. This rule has been eased somewhat. However, the taxation of lump sum distributions remains a complex area, and professional tax assistance in this area is particularly necessary.

SUMMARY OF EFFECTIVE DATES

The time limits for complying with the various provisions of the Act are summarized below for convenience.

Participation and Vesting Standards. Plan years beginning after December 31, 1975. Under special circumstances, some collectively bargained plans can postpone the effective date until the existing labor agreements expire but no later than December 31, 1980.

Funding Standards. The same as for participation and vesting standards.

Plan Termination Insurance. Premiums start on enactment. Coverage starts on July 1 for single-employer plans and, generally, on January 1, 1978 for multi-employer plans.

Reporting and Disclosure. These provisions are effective for plan years beginning in 1975.

Newly Established Plans. New plans are immediately subject to the above provisions.

H.R. 10s. In general, the increased contribution limits apply to tax years starting in 1974.

Individual Retirement Accounts. The deductions for IRAs apply to tax years beginning after December 31, 1974.

ACTION PLAN

The impact of this legislation on your retirement program can be dramatic. It is important to ascertain what changes in your retirement program are mandated by the legislation and when they must be put into effect, and to carry them out smoothly. It is also important to rethink your entire compensation program in the light of the mandated changes in your retirement program. The following action plan offers suggestions about how to proceed.

1. Develop a Plan to Study Your Present Program.

As a necessary first step, the people who will be responsible for the various aspects of the study and the person who will coordinate the entire study should be selected. The persons selected should be given broad responsibilities as they will probably not only determine what changes are required but will also follow up later to see that the changes are put into effect. Among other matters, the study should include:

- Changes needed to effect compliance with the law
- Cost considerations – both the added cost of providing and administering retirement benefits and the resulting cost effect on your products or services

- Employee and personnel relations, including matters that are subject to collective bargaining
- Integration of the new pension (profit-sharing) provisions with other fringe benefits
- The added record keeping and reporting requirements, including annual reports to both federal authorities and plan participants
- Management of the fund assets, including an evaluation of investment performance

The designation of responsibility and control for amendments and other changes in the plan are especially important in light of the varying effective dates for different portions of the legislation and the potential penalties for noncompliance. All or much of the study may be performed by knowledgeable persons on your own staff, or by outside consultants.

2. **Review Your Entire Compensation Program.**

Because of the cost and design changes required by the legislation, this is an opportune time to review such other matters as the actuarial funding method and assumptions, the medium of funding, the question of integrating your plan with Social Security, and other design changes. Since your plan will probably require considerable revamping, this may also be the appropriate time to streamline your plan and eliminate any costly provisions that are not important or necessary. Furthermore, it may also be a good time to review other segments of your total fringe benefit program such as group life and medical insurance, stock option plans, vacation policies, and disability benefits.

Finally, your action plan must be tailored to your particular situation. The complexities of this legislation are such that a great deal of study will be required. Much planning and coordination also will be needed to make sure that you are not only in compliance, but also that this study is utilized to revitalize your entire compensation program and ensure that it is in tune with current realities.