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Federal Regulation of Retirement Plans: The Quest for Parity

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VANDERBILT LAW REVIEW

VOLUME 28 MAY 1975 NUMBER 4

Federal Regulation of Retirement Plans: The Quest for Parity

*William J. Chadwick**
*David S. Foster***

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The opinions expressed herein are solely those of the authors and do not necessarily reflect those of the U.S. Labor Department or the U.S. Treasury Department.

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I. INTRODUCTION

Converging economic and social trends in our society have created a favorable environment for the growth of retirement plans,[1] and longer life spans and a weakening of family ties have made Americans more security conscious. The increase in social needs that resulted from the forces of industrialization operating upon the superannuated worker culminated in the passage of the Social Security Act.[2] In addition, unions have received the right to bargain for retirement security and have exercised that right. Wage controls during World War II and the Korean War encouraged the growth of retirement plans as a way to increase the total compensation package.[3] Finally, federal tax laws have encouraged retirement plans by providing incentives for retirement saving.[4]

The Internal Revenue Code contains numerous provisions designed to encourage retirement saving.[5] If a corporation establishes

1. *See generally* H.R. REP. No. 533, 93d Cong., 1st Sess. 2 (1973). The term "retirement plans," as used in this article, includes any plan or arrangement that has the effect of deferring the receipt or use of funds to a period that may include retirement.

2. A. COLLINS, FEDERAL INCOME TAXATION OF EMPLOYEE BENEFITS § 5.01 at 5-111 (1973). The passage of the Social Security Act itself increased security consciousness.

3. Originally, employers established retirement plans as a means of securing employee loyalty. As early as 1874, when the Grand Trunk Railroad established the first industrial pension plan, a change in the social philosophy of pensions was discernible. *See generally* DEERING, INDUSTRIAL PENSIONS 30-65; HAMILTON & BRONSON, PENSIONS 81-104. Largely as a result of the passage of the Social Security Act, the union movement and wage controls, employees became increasingly aware that retirement benefits were a form of "wages."

4. The special tax treatment accorded to certain retirement plans is often thought of as a special advantage that justifies their regulation. *See, e.g.*, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PEIVATE EMPLOYEE RETIREMENT PLANS 19 (1965). The Federal budget lists "net exclusion of pension contributions and earnings" as an item of tax expenditure. For fiscal 1976, $5,740 million is estimated as a tax expenditure for employer plans, and $710 million is estimated for plans for self-employed individuals and others. SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, 1976, at 109. On the other hand, it has been suggested that the tax treatment of these plans conforms with a theoretical norm and that the tax treatment of nonqualified, funded plans is, in effect, a penalty. *See* R. GOETZ, TAX TREATMENT OF PENSION PLANS: PREFERENTIAL OR NORMAL? (1969).

5. *See* INT. REV. CODE OF 1954, §§ 72, 101(b), 219, 401-15, 501-03, 1379, 2039(c), 2517. Typically, state and local taxes contain provisions similar to federal law, often in order to conform with federal statutes.

and maintains a "tax-qualified"[6] retirement plan, such as a pension or profit-sharing plan,[7] contributions under the plan are deductible even though no current distributions are made to employees.[8] Earnings on the amounts set aside for eventual distribution are not taxable;[9] employees participating in the plan must include neither employer contributions nor investment earnings in gross income until the funds are distributed or made available to them.[10] When the funds are distributed, the recipient receives favorable tax treatment because at that time his total income and, therefore, the applicable tax rate probably will be lower than during his working years. Moreover, if the employee receives his benefit in a lump sum, rather than in installments, he may be entitled to special tax treatment that mitigates the effect of receiving a large amount of income in one year.[11]

Because the types of retirement plans that may qualify for favorable tax treatment are varied and the forms of conducting a business are numerous, differences inevitably will exist in the treatment of fundamentally similar plans. For example, a pension plan maintained by a "Fortune 500" company may present revenue and regulatory considerations distinct from those presented by a pension plan established by a closely held corporation. Similarly, these considerations may vary depending on whether the employer maintaining the plan is a partnership or a corporation and whether the plan is of the pension or profit-sharing type.

The *ad hoc* development of the law in this area has com-

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6. The term, "tax-qualified" plan, as used in this article, includes pension, profit-sharing and stock bonus plans referred to in § 401(a) of the Internal Revenue Code, annuity plans referred to in § 403(a), purchases of annuities referred to in § 403(b), hond purchase plans referred to in § 405, individual retirement accounts and annuities referred to in § 408, and retirement bonds referred to in § 409. Section 403(h) annuities, individual retirement accounts and annuities and retirement bonds are not technically considered "plans."

7. For a definition of the types of plans, see text accompanying notes 301-351 *infra*.

8. INT. REV. CODE OF 1954, §§ 404(a)(1), (2), (3), (6), 405(c). As a general rule, a deduction for compensation paid is allowable only at the time the employee includes the amount in income. *Id.* § 83(h).

9. *See, e.g., id.* § 501(a).

10. Treas. Reg. §§ 1.402(a)-1(a)(1)(i), 1.403(a)-1(a) (1960). *But cf.* Employment Retirement Income Security Act of 1974, § 2006, Pub. L. No. 93-406, 88 Stat. 829, 992 (codified in scattered sections of 26, 29 U.S.C.A.) [hereinafter cited as ERISA] for the rules applicable if the contribution is made pursuant to an arrangement under which it will he made only if the employee elects to receive a reduction in his compensation or to forego an increase in his compensation.

11. INT. REV. CODE OF 1954, § 402(e). In addition to the income tax advantages, there are also estate and gift tax advantages. The employee's interest in the plan is exempt from estate tax, except to the extent attributable to his own contributions. *Id.* § 2039(c). His exercise of a right to designate a beneficiary under the plan is exempt from gift tax. *Id.* § 2517.

pounded the problems inherent in a free enterprise system in which retirement savings are encouraged. As the number of employees covered by private retirement plans has expanded from an estimated four million in 1940 to over thirty million today and the assets held by private plans have grown from $2.4 billion to $160 billion,[12] federal regulation has increased.[13] Moreover, the tax treatment of retirement plans has varied significantly in the Revenue Act of 1942,[14] the Internal Revenue Code of 1954,[15] the Self-Employed Individuals Tax Retirement Act of 1962,[16] and the Tax Reform Act of 1969.[17] In addition, various aspects of retirement plans have been affected by most of the major labor legislation of the twentieth century, including the National Labor Relations Act,[18] the Labor-Management Relations Act,[19] the Welfare and Pension Plans Disclosure Act,[20] and the Labor-Management Reporting and Disclosure Act of 1959.[21]

In 1974, the Employee Retirement Income Security Act was enacted.[22] This legislation substantially revised the treatment of retirement plans under the Internal Revenue Code and accomplished the first comprehensive non-tax regulation of employee benefit plans.[23] Although this legislation sprang from four congressional

12. *See* H.R. REP. No. 807, 93d Cong., 2d Sess. 3 (1974).
13. *See* H.R. REP. No. 533, 93d Cong., 1st Sess. 2 (1973).
14. Ch. 619, 56 Stat. 798 (codified in scattered sections of 7, 15, 50 U.S.C.).
15. INT. REV. CODE OF 1954 §§ 401-25.
16. Pub. L. No. 87-792, 76 Stat. 809 (codified in scattered sections of 26 U.S.C.).
17. Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26, 42 U.S.C.).
18. 29 U.S.C. §§ 151-68 (1970).
19. Cb. 120, 61 Stat. 136 (1947) (codified in scattered sections of 18, 29 U.S.C.).
20. 29 U.S.C. §§ 301-09 (1970).
21. Pub. L. No. 86-257, 73 Stat. 519 (codified in scattered sections of 29 U.S.C.).
22. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 26, 29 U.S.C.A.).
23. The term "employee benefit plan" means an "employee welfare benefit plan or an employee pension benefit plan or a plan which is botb an employee welfare benefit plan and an employee pension benefit plan." ERISA § 3(3), 29 U.S.C.A. 1002(3) (Supp. 1975). "Employee welfare benefit plan" is defined as any plan, fund, or program which is established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or maintained for the purpose of providing for its participants or tbeir beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or henefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in § 302(c) of the Labor Management Relations Act, 1947 (other than pensions on retirement or death, and insurance to provide such pensions). ERISA § 3(1), 29 U.S.C.A. § 1002(1) (Supp. 1975). The term "employee pension benefit plan" means any plan, fund, or program which is established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or a result of surrounding circumstances such plan, fund, or program—

(A) provides retirement income to employees, or (B) results in a deferral of income by employ-

committees with radically different approaches to the problem,[24] the Employee Retirement Income Security Act of 1974 has had a major impact on retirement plans. Accordingly, it is appropriate at this time to reflect upon and evaluate the federal regulation of retirement plans.

An analysis of the regulatory scheme behind the varied treatment of retirement plans reveals that many of the distinctions made are not justifiable. For example, an incorporated, one-man law firm with net income of $125,000 can make a deductible contribution to a money-purchase pension plan of $25,000.[25] If the lawyer conducted his practice as a sole proprietorship, however, his annual deductible contribution would be limited to $7,500.[26] The form in which the lawyer conducts his business determines the tax burden that he must assume in providing for his retirement. Thus, retirement parity remains unachieved, even after a comprehenisve revision of the regulatory system. It is the purpose of this article to review the historical development of the federal regulation of retirement plans, to analyze and evaluate the current regulatory scheme, and to suggest appropriate changes in the quest for parity.

II. The Foundation Is Laid—Historical Development

A. *Initial Regulatory Scheme*

The first income tax law enacted after the adoption of the sixteenth amendment contained no provisions relating specifically to retirement plans.[27] Individuals, however, could deduct actual expenses in carrying on any business,[28] and corporations could deduct ordinary and necessary business expenses.[29] The regulations interpreting the business-expense provision relating to corporations provided that employers were entitled to a deduction from gross income for amounts paid as pensions to retired employees, their families,

ees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan. ERISA § 3(2), 29 U.S.C.A. § 1002(2) (Supp. 1975). Obviously, the definition of the term "employee benefit plan" is very broad.

24. The four committees were the Senate Committee on Finance, the Senate Committee on Labor and Public Welfare, the House Committee on Ways and Means and the House Committee on Education and Labor.

25. ERISA §§ 1013(c)(1), 2004(a)(2), Int. Rev. Code of 1954, §§ 404(a)(1)(A)(iii), 415(c)(1).

26. ERISA §§ 1013(c)(1), 2001(a)(1)-(3), Int. Rev. Code of 1954, §§ 404(a)(1)(A)(iii), 404(e).

27. Act of Oct. 3, 1913, ch. 16, § II, 38 Stat. 166.

28. *Id.* § IIB, 38 Stat. 167.

29. *Id.* § IIG(b), 38 Stat. 172.

or other dependents.[30] Presumably, the expense contemplated was one in which the employer makes payments out of current income to the employee after the employment terminates. If, however, the employer established a trust to meet anticipated pension payments, the tax treatment was uncertain. Although trusts were not subject to income tax, it was not clear whether such an arrangement would be treated as a trust.[31] It was similarly unclear whether the employer who contributed to a trust was entitled to a deduction or whether the employee beneficiary of a trust was subject to tax.

The Revenue Act of 1916 extended the federal income tax to trusts.[32] While the statute still did not refer to retirement plans, the regulations interpreting the corporate business-expense provision denied the deduction of contributions to a pension fund if assets of the fund were held by the contributing employer.[33] Allowable deductions were limited to amounts actually paid to employees.

Two cases decided under the Revenue Act of 1916 illustrate the type of arrangement in existence at that time and the difficulty of categorizing arrangements for tax purposes. One case, the subject of a Solicitor's Memorandum, involved a profit-sharing fund to which contributions were made by a securities firm on behalf of a select group of employees; fund investments were made in securities related to the firm's business. The Bureau of Internal Revenue held that the fund was neither a separate business venture nor an irrevocable trust, but a part of the firm's business.[34] Therefore, earnings on contributions made to the fund were taxable to the employer. The second case, *Sears, Roebuck & Co. Employees' Savings & Profit-Sharing Pension Fund v. Commissioner*,[35] involved a retirement plan that provided for both employer and employee contributions to a fund created by the employer and "handled, entrusted, and invested" by a board of five trustees who were directors or employees.[36] The Court of Appeals for the Seventh Circuit held that the fund thus established was taxable as an association and not as a

30. Treas. Reg. 33, art. 120 (1914).

31. Taxes were levied only on individuals, Act of Oct. 3, 1913 ch. 16, § IIA, 38 Stat. 166, and on corporations, joint-stock companies or associations, and insurance companies, *id.* § IIG(a), 38 Stat. 172.

32. Revenue Act of 1916, ch. 463, tit. I, § 2(b), 39 Stat. 757.

33. Treas. Reg. 33, art. 136 (1918).

34. Sol. Mem. 1329, 2 CUM. BULL. 69-70 (1920). This Solicitor's Memorandum dealt with a discretionary profit-sharing fund established for employees selected by the firm. These employees held certificates that entitled them to receive distributions and to elect employees, called managers and trustees, to invest the cash contributed by the firm. The firm reserved the right to cancel any certificate with or without cause.

35. 45 F.2d 506 (7th Cir. 1930).

36. *Id.* at 508.

trust.[37]

The Revenue Act of 1918 contained detailed provisions for the taxation of trusts, but funded retirement plans still were not explicitly recognized.[38] According to the income tax regulations, payments made to a retired employee constituted taxable income to the recipient and were deductible by the employer when made.[39] The rule denying a deduction for amounts held by the employer was not changed,[40] but its application was questioned on several occasions. A Solicitor's Memorandum illustrated a substance-over-form approach, holding that a business expense deduction was not available to a corporation that designated itself the trustee for amounts contributed but reserved absolute discretion to select the employee beneficiaries.[41] On the other hand, contributions to an entirely separate pension fund, over which the employer retained no control, were deductible as donations to a charitable institution for the benefit of the corporation's employees or their dependents.[42] Somewhat inconsistently, however, the fund was not tax-exempt as a "charitable" organization.[43]

Subjecting a fund to taxation reduces the amount available for eventual distribution. The Revenue Act of 1921 solved this problem by providing a tax exemption for trusts "created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees."[44] Both deductible employer and nondeductible employee contributions to these trusts were contemplated, and the employees or their dependents were not taxed until the year in which the amounts accumulated on their behalf were "distributed or made available."[45] At that time the portion of the distribution attributable to employer contributions and the income earned through trust investments was taxable to the recipients as ordinary income. The portion of the distribution representing the employee's contribution was not taxable to him when returned since

37. *Id.* at 509. The taxation rates applied to associations during the years in question, 1917-20, were lower than those applied to trusts. For association tax rates in those years, see 40 Stat. 1075-76; Act of Oct. 3, 1917, ch. 63, tit. I, § 4, 40 Stat. 302; Act of Sept. 8, 1916, ch. 463, tit. I, § 10, 39 Stat. 765. For trust tax rates, see Act of Feb. 24, 1919, ch. 18, tit. II, pt. II, §§ 210, 211, 219, 40 Stat. 1062-64, 1071; Act of Oct. 3, 1917, ch. 63, tit. I, §§ 1, 2, 40 Stat. 300; Act of Sept. 8, 1916, ch. 463, tit. I, §§ 1, 2(b), 39 Stat. 756.

38. Revenue Act of 1918, ch. 18, tit. II, pt. II, §§ 1, 219, 40 Stat. 1057, 1071 (1919).

39. Treas. Reg. 45, arts. 32, 108 (1921).

40. Treas. Reg. 45, art. 108 (1921).

41. Sol. Mem. 965, 1 CUM. BULL. 224 (1919).

42. O.D. 110, 1 CUM. BULL. 224 (1919); Treas. Reg. 45, art. 562 (1921).

43. A.R.R. 477, 4 CUM. BULL. 264 (1921).

44. Revenue Act of 1921, ch. 136, tit. II, pt. II, § 219(f), 42 Stat. 247.

45. *Id.*

no deduction from gross income was allowed for amounts he contributed.[46] Although the federal tax law failed to provide specifically for nontrusteed annuity plans until 1942,[47] in 1923 the purchase of certain annuities by an employer for his employees was held not to constitute taxable income to the employee at the time he received the contract.[48] Payments under the contract were includible in gross income only at the time and to the extent that the aggregate amounts received exceeded the cost of the annuity.[49]

Under the Revenue Act of 1926, the tax exemption granted to trusts that formed part of a stock bonus or profit-sharing plan was extended to trusts that formed part of a pension plan.[50] Apart from this amendment,[51] the tax legislation enacted from 1921 through 1937 had little effect on the scope and operation of the retirement system.[52] Labor-oriented legislators, however, made their presence

46. Presumably these amounts were taxed as annuities under Treas. Reg. 33, arts. 5(b), 63 (1914).

47. In 1936, the regulations concerning employer deductions required information concerning refunds in cases "where the annuity plan is underwritten by an insurance company." Treas. Reg. 94, art. 23(p)-1 (1936). It was not clear whether this referred to nontrusteed plans. This provision was eliminated during the next revision of the regulations. T.D. 4792, 1938-1 CUM. BULL. 152.

48. I.T. 1810, II-2 CUM. BULL. 70-71 (1923), *revoked*, I.T. 4041, 1951-1 CUM. BULL. 5-6. Under the facts of the ruling, each employee had complete ownership in and possession of his "pension bond" and could designate the beneficiary of its death benefit. The pension bonds, however, were neither assignable nor unconditional promises to pay. The ruling indicated that no financial benefit was realized or realizable by the employees at the time the promise was made or the bonds delivered. The bond's fair market value was not taxable under the provisions of the regnlations requiring inclusion in gross income of compensation received other than in cash, because such value was not "readily realizable." *See* Treas. Reg. 62, art. 33 (1923).

49. Treas. Reg. 33, arts. 5(b), 63 (1914). In 1934, the taxation of annuities was changed to a 3% rule. Revenue Act of 1934, 48 Stat. 680, 687, § 22(b)(2). Under this rule, payments were taxable each year to the extent of 3% of the cost of the annuity; the excess over 3% was subject to tax only to the extent that the aggregate of such excess exceeded the cost of the annuity.

50. Revenue Act of 1926, ch. 27, § 219(f), 44 Stat. 33.

51. H.R. REP. No. 356, 69th Cong., 1st Sess. 35 (1926) states: "The existing law is not clear concerning the proper method of taxing trusts created by an employer as part of a pension fund established for the exclusive benefit of his employees. Such pension funds are similar to the stock bonus and profit-sharing plans covered by subdivision (f) of section 219, and this amendment applies to such pension funds the clear and definite method of taxation heretofore applied to stock bonus and profit-sharing plans."

52. The Revenue Act of 1928 specifically permitted deductions for employer contributions to an employees' pension trust. Revenue Act of 1928, ch. 852, §§ 23(a), (q), 45 Stat. 799, 802. Section 23(a) allowed deductions for "ordinary and necessary" expenses, without any specific reference to pension trusts. Section 23(q), however, specifically allowed the deduction of contributions for past service costs (over 10 years) and referred to such contributions as being additional to the contributions for current service costs allowed under § 23(a). Although deductions for past service liability under § 23(q) were limited to "pension" trusts, presumably current service contributions to profit-sharing or stock bonus plans were deducti-

felt with the enactment of the National Labor Relations Act of 1935.[53] This legislation, as amended twelve years later by Title I of the Labor-Management Relations Act of 1947[54] and as judicially interpreted, brought attention to the impact of labor laws on the institution and administration of retirement plans. Covering virtually all employees in interstate commerce, the Act established a code of union-management relations and required collective bargaining on wages, hours of employment, and other terms and conditions of employment.[55] Although these terms were not defined in the statute, the Seventh Circuit, in *Inland Steel Co. v. NLRB*,[56] established that retirement plans are within the scope of "wages" and "other conditions of employment." Consequently, an employer presented with a proper demand cannot refuse to bargain with respect to a retirement plan for his employees. Furthermore, section 302 of the National Labor Relations Act provided fundamental guidelines for the establishment and operation of retirement funds administered jointly by an employer and a union.[57]

The next siguificant tax legislation, the Revenue Act of 1938, narrowed the tax exemptions for trusts that formed part of a tax-qualified plan.[58] The exemption was specifically restricted to trusts in which no part of the corpus or income was used for purposes other than the exclusive benefit of employees until all obligations to employees under the trust were satisfied. The regulations under the 1938 Revenue Act provided the first elaboration on the tax exemption established by the Revenue Act of 1921 for trusts that formed part of tax-qualified plans. These regulations construed the statutory requirement that the trust be "for the exclusive benefit of some or all of [the employer's] employees" to mean that the trust must

ble under § 23(a). The Revenue Act of 1928 renumbered the § 219(f) exemption for trusts as § 165. Under the Revenue Act of 1934, the 3% rule of taxing annuities was substituted for the excess-over-cost rule in effect under the regulations until then, but without any reference to employees' annuities. Revenue Act of 1934, ch. 277, § 22(b)(2), 48 Stat. 687. In G.C.M. 14593, XIV-1 CUM. BULL. 50 (1935), it was held that noncontributory old age pensions did not constitute annuities within the meaning of these provisions. There was no discussion of how contributory pensions should be taxed.

53. 49 Stat. 449.

54. 61 Stat. 136.

55. Section 8(a)(5) of tbe National Labor Relations Act requires an employer to "bargain collectively with a representative of his employees, subject to the provisions of Section 9(a)," and the latter section provides that the duly selected representative of the employees and an appropriate unit shall be the exclusive representative "for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment . . . ."

56. 170 F.2d 247 (7tb Cir. 1948), *cert. denied*, 336 U.S. 960 (1949).

57. 61 Stat. 136.

58. Revenue Act of 1938, ch. 289, § 165(a)(2), 52 Stat. 518.

benefit all or a large percentage of the total number of the employer's clerks and workmen, as distinguished from persons in authority.[59] After the Commissioner published an income tax ruling that a pension-trust plan covering sixty-five of a corporation's 25,000 employees was not sufficiently broad,[60] the Board of Tax Appeals held that the regulations were too restrictive.[61] As a result, the Commissioner liberalized the regulations.[62] Under the new regulations, the Tax Court found a trust to be tax-qualified although it was established for key employees only.[63] In another case the court held qualified a trust in which two-thirds of the contributions were for the benefit of the president and sole shareholder.[64]

While the statutory provisions developed over the years were incorporated into the Internal Revenue Code of 1939 without substantive modification,[65] this incorporation apparently did not reflect complete satisfaction with the tax treatment of retirement plans. Legislators were concerned with alleged abuses like the proliferation of plans covering only a small percentage of employees or favoring higher-paid or stockholding employees.[66] The growing movement for comprehensive revision in this area of the law came to fruition with the Revenue Act of 1942.[67]

B. Revisions of Regulatory Schemes

(1) Revenue Act of 1942

The 1942 amendments to the Internal Revenue Code of 1939 represent the first comprehensive regulation of retirement plans. Regulation was considered necessary to produce revenue and to prevent evasion of tax obligations. As a result, exemption from taxation was limited to trusts meeting specific requirements delineated in the Code.[68] In addition to the requirement that the trust be for the exclusive benefit of employees, it had to constitute part of a plan

59. Treas. Reg. 101, art. 165-1(a) (1939).

60. I.T. 3346, 1940-1 CUM. BULL. 62.

61. Harris v. Commissioner, B.T.A. Mem., Dec. 10, 864-A (Oct. 27, 1939). This case did not refer to Parker v. Commissioner, 38 B.T.A. 989 (1938), which held that when a pension trust was primarily for the benefit of, and virtually managed by the president and controlling stockholder of the employer, the trust failed to qualify.

62. T.D. 4973, 1940-1 CUM. BULL. 65; Treas. Reg. 103, § 19.165-1(a) (1940).

63. Moore v. Commissioner, 45 B.T.A. 1073 (1941), *acquiesced in*, 1943 CUM. BULL. 17.

64. Lord v. Commissioner, 1 T.C. 286 (1942), *acquiesced in*, 1943 CUM. BULL. 15.

65. Int. Rev. Code of 1939, ch. 1, 53 Stat. 1.

66. H.R. REP. No. 2333, 77th Cong., 2d Sess. 51 (1942).

67. Revenue Act of 1942, ch. 619, 56 Stat. 798.

68. Int. Rev. Code of 1939, ch. 1, § 165, 53 Stat. 67, *as amended*, Revenue Act of 1942, ch. 619, § 162(a), 56 Stat. 862 [hereinafter cited as Int. Rev. Code of 1939, *as amended*, Revenue Act of 1942].

that met one of two alternative coverage tests, a percentage test or a classification test. The percentage coverage test required that a plan benefit either seventy percent of all employees, or eighty percent of all eligible employees when seventy percent of all employees were eligible.[69] The classification test required that coverage not favor officers, shareholders, supervisory personnel, or the highly compensated.[70] In addition, contributions or benefits under the plan could not discriminate in favor of those kinds of personnel.[71] Integration with social security was permitted, however, and the nondiscrimination rule was subject to this provision.[72]

In addition to the qualification requirements, the Revenue Act of 1942 contained detailed treatment of deductions for an employer's contributions pursuant to the terms of a plan, whether or not qualified. To be deductible a contribution had to constitute an ordinary and necessary business expense and meet requirements of reasonableness.[73] The deduction limitations depended on whether the contribution was paid pursuant to the terms of a tax-qualified pension or annuity plan,[74] a tax-qualified profit-sharing or stock bonus plan,[75] or a nonqualified plan.[76] Deductions for contributions to a tax-qualified pension trust or for the purchase of retirement annuities under a tax-qualified annuity plan were generally limited to five percent of the aggregate compensation paid or accrued to all employees under the trust, plus any excess amounts needed to fund benefits over the remaining lives of the employees.[77] Alternatively, these deductions were limited to the normal cost of the plan plus ten percent of past service liability.[78] Contributions to tax-qualified profit-sharing or stock bonus trusts, on the other hand, were deduct-

69. Int. Rev. Code of 1939, § 165(a)(3)(A), *as amended*, Revenue Act of 1942, § 162(a).

70. Int. Rev. Code of 1939, § 165(a)(3)(B), *as amended*, Revenue Act of 1942, § 162(a).

71. Int. Rev. Code of 1939, § 165(a)(4), *as amended*, Revenue Act of 1942, § 162(a).

72. Int. Rev. Code of 1939, § 165(a)(5), *as amended*, Revenue Act of 1942, § 162(a). The nondiscrimination requirement was subject to the provision that a classification of employees "shall not be considered discriminatory . . . merely because it excludes employees the whole of whose remuneration constitutes 'wages' under [The Federal Insurance Contributions Act] . . . or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from 'wages' . . . differ from the contributions or benefits based on employee's remuneration not so excluded . . . ." *Id.*; *see* note 171 *infra* and accompanying text.

73. Treas. Reg. 103, art. 19.23(p)(1)-1 (1943).

74. Int. Rev. Code of 1939, § 23(p)(1)(A)-(B), *as amended*, Revenue Act of 1942, § 162(b).

75. Int. Rev. Code of 1939, § 23(p)(1)(C), *as amended*, Revenue Act of 1942, § 162(b).

76. Int. Rev. Code of 1939, § 23(p)(1)(D), *as amended*, Revenue Act of 1942, § 162(b).

77. Int. Rev. Code of 1939, § 23(p)(1)(A)(i)-(ii), *as amended*, Revenue Act of 1942, § 162(b).

78. Int. Rev. Code of 1939, § 23(p)(1)(A)(iii), *as amended*, Revenue Act of 1942, § 162(b).

ible to the extent of fifteen percent of the aggregate compensation of all employees under the plan, with carryover provisions that could increase the fifteen percent deduction to thirty percent.[79] An overall limit of twenty-five percent of the employees' compensation was imposed on employers contributing under both a tax-qualified pension or annuity plan and a profit-sharing or stock bonus plan.[80] Contributions to nonqualified trusts were deductible only if the employees' rights were nonforfeitable at the time the contribution was made.[81]

Because the Revenue Act of 1942 established deduction limitations that varied with the type of plan to which the employer made his contribution, employers became increasingly conscious of the various types of tax-qualified plans available. The arrangement a particular employer established and maintained could affect the employer's cost of providing a retirement benefit for his employees. Although the tax incentive provided by deductible contributions was recognized prior to 1942, the new limits forced employers to consider plan design for the first time. While taxpayer awareness of the various types of tax-qualified plans increased, the Commissioner of Internal Revenue demonstrated renewed interest in the plans. As a result, the requirements attendant to each type of plan and the distinctions between them were first set forth in the regulations in 1944.[82]

The 1942 legislation also contained specific rules for the tax treatment of distributions from a tax-qualified[83] or a nonqualified[84] trust to employees or their beneficiaries. Benefit payments under a tax-qualified plan in excess of amounts contributed by the employee were taxed as ordinary income when distributed.[85] To mitigate the adverse consequences of a large amount of income accumulated throughout the period of the employees' participation in the plan, subject to tax at progressively higher rates in the single year of distribution, certain lump sum distributions were taxed at long-term capital gains rates.[86] Under this provision if the total distribu-

79. Int. Rev. Code of 1939, § 23(p)(1)(C), *as amended*, Revenue Act of 1942, § 162(b).

80. Int. Rev. Code of 1939, § 23(p)(1)(F), *as amended*, Revenue Act of 1942, § 162(b).

81. Int. Rev. Code of 1939, § 23(p)(1)(D), *as amended*, Revenue Act of 1942, § 162(b).

82. T.D. 5422, 1944 CUM. BULL. 318.

83. Int. Rev. Code of 1939, § 165(b), *as amended*, Revenue Act of 1942, § 162(a).

84. Int. Rev. Code of 1939, §§ 22(b)(2)(B), 165(c), *as amended*, Revenue Act of 1942, §§ 162(a),(c).

85. Int. Rev. Code of 1939 § 165(b), *as amended*, Revenue Act of 1942, § 162(a). The distributee was taxed under the 3% annuity rule of § 22.

86. Int. Rev. Code of 1939, § 165(b), *as amended*, Revenue Act of 1942, § 162(a). This treatment was limited to distributions from qualified trusts. Distributions from nontrusteed plans did not receive similar treatment until 1954. Int. Rev. Code of 1954, ch. 1, § 403(a)(2),

tions payable to an employee were paid within one taxable year because of the employee's death or separation from service, the net amount of the distribution was taxed as gain from the sale or exchange of a capital asset held for more than six months. Under nonqualified plans, contributions were included in the gross income of employees for the year in which the employer contributed even if no distributions to employees were made, provided that the beneficial interests of the employees were nonforfeitable at the time of the contribution.[87] Thus, the employee was taxed on income he had not received, solely because the plan maintained by his employer was not tax-qualified. If an employee did not have nonforfeitable rights at the time of contribution, however, he was not taxed on his employer's contributions until he received a distribution.[88]

Additionally, the Revenue Act of 1942 extended tax benefits to annuities purchased for an employee by an employer who was exempt from taxation as a religious, charitable, scientific, literary, or educational organization or institution.[89] Because entities organized and operated for these purposes were not subject to taxation, there was no need to establish rules relating to the deductibility of amounts used to purchase these contracts. The legislation specifically provided, however, that employees on whose behalf annuity contracts were purchased would not be subject to tax until payments were actually received under the contract. The payments received were then taxable under the "three percent rule" generally applicable to annuities at that time.[90] This favorable treatment was extended to an annuity purchased under a tax-qualified plan or under a nonqualified arrangement and applied regardless of whether the employee's rights were forfeitable or nonforfeitable. It was not clearly stated why employees of selected tax-exempt institutions were subject to more favorable tax treatment than other employees who were not covered by a tax-qualified plan. The legislative history was silent on this question.[91]

The 1942 Revenue Act set the pattern for the current Code provisions concerning employer's deductions for contributions, the tax exemption of income on accumulations, and the taxation of benefits received. Under this pattern, the rules were set forth for

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68A Stat. 138; G.C.M. 25358, 1947-2 CUM. BULL. 90.

87. Int. Rev. Code of 1939, § 165(c), *as amended*, Revenue Act of 1942, § 162(a); *see* note 190 *infra* and accompanying text.

88. Int. Rev. Code of 1939, § 165(c), *as amended*, Revenue Act of 1942, § 162(a).

89. Int. Rev. Code of 1939, § 22(b)(2)(B), *as amended*, Revenue Act of 1942, § 162(c).

90. *See* note 49 *supra* and accompanying text.

91. *See* S. REP. No. 1631, 77TH CONG., 2d Sess. 142 (1942). This provision was added by the Senate.

qualification of plans involving trusts.[92] The rules governing deductions for employer contributions were covered by another section, and separate provisions were made for pension trusts, profit-sharing and stock bonus trusts, and nontrusteed annuity plans.[93] The taxation of distributions from trusts to employees or their beneficiaries was dealt with in a different section.[94] The rules applicable to distributions from nontrusteed plans also were set forth separately.[95] The basic structure established in 1942 was responsible for many differences in the treatment of trusteed and nontrusteed plans. Under this structure, most of the tax advantages of nontrusteed plans were provided indirectly, by cross-reference to the provisions covering trusteed plans. These cross-references were not always sufficiently broad or explicit to achieve tax parity.

(2) Internal Revenue Code of 1954

In 1954, the House Ways and Means Committee sought to simplify and clarify the tax treatment of retirement plans in a proposal that would have permitted taxpayers to determine if their plans were tax-qualified without obtaining a ruling from the Internal Revenue Service.[96] Unfortunately, the proposal was abandoned by the Senate Committee on Finance, and the Internal Revenue Code of 1954 continued the framework established in 1942.[97] Several important substantive changes were made, however. Taxation at capital gains rates of certain lump sum distributions from tax-qualified plans was extended to nontrusteed plans.[98] The result was the elimination of an unjustifiable distinction in tax treatment based on the status of the funding medium. In addition, this favorable treatment was made available to recipients of lump sum distributions following an employee's death after retirement.[99] Another tax benefit liberalized by the Eighty-Third Congress was the $5,000 death benefit exclusion, added to the Internal Revenue Code in 1951.[100] This ex-

92. Int. Rev. Code of 1954, ch. 1, § 401, 68A Stat. 134; Int. Rev. Code of 1939, § 165(a), *as amended*, Revenue Act of 1942, § 162(a).

93. Int. Rev. Code of 1954, ch. 1, § 404, 68A Stat. 138; Int. Rev. Code of 1939, § 23(p), *as amended*, Revenue Act of 1942, § 162(b).

94. Int. Rev. Code of 1954, ch. 1, § 404, 68A Stat. 138; Int. Rev. Code of 1939, § 165(b), *as amended*, Revenue Act of 1942, § 162(a).

95. Int. Rev. Code of 1954, ch. 1, § 403(a), 68A Stat. 137; Int. Rev. Code of 1939, § 22(b)(2)(B), *as amended*, Revenue Act of 1942, § 162(c).

96. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 145 (1954).

97. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 289 (1954).

98. Int. Rev. Code of 1954, ch. 1, § 403(a)(2), 68A Stat. 138.

99. *Id.* §§ 402(a)(2), 403(a)(2)(A)(iii), 68A Stat. 136, 138.

100. Int. Rev. Code of 1939, ch. 1, § 22(b)(1), *as amended*, Revenue Act of 1951, tit. III, 65 Stat. 483, § 302.

clusion was extended to lump sum distributions received by beneficiaries of a deceased employee even if the employee's rights were nonforfeitable prior to his death.[101] Similarly, the portion of a survivor's annuity attributable to the employer's contributions was exempted from estate tax.[102]

Not all of the changes made in 1954 were as welcome to taxpayers. A new addition to the Internal Revenue Code of 1954 was the inclusion of trusts that formed part of a tax-qualified pension, profit-sharing, or stock bonus plan among the otherwise tax-exempt organizations that could lose their favored status by engaging in certain "prohibited transactions."[103] For example, if the trust loaned any part of its corpus or income to the employer without the receipt of adequate security and a reasonable rate of interest,[104] or if property was purchased from the employer for more than adequate consideration,[105] the trust would lose its exempt status.[106] Similarly, the provisions governing the taxation of unrelated business income of certain exempt organizations were amended to encompass profit-sharing and stock bonus trusts.[107] As a result, income derived from any trade or business regularly carried on by that trust or by a partnership in which the trust held a partnership interest was subject to taxation as if the trust were a corporation.[108] These provisions eliminated a distinction between employees' trusts and other exempt organizations. At the same time, however, they created a further distinction between retirement plans, because neither section 503 nor section 511 was applicable to annuity plans.[109]

101. Int. Rev. Code of 1954, ch. 1, §§ 402(a)(2), 403(a)(2)(A)(iii), 68A Stat. 136, 138; *see* text accompanying note 86 *supra*.

102. INT. REV. CODE OF 1954, § 2039(c).

103. *Id.* Int. Rev. Code of 1954, ch. 1, § 503(b), 68A Stat. 166 (repealed in 1969); *see* notes 260-61 *infra* and accompanying text.

104. Int. Rev. Code of 1954, ch. 1, § 503(c)(1), 68A Stat. 167 (now INT. REV. CODE OF 1954, § 503(b)(1)).

105. *Id.* § 503(c)(4), 68A Stat. 167 (now INT. REV. CODE OF 1954, § 503(b)(4)).

106. *Id.* § 503(a)(1), 68A Stat. 166.

107. *Id.* § 511(a)(2)(A), 68A Stat. 169.

108. *Id.* §§ 511(a), 513(b), 68A Stat. 169, 172. In addition, under the Internal Revenue Code of 1954, the "life expectancy method" for taxing income from annuities was substituted for the "three percent rule," explained in note 49 *supra*. Under the "life expectancy method," a portion of each payment is excluded from income. The portion is computed in such a way that if the employee lived to his exact life expectancy he would recover his cost exactly. Int. Rev. Code of 1954, ch. 1, § 72, 68A Stat. 20. The new annuity rule was made inapplicable to employees' annuities under which the total of the employee's own contribution does not exceed the aggregate annuity payments receivable during the first three years. In such cases, the old "excess-over-cost rule" (*see* text accompanying note 49 *supra*) was again made applicable. *Id.* § 72(d), 68A Stat. 21.

109. In general, this distinction is justified. The prohibited transaction abuse is unlikely to arise under an annuity plan because the insurance company is an independent party.

(3) Four Acts in 1958 and 1959.

After the promulgation of the Internal Revenue Code of 1954, tax-oriented legislators turned their attention to retirement plans of life insurance companies and to plans maintained by tax-exempt organizations. At tbe same time, legislators interested in the labor-management relations aspects of retirement plans became concerned over the question of disclosure. As a result, four significant Acts were passed: the Technical Amendments Act of 1958,[110] the Life Insurance Company Income Tax Act of 1959,[111] the Welfare and Pension Plans Disclosure Act,[112] and the Labor-Management Reporting and Disclosure Act of 1959.[113]

The Technical Amendments Act of 1958[114] made a significant move toward parity in the exempt organization area. The regulations promulgated under the 1954 Code had provided that the favorable tax treatment of annuities purchased by certain tax-exempt organizations[115] for their employees was not available when the purchase was made in exchange for an agreement by the employee to accept a decrease in his salary or forego a profferred increase.[116] In those cases, the amount paid for the annuity contract was considered to be current compensation to the employee. This regulatory treatment was invalidated by the Technical Amendments Act and replaced by a rule that taxed employees only on employers' purchases of annuities in excess of an "exclusion allowance."[117] Generally, the exclusion allowance for any taxable year was determined by multiplying twenty percent of the employee's annual compensation by his years of service. From this amount, the employee was required to deduct the aggregate of all amounts contributed by the employer to purchase annuity contracts that were excludable from his gross income in any taxable year prior to the year in question. The remaining amount was excludable from the employee's gross income for the current taxable year.

The Technical Amendments Act of 1958 also provided that an

Abuse is possible, however, when the insurance company holds assets in a segregated asset account. In 1974, the prohibited transaction provisions were made applicable in such cases. ERISA § 401(b)(2), 29 U.S.C.A. 1101(b)(2) (Supp. 1975); ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(g)(1).

110. Pub. L. No. 85-866, 72 Stat. 1606 (1958).

111. Pub. L. No. 86-69, 73 Stat. 112 (1959).

112. Pub. L. No. 85-836, 72 Stat. 997 (1958).

113. Pub. L. No. 86-257, 73 Stat. 519 (1959).

114. Pub. L. No. 85-866, 72 Stat. 1606 (1958).

115. *See* text accompanying note 89 *supra*.

116. Treas. Reg. § 1.403(a)-1(3), T.D. 6203, 1956-2 CUM. BULL. 216, at 249, *incorporating* Rev. Rul. 54-267, 1954-2 CUM. BULL. 58.

117. Int. Rev. Code of 1954, ch. 1, § 403(b)(2), 72 Stat. 621.

employee's exercise of an election to receive a joint and survivor annuity or a similar payment under a retirement plan would not be subject to gift tax.[118] The rule paralleled the estate tax exclusion enacted in 1954.[119] The rule was applicable to tax-qualified pension, profit-sharing, stock bonus and annuity plans, but only to the extent of employer contributions. At the same time, both the estate tax exclusions and the gift tax exclusions were extended to retirement annuity contracts purchased by an exempt religious organization or an exempt educational organization for its employees.[120]

Although tax law established the conditions under which retirement plans might be entitled to tax advantages, no federal legislation ensured the honest administration of retirement plan assets. Congress determined that a nationally applicable law was necessary. Thus, in 1958, the Welfare and Pension Plans Disclosure Act was enacted. The policy underlying the enactment of this legislation sought to protect the interests of retirement plan participants and beneficiaries by requiring disclosure of information about these plans.[121] Plan administrators were required to prepare descriptions and annual reports, file them with the Secretary of Labor, and send copies of them to plan participants and their beneficiaries upon written request. It was expected that the knowledge thus disseminated would enable participants to police their plans.

At approximately the same time, the Senate Select Committee on Improper Activities in the Labor-Management Field, known as the McClellan Committee, was conducting investigations and hearings. In its first interim report, made public in March 1958, the McClellan Committee publicized widespread abuses in the handling and use of union funds.[122] The legislative response, the Labor-Management Reporting and Disclosure Act of 1959, required the bonding of personnel who handled funds of any labor organization or trust in which a labor organization had an interest.[123] A 1965 amendment to the Act required surety companies that issued the bonds to file annual reports with the Secretary of Labor.[124] Such

118. *Id.* § 2517.

119. *Id.* § 2039(c).

120. The exclusion applies to organizations referred to in INT. REV. CODE of 1954, § 170(b)(1)(A)(ii). The Technical Amendments Act of 1958 also cured a minor statutory defect. Prior to 1958, the statutory provisions dealing with tax-qualified plans technically applied only to plans of employers entitled to a deduction under a special section which was not applicable to certain tax-exempt organizations or life insurance companies, although the Bureau of Internal Revenue had held these provisions applicable in any event. I.T. 3715, 1945 CUM. BULL. 62. This defect was cured in 1958.

121. *See generally*, H.R. REP. No. 533, 93rd Cong., 1st Sess. (1973).

122. 1 CCH PENSION PLAN GUIDE ¶ 5410 (1969).

123. Pub. L. No. 86-257, § 502, 73 Stat. 536 (1959).

124. Pub. L. No. 89-216, § 211, 79 Stat. 888 (1965).

reports were to include information covering bond premiums written and earned, expenses incurred in writing bonds, and losses paid and incurred on bonds.

(4) Self-Employed Individuals Tax Retirement Act of 1962

The last major legislative development in the area of retirement plans prior to the Employee Retirement Income Security Act of 1974 evolved during the 1950's. On June 7, 1951, Congressmen Keogh and Reed of New York introduced bills designed to extend preferential tax treatment to self-employed individuals.[125] At that time a sole proprietorship or partnership could establish a tax-qualified retirement plan for its common-law employees.[126] Contributions to the plan were tax-deductible,[127] the income of the fund was tax-exempt,[128] and employees were not taxed until distribution.[129] No self-employed individual, however, could participate in the plan, nor could a general partner, according to the Bureau of Internal Revenue, because he was not an "employee" of the partnership.[130] As a result, the retirement plan privileges available to corporate executives were denied to self-employed individuals.[131]

The original Keogh-Reed bill would have allowed "all" taxpayers to deduct or exclude up to the lesser amount of ten percent of earned net income or $7,500 paid into a restricted retirement fund. Employees already participating in tax-qualified plans would have been able to avail themselves of the deduction only to the extent that the amount computed under the ten percent-$7,500 limit exceeded any amount contributed during the taxable year by their employers under tax-qualified plans. Presumably, the original

125. H.R. 4371, 82d Cong., 1st Sess. (1951) (Keogh); H.R. 4373, 82d Cong., 1st Sess. (1951) (Reed). *See generally*, Rapp, *The Quest for Tax Equality for Private Retirement Plans: A Short History of the Jenkins-Keogh Bill*, 14 TAX L. REV. 55 (1958) [hereinafter cited as Rapp].

126. I.T. 3350, 1940-1 CUM. BULL. 64.

127. Int. Rev. Code of 1954, ch. 1, § 404, 68A Stat. 138.

128. *Id.* 501(a), 68A Stat. 163.

129. Treas. Reg. § 1.402(a)-1(a)(1)(i).

130. I.T. 3350, 1940-1 CUM. BULL. 64; I.T. 3268, 1939-1 CUM. BULL. 196.

131. A group of doctors, however, devised a way for professional people to obtain the favorable tax treatment extended to common-law employees under tax-qualified plans. They formed an association having the necessary characteristics to be treated as a corporation for federal tax purposes. The associated doctors thereby became "employees" of the "corporation" and qualified for benefits under the plan that they set up. *See* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954). The Internal Revenue Service at first refused to follow the *Kintner* decision (Rev. Rul. 56-23, 1956-1 CUM. BULL. 598) but subsequently ruled that an association formed for the purpose of qualifying its members for treatment as employees under a tax-qualifed plan is not determinative of whether the organization will be classified as a partnership or as an association taxable as a corporation. Rev. Rul. 57-546, 1957-2 CUM. BULL. 87. *See* text accompanying note 404 *infra*.

Keogh-Reed bill was extended to employees not covered by tax-qualified plans as well as self-employed individuals, because the self-employed professional groups that were responsible for the introduction of this legislation felt they could not ask for relief for themselves without seeking similar benefits for corporate employees not covered by a tax-qualified plan.[132]

Over the next eleven years the bill went through various changes in both form and substance designed to secure legislative approval of the underlying principle in the face of Treasury Department opposition based on revenue needs.[133] As a result of the efforts of Congressmen Keogh, Reed, Jenkins, Ray and others, legislation extending the tax incentives for retirement saving to self-employed individuals was finally enacted in 1962. The original concept of allowing all taxpayers to participate in restricted retirement funds was abandoned. As enacted, the Self-Employed Individuals Tax Retirement Act of 1962 (hereafter, the 1962 Act) enabled self-employed individuals to participate in tax-qualified plans established for their own employees.[134] It did not, however, extend to employees whose employers had not established plans.

Under the 1962 Act, when self-employed individuals participated in a plan, it was required to meet additional standards. The legislators imposed special restrictions on plans covering self-employed individuals to offset the greater opportunities for abuse offered by such plans, which normally covered a smaller number of employees than corporate plans. The extension of retirement tax benefits to self-employed individuals was a major step in the quest for parity, but the effort to extend tax benefits to employees not covered by retirement plans failed. The 1962 Act's advantages were further limited by the complicated restrictions applicable when self-employed individuals participated.[135]

Under the 1962 Act, employer contributions on behalf of a self-employed individual were limited to the lesser of $2,500 or ten percent of the individual's earned income from the trade or business for which the plan was established.[136] Deductions for contributions

132. Rapp, *supra* note 125, at 60.

133. *Id.* at 82.

134. Pub. L. No. 87-792, 76 Stat. 809 (1962).

135. In 1960, at the request of the Senate Committee on Finance, the Treasury Department developed an approach that not only would have imposed additional restrictions on the participation of self-employed individuals but also would have imposed similar restrictions on the participation of corporate owner-managers. S. REP. No. 992, 87th Cong., 1st Sess. 8 (1961). The Finance Committee adopted a similar approach in 1973. *See* S. 1179, 93d Cong., 1st Sess. § 704 (1973). In general, this approach would have resulted in justifiable distinctions, instead of merely continuing the existing unjustifiable distinctions.

136. Int. Rev. Code of 1954, ch. 1, § 404(e)(1), 76 Stat. 820. [Hereinafter, all sections

on behalf of self-employed individuals were limited to fifty percent of the amount contributed.[137] Lump sum distributions, which were taxed as long-term capital gains when made with respect to common-law employees, were taxed as ordinary income when made with respect to self-employed individuals, subject to a special five-year averaging computation.[138] In addition, the plan was required to provide that distributions to a self-employed individual must commence not later than the taxable year in which he attained the age of seventy and one half years.[139] Finally, the estate tax exclusion and the $5,000 death benefit exclusion—available to common-law employees under tax-qualified plans—were denied to self-employed individuals.[140]

The 1962 Act also created a new category of self-employed individuals. If a self-employed individual owned either the entire interest in an unincorporated trade or business, or was a partner who owned more than ten percent of either the capital interest or the profit interest in the partnership, he was considered an "owner-employee."[141] Tax-qualified plans covering owner-employees were subject to an additional set of special rules. Hence, the 1962 Act not only perpetuated a distinction between the self-employed and the employed, it also drew a new distinction among self-employed individuals.

To qualify for favorable tax treatment, a plan covering an owner-employee was required to cover all of his employees who had three or more years of service, except part-time and seasonal workers.[142] In this respect, the requirements differed from those applicable to plans that did not cover owner-employees. Tax-qualified plans generally could exclude employees from coverage so long as enough employees were covered to satisfy either the percentage coverage test or the classification coverage test, established in 1942.[143] To determine whether all employees were covered under a plan covering an owner-employee, all of the unincorporated trades or businesses controlled by the employer were considered as one trade

in the Act of 1962 amending the Internal Revenue Code will he cited solely to the Code].

137. Int. Rev. Code of 1954, ch.1, § 404(a)(10). This section was repealed in 1966. *See* note 180 *infra*.

138. *Id.* §§ 72(n), 402(a)(2), 403(a)(2)(A). This treatment was changed in 1974. *See* notes 290-93 *infra*.

139. INT. REV. CODE OF 1954, § 401(a)(9)(A). The House had extended this rule to all employees. H.R. REP. No. 87-378, 87th Cong., 1st Sess. 16 (1961).

140. INT. REV. CODE OF 1954, §§ 101(b), 2039(c), 2517.

141. *Id.* 401(c)(3).

142. Int. Rev. Code of 1954, ch. 1, § 401(d)(3).

143. *Id.* § 401(a)(3).

or business.[144] The same grouping of controlled trades or businesses was required to determine the amount of allowable contributions and deductions. In addition, these requirements applied to two or more owner-employees who together controlled two or more trades or businesses. Furthermore, the new legislation provided that an owner-employee in a business, whether or not it was controlled by him, who was also an owner-employee of a second business, which he controlled, could not be covered under a plan of the first business unless he established a plan for the employees of the second.[145] The plan for the business that he controlled was required to provide contributions and benefits that were at least as favorable as the contributions and benefits provided owner-employees under the plan of the first business.

In addition to the requirement that virtually all employees be covered, the 1962 Act directed that a plan covering an owner-employee must provide for total vesting of the benefits of every participant.[146] This nonforfeiture clause was the first appearance of an explicit vesting requirement in the Internal Revenue Code. The Commissioner for some time had taken the position that the nondiscrimination requirement implied a vesting requirement.[147] Under the nondiscrimination requirement, contributions or benefits provided under a tax-qualified plan cannot discriminate in favor of officers, shareholders, supervisors and the highly compensated. Arguably, if lower-paid employees are severed from employment before their rights vest, while highly paid employees' rights are nonforfeitable, the plan is discriminatory.[148] Obviously, this vesting requirement is very difficult to administer. The nonforfeiture provision presumably was placed in the Code on the theory that in most cases very early vesting would be required anyway, and a total vesting requirement would simplify administration.

Owner-employee plans were further restricted in the 1962 Act

144. INT. REV. CODE OF 1954, § 401(d)(9)(A).

145. *Id.* § 401(d)(10). For example, an individual operated a business as a sole proprietorship and employed six individuals. He decided not to establish a tax-qualified plan for these employees but wanted to establish such a plan for a partnership in which he had a 75% interest. He was precluded from doing this unless he established a plan for the employees of his sole proprietorship and provided contributions and benefits which were not less favorable than those provided for himself and his co-partner under the plan established by the partnership.

146. *Id.* § 401(d)(2)(A), providing that employees' rights under a qualifying plan must be "nonforfeitable."

147. Int. Rev. Code of 1954, ch. 1, § 401(a)(4). *See* Rev. Rul. 71-151, 1971-1 CUM. BULL. 123.

148. Treas. Reg. § 1.401-1(b)(3) states that the law is concerned not only with the form of a plan but also with its effect in operation.

with respect to trustee qualification. When a tax-qualified plan covering an owner-employee was funded through a trust, the trustee was required to be a bank.[149] Since other tax-qualified plans could freely designate trustees, including highly paid shareholder-managers, this bank trustee requirement presumably was intended to reduce the potential for abuse in the owner-employee plan.[150]

The 1962 Act also imposed penalties for "excess contributions" to a tax-qualified plan covering an owner-employee.[151] If contributions were made in excess of the maximum deductible amount and the maximum voluntary contributions permitted, the excess was to be returned to the owner-employee on whose behalf it was made, together with the income earned thereon,[152] and the income returned was taxable to the owner-employee.[153] If an excess contribution was not repaid within six months after the receipt of notification that the contribution was excessive, the plan was disqualified with respect to the owner-employee.[154] Moreover, the owner-employee was taxed on the annual income earned by the entire fund that was attributable to his interest.[155] If an excess contribution was willfully made, the entire interest of the individual on whose behalf it was made in all plans in which he participated as an owner-employee—including the corpus allocated to his account—was required to be distributed to him, and he was disqualified from partic-

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149. Int. Rev. Code of 1954, ch. 1, § 401(d)(1). This subsection provided:

> For purposes of this paragraph, the term "bank" means a bank as defined in section 581, a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or other officer of such State in charge of the administration of the banking laws of such State, and, in the case of a trust created or organized outside the United States, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

Section 581 defines a bank to include a trust company and a domestic building and loan association. In 1974, § 401(d)(1) was amended to include an insured credit union as a bank and to allow as a trustee any other person who demonstrated to the satisfaction of the Treasury that the manner in which he will administer the trust will be consistent with the requirements of § 401. ERISA §§ 1022(c)(1), (2), *amending* INT. REV. CODE OF 1954, § 401(d)(1).

150. A bank custodial account could be used instead of a trust, if the investment were made in the stock of a mutual fund or other regulated investment that issued only redeemable stock or solely in life endowment or annuity contracts issued by an insurance company. A custodial account could be used by the plan even though it did not include the owner-employee as a participant. Int. Rev. Code of 1954, ch. 1, § 401(f).

151. *Id.* § 401(e).

152. *Id.* § 401(e)(2).

153. *Id.* § 401(e)(2)(B).

154. *Id.* § 401(e)(2)(A). Such disqualification, however, only applied to the interest of the owner-employee on whose behalf the excess contribution was made, and did not disqualify the plan with respect to the other participants. Treas. Reg. § 1.401-13(d)(3)(i) (1963).

155. Int. Rev. Code of 1954. ch. 1, § 401(e)(2)(B).

ipating in any tax-qualified plan as an owner-employee for a five-year period.[156] Return of a willful excess contribution provided no escape from the adverse consequences.[157]

In addition, the 1962 Act prevented premature distributions to owner-employees by requiring plans to prohibit benefit payments to owner-employees before the owner-employee attained the age of fifty-nine and one half years or became permanently disabled or died.[158] The reason advanced for this requirement was that the accumulated funds were to be used strictly for retirement purposes and not to be diverted to other private purposes prior to the prescribed time of distribution.[159] To discourage possible abuse, specific penalties were provided;[160] if the distribution was greater than $2,500, the tax imposed should not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the five years ending with the year of distribution;[161] if the premature distribution was less than $2,500, the tax due was 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year.[162] In either event, the taxable income for the year in which the distribution occurred was treated as being not less than the excess of the amount of the distribution includible in gross income over the deductions allowable for personal exemptions.[163] As a further penalty in the case of a premature distribution, the owner-employee was disqualified from participating in a retirement plan on his own behalf for five years following the year in which the premature distribution was made.[164] These penalties were imposed to prevent tax-qualified plans from in effect becoming income averaging plans, under which deductible contributions would be made to the plan in high income, high tax years, and assets would be withdrawn in low income or loss years when little or no tax would be due.[165] Even without an outright distribution of retirement funds, the owner-employee might be subject to taxation and penalties on

156. *Id.* § 401(e)(2)(E).
157. *Id.* § 401(e)(2)(B).
158. *Id.* § 401(d)(4)(B).
159. S. REP. No. 993, 87th Cong., 1st Sess. 23 (1961).
160. Int. Rev. Code of 1954, ch. 1, § 72(m)(5).
161. *Id.* § 72(m)(5)(B).
162. *Id.* § 72(m)(5)(C).
163. *Id.* § 72(n)(3)(A). Any resulting increase in tax could not be reduced by credits except for the credit for withheld taxes or the credit with respect to certain uses of gasoline, special fuels and lubricating oil. *Id.* § 72(n)(3).
164. *Id.* § 401(d)(5)(C).
165. S. REP. No. 993, 87th Cong., 1st Sess. 23 (1961).

a constructive premature distribution[166] if he assigned or pledged (or agreed to assign or pledge) any portion of his interest in the trusts.

The 1962 Act further provided that a profit-sharing plan covering an owner-employee must have a definite formula for determining contributions.[167] The Treasury Department had attempted to apply this requirement to all profit-sharing plans as early as 1946, but, after losing in the courts, it gave up in 1956.[168] Thus, profit-sharing plans that did not cover an owner-employee could provide for such contributions as the employer deemed appropriate from year to year, so long as the payments came out of current or accumulated profits.[169]

The normal rules for integrating a plan with social security benefits were not made applicable to a plan covering an owner-employee. A special limited integration program, however, was made available if not more than one-third of the deductible contributions under the plan were on behalf of owner-employees.[170] Under the normal rules a defined contribution plan generally could contribute up to 9⅜ percent more with respect to compensation above $4,800 than below that amount, and a defined benefit plan could pay 37½ percent higher benefits with respect to compensation above $4,800.[171] Under the special limited integration program, for purposes of the nondiscrimination test, the social security (self-employment) taxes paid by self-employed individuals on their own behalf would be counted as contributions by the employer, along with the social security taxes paid by the employer for other employees. Since self-employment taxes were higher than the employer's half of social security taxes, the scope of the special integration program was much more limited than the normal rules. Moreover, the special integration program clearly discriminated against self-employed individuals, because the entire amount of their tax liability was taken into account, while only the employer's half was taken into account with respect to employees, in computing relative contributions. A further restriction in the 1962 Act prohibited owner-employees from making nondeductible contributions to a tax-qualified plan unless the plan covered at least one common-law

166. INT. REV. CODE OF 1954, § 72(m)(4)(A).

167. *Id.* § 401(d)(2)(B).

168. The requirement was added to Treas. Reg. 111, § 29.165-1(a) by T.D. 5422, 1944 CUM. BULL. 318, and was deleted by T.D. 6189, 1956-2 CUM. BULL. 972. The relevant cases are cited in T.D. 6169.

169. Treas. Reg. § 1.401-1(b)(2) (1963).

170. INT. REV. CODE OF 1954, § 401(a)(6), (10).

171. Treas. Reg. § 1.401-3(e)(2) (1956); Rev. Rul. 61-75, 1961-1 CUM. BULL. 140.

employee.[172] When nondeductible contributions were permitted, they were limited to the lesser of $2,500 or ten percent of earned income.[173]

A tax-qualified plan covering an owner-employee was required to provide for acceleration of benefit payments in the case of death.[174] If the owner-employee died before his entire interest had been distributed to him, and distribution had not commenced during the permitted period, his entire interest was to be either distributed or applied to the purchase of an annuity for his beneficiaries within five years of his death. The annuity had to be immediate and payable for life or for a term certain, not greater than the life expectancy of the beneficiaries. A similar rule applied to the death of the employee's surviving spouse.

Finally, in addition to extending tax incentives for retirement saving to self-employed individuals, the 1962 Act created a new type of tax-qualified plan—the bond purchase plan.[175] A tax-qualified bond purchase plan had to meet most of the requirements generally applicable to tax-qualified plans, and if it covered self-employed individuals, it was subject to the additional requirements applicable to those plans.[176] Bond purchase plans were limited to investment of plan funds in a special series of U.S. Government securities issued under the Second Liberty Bond Act.[177] An employee realized no income upon the distribution of the bonds,[178] which were subject to taxation at the time of redemption.[179]

(5) Tax Reform Act of 1969

Except for a rider attached to the Foreign Investors Tax Act of 1966, which made a major change in the tax benefits available to self-employed individuals by allowing employer contributions on behalf of self-employed individuals to be deducted in full,[180] there were no legislative changes in the reglation of retirement plans between 1962 and 1969. The Tax Reform Act of 1969, however, made three significant modifications in this area. Beginning with contri-

172. INT. REV. CODE OF 1954, 401(d)(5)(B).
173. *Id.* § 401(e)(1)(B)(iii).
174. INT. REV. CODE OF 1954, § 401(d)(7).
175. Int. Rev. Code of 1954, ch. 1, § 405.
176. *Id.* § 405(a)(1).
177. INT. REV. CODE OF 1954, § 405(a)(2).
178. *Id.* § 405(d)(1).
179. *Id.* No part of the proceeds was treated as an amount received from the sale or exchange of a capital asset under § 1232 of the Code.
180. Pub. L. No. 89-809, 80 Stat. 1539, 1577, § 204, *repealing* Int. Rev. Code of 1954, ch. 1, § 404(a)(10).

butions made in taxable years after 1970, a shareholder-employee owning more than five percent of the outstanding stock of a subchapter S corporation had to include in gross income for each year the amount by which the corporation's contributions on his behalf to a tax-qualified plan exceeded the lesser of ten percent of his compensation or $2,500.[181] Any amount taxed currently to a shareholder-employee would be recovered by him tax free under the annuity rules when he started receiving plan benefits. If his right to participate in the plan terminated, or if he died without recovering the full amount of the corporation's contributions currently due him, the shareholder-employee (or his beneficiary) was entitled to deduct the unrecovered portion for that year from his gross income. The subchapter S corporation's contribution deduction was not affected by the Tax Reform Act of 1969, and any excess corporate contribution was included for the purpose of determining the plan's tax-qualified status.[182] In addition, a tax-qualified plan of a subchapter S corporation was required to provide that forfeitures could not inure to the benefit of a shareholder-employee.[183] Forfeitures were still permitted, however, in sharp contrast to their prohibition when owner-employees participated in the plan.[184]

The new rules for subchapter S corporations can be viewed as a step toward parity, because they extended some of the restrictions applicable to the self-employed to certain closely held corporations.[185] Because very few restrictions were thus extended, however, this step toward parity was a small one. In addition, the parity achieved was accomplished at the cost of creating a new and complex set of rules.

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181. INT. REV. CODE OF 1954, § 1379(b).

182. S. REP. No. 552, 91st Cong., 1st Sess. 215 (1969). Based on this proposition, the Internal Revenue Service has held that the excess contribution may not be withdrawn from a pension plan prior to severance of employment. Rev. Rul. 73-533, 1973-2 CUM. BULL. 129. In addition, any portion of a contribution made by a subchapter S corporation to a profit-sharing or stock bonus plan not deductible in one year was not permitted to be carried forward to a year when the corporation did not have subchapter S status. INT. REV. CODE OF 1954, § 1379(c). Carry-forwards from a year when the corporation was not an electing subchapter S corporation to a year when it does have subchapter S status, however, were permitted.

183. INT. REV. CODE OF 1954, § 1379(a).

184. *See* notes 146-48 *supra* and accompanying text.

185. The House Committee Report stated: "Your committee is concerned that a mechanism intended to simplify the tax complexity of corporations . . . [Subchapter S] is instead becoming a method of avoiding the tax limitations of partnerships and proprietorships. Your committee believes that if an enterprise wants to incorporate for business purposes but wants to be taxed in a manner similar to a partnership, then it should be subject to the same H.R. 10 limitations as partnerships in the case of the tax treatment of pension plans." H. REP. No. 413, 91st Cong., 1st Sess. 170 (1969). In fact, only the contribution limitation and the vesting requirement were extended to subchapter S plans, and those were extended in completely different forms.

Having been criticized from several quarters,[186] the taxation at long-term capital gains rates of certain lump sum distributions from tax-qualified plans provided under the Revenue Act of 1942 was modified by the Tax Reform Act of 1969.[187] In that Act Congress decided to limit long-term capital gains treatment to that portion of a lump sum distribution attributable to pre-1970 years. The portion attributable to the post-1969 years was taxed in two ways: Employer contributions were treated as ordinary income subject to a special seven year averaging computation;[188] appreciation, interest and dividends on the amounts accumulated were still taxed at capital gains rates.[189] The part of the lump sum distribution attributable to employee contributions was not subject to income tax at all. The Tax Reform Act of 1969 did not change the special five-year averaging computation applicable to self-employed individuals. Hence, the effect of the lump sum change was to move closer to parity in the tax treatment of the self-employed and the employed because the seven-year averaging concept was similar to the five-year averaging concept. This step toward parity was limited, however, because capital gains treatment continued to be available to a portion of a lump-sum distribution to a common-law employee, and the seven-year averaging provision afforded more significant tax relief than the five-year provision.

The Tax Reform Act of 1969 significantly changed the tax rules applicable to nonqualified plans. Previously, employees were taxed and employers were entitled to deductions with respect to contributions at the time they were made, but only if the employees' rights were nonforfeitable at that time.[190] The Tax Reform Act required employer contributions to be included in the employee's income in accordance with the new section 83 at the time when his interest became transferrable or was no longer subject to a substantial risk of forfeiture.[191] Contributions were deductible at the same time,

186. *See generally* Chadwick, *Taxation of Certain Lump Sum Distributions*, 28 TAX LAW 555 (1975).

187. Pub. L. No. 91-172, § 515, 83 Stat. 643 (1969), *amending* INT. REV. CODE OF 1954 §§ 402(a), 72(n), 403(a)(2).

188. INT. REV. CODE OF 1954, § 72(n).

189. *Id.* §§ 402(a), 403(a)(2).

190. Revenue Act of 1964, Pub. L. No. 88-272, § 232(e)(2), 78 Stat. 111 (formerly codified at Int. Rev. Code of 1954, ch. 1, § 402(b)); Treas. Reg. § 1.402(b)-1(a) (1956). The Internal Revenue Service took the position that no deduction was allowable at any time if rights were not vested at the time the contribution was made. *See* Treas. Reg. § 1.404(a)-12 (1956). The Court of Claims disagreed in Russell Mfg. Co., 175 F. Supp. 159 (Ct. Cl. 1959). The Internal Revenue Service, however, declined to follow the case. Rev. Rul. 59-383, 1959-2 CUM. BULL. 456. *See also* notes 87-88 *supra* and accompanying text.

191. INT. REV. CODE OF 1954, § 83(a).

provided that separate accounts were maintained under the plan with respect to each employee.[192] Moreover, section 83 was broadly applicable to any transfer of property to any person in connection with the performance of services. Also, the amount subject to tax and the amount of the deduction were measured by the value of the property at the time it became taxable. Thus, when vesting occurred in a nonqualified plan, the amount subject to tax and deductible was equated not to the amount contributed, but to the value of the employee's interest at the time of vesting.[193]

III. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Five years after the Tax Reform Act of 1969, the tax treatment of retirement plans was completely revised in the Employee Retirement Income Security Act of 1974.[194] In some areas, great progress toward parity was made, but many new and unjustifiable distinctions were drawn. In any case, the changes made were far more numerous and substantial than those of any previous act.

The legislative history of ERISA, the acronym for the Employee Retirement Income Security Act of 1974, is a fascinating story that can only be touched upon here. ERISA probably had its genesis in 1962 when President Kennedy formed a committee to conduct a thorough investigation of the private retirement system. The committee's report, issued in 1965, called for greater vesting of retirement plan rights, more funding and disclosure requirements, new federal fiduciary standards, and a solution for benefit portability and insurance problems.[195] In 1964, the Studebaker plant in South Bend, Indiana, was closed, employees were discharged, and the corporation's pension plan was terminated. The Studebaker case, which was widely publicized, illustrated the need for regulation of

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192. *Id.* §§ 83(h), 401(a)(5).

193. Proposed Treas. Reg. § 1.83-8(a)(2) (June 3, 1971) provides that § 83 is not applicable to a transfer to or from a nonqualified plan except as provided in §§ 402(b) and 403(c) of the Code. The extent to which those sections make § 83 applicable is set forth in Proposed Treas. Reg. §§ 1.402(b)-1, 1.403(c)-1 (June 3, 1971).

194. The reader should note that ERISA contains several provisions relating to effective dates. For example, certain provisions are effective for plan years beginning after December 1, 1953 (ERISA § 1014, INT. REV. CODE OF 1954, § 413), while others are not effective until 1980. *See* ERISA § 1017(c)(1)(B), INT. REV. CODE OF 1954, § 410, note. In general, plans established on or before January 1, 1974, must comply with ERISA for plan years beginning after December 31, 1975. ERISA § 1017(b), INT. REV. CODE OF 1954, § 410, note. Plans established after January 1, 1974, must comply with ERISA for plan years beginning after September 2, 1974. ERISA § 1017(a), INT. REV. CODE OF 1954, § 410, note. *See generally*, Rhodes & Chadwick, *Guide to Effective Dates*, 41 J. TAX. 327 (1974).

195. PUBLIC POLICY AND PRIVATE PENSION PROGRAM, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS (1965).

retirement plans. More than 4,000 participants, aged forty to sixty, lost $14 million—about eighty-five percent of the then current value of their vested benefits.[196]

Reacting to these events, the Senate Committee on Labor and Public Welfare and the House Committee on Education and Labor held extensive hearings on the need for reforms in the regulation of private retirement plans.[197] The Administration submitted limited legislation in March of 1970 and more complete legislation in December of 1971.[198] In September 1972, the Labor and Public Welfare Committee reported out a bill.[199] The bill, however, was referred to the Senate Committee on Finance, which traditionally had jurisdiction over many aspects of retirement plans, and this committee deleted most of the bill.[200] In 1973, the Executive submitted a revised legislative package,[201] the Labor and Public Welfare Committee reported out a new version of its original bill,[202] and the Finance Committee reported out its own bill.[203] In the summer of 1973, the two committees worked out a compromise, which the Senate passed.[204] Two major bills also were reported out of committee in the House. The House Committee on Education and Labor reported out a bill in October 1973,[205] and the House Ways and Means Committee produced a bill in February 1974.[206] Instead of combining the two approaches into a single unified measure, the House adopted a compromise that literally combined the two bills as reported out of the Committees.[207] The differences between the Senate and House versions of reform were resolved by the Committee of Conference in six weeks of meetings followed by extensive redrafting.

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196. S. REP. No. 383, 93d Cong., 1st Sess. 78 (1973); *Hearings on Private Pension Plans Before the Subcomm. on Fiscal Policy of the Joint Economic Comm.*, 89th Cong., 2d Sess. 103-06, 123 (1966). Workers under age 40 lost some unspecified amount of vested benefits.

197. *See Hearings Before the Subcomm. on Labor of the Senate Comm. on Labor and Public Welfare*, 92d Cong., 2d Sess. (1972).

198. The December 1971 legislation was introduced as H.R. 12272, 92d Cong., 1st Sess. (1971), and S. 3024, 92d Cong., 1st Sess. (1971).

199. S. 3579, 92d Cong., 2d Sess. (1972).

200. *Id.*

201. The Administration's 1973 legislation was introduced in the House as H.R. 7157, 93d Cong., 1st Sess. (1973) and H.R. 6900, 93d Cong., 1st Sess. (1973), and in the Senate as S. 1631, 93d Cong., 1st Sess. (1973) and S. 1557, 93d Cong., 1st Sess. (1973).

202. S. 4, 93d Cong., 1st Sess. (1973).

203. S. 1179, 93d Cong., 1st Sess. (1973).

204. H.R. 4200, 93d Cong., 1st Sess. (1973).

205. H.R. 2, 93d Cong., 1st Sess. (1973), later revised as H.R. 12906 introduced by Congressman Dent.

206. H.R. 12481, 93d Cong., 2d Sess. (1974), later revised as H.R. 12855, botb introduced by Congressman Ullman.

207. H.R. 2, 93d Cong., 2d Sess. (1974).

The resulting legislation repeals the Welfare and Pension Plans Disclosure Act and imposes new reporting and disclosure requirements.[208] It also establishes minimum participation, vesting, and funding standards,[209] and establishes federal standards governing fiduciary responsibility.[210] Additionally, ERISA limits contributions and benefits under tax-qualified plans[211] and increases the deductible contribution that can be made to a tax-qualified plan with respect to a self-employed individual or a shareholder-employee.[212] Finally, it provides a tax deduction for retirement savings to employees not covered by a plan,[213] modifies the taxation of certain lump sum distributions,[214] and establishes a system of termination insurance.[215] Generally, all employee benefit plans[216] are affected by ERISA, and virtually all retirement plans have had to be amended. The portion amending the Internal Revenue Code imposes many new requirements on tax-qualified plans and provides excise taxes and new tax rules with respect to them. In addition, the same new requirements imposed as a condition for tax qualification are imposed by the labor provisions of ERISA on certain retirement plans, regardless of whether they are tax-qualified. Governmental plans and certain other plans, however, are exempted from the new requirements, thus creating new parity problems.

Title I of ERISA significantly modifies and increases the reporting, record keeping, and disclosure requirements of certain retirement plans, in replacing the Welfare and Pension Plans Disclosure Act.[217] A description of every employee benefit plan must be furnished to employees,[218] and certain financial and actuarial data must be reported annually to the Secretary of Labor.[219] Title II of ERISA, which contains the amendments to the Internal Revenue Code, provides additional, and sometimes repetitive, requirements for reporting to plan participants and the Treasury Department.[220] Title III requires disclosure to "interested parties" when a determi-

208. ERISA §§ 101-11, 29 U.S.C.A. §§ 1021-31 (Supp. 1975).

209. ERISA §§ 201-11, 301-06, 1011-12, 29 U.S.C.A. §§ 1051-61, 1081-86 (Supp. 1975), INT. REV. CODE OF 1954, §§ 410-12, 4971.

210. ERISA §§ 401-14, 29 U.S.C.A. §§ 1011-14 (Supp. 1975).

211. ERISA § 2004, INT. REV. CODE OF 1954, § 415.

212. ERISA § 2001, INT. REV. CODE OF 1954, § 4972.

213. ERISA § 2002, INT. REV. CODE OF 1954, §§ 219, 408-09, 4973-74, 6693.

214. ERISA § 2005, INT. REV. CODE OF 1954, § 402(e).

215. ERISA §§ 4001-82, 29 U.S.C.A. §§ 1301-81 (Supp. 1975).

216. For a definition of the term "employee benefit plan," see note 23 *supra*.

217. ERISA §§ 101, 104, 110, 111, 29 U.S.C.A. §§ 1021, 1024, 1030, 1031 (Supp. 1975).

218. ERISA §§ 102, 104(b), 29 U.S.C.A. §§ 1022, 1024 (Supp. 1975).

219. ERISA §§ 103, 104(a), 109, 29 U.S.C.A. §§ 1023, 1024, 1029 (Supp. 1975).

220. ERISA §§ 1031-34; INT. REV. CODE OF 1954, §§ 6057-59.

nation letter on the status of a retirement plan is sought from the Internal Revenue Service.[221] Title IV contains requirements for reporting by defined benefit plans to the Pension Benefit Guaranty Corporation.[222]

A. Participation Requirements

ERISA was the first attempt to legislate specific participation requirements of general application. Under prior law, participation requirements were only a factor to be considered in determining whether the coverage requirements were met, except when the plan covered owner-employees. The old percentage test was met if the plan benefited either seventy percent of all employees or eighty percent of all eligible employees, provided seventy percent of all employees were eligible.[223] In applying this test, employees of five years or less longevity, part-time employees, and seasonal employees could be excluded.[224] Moreover, a plan that failed the percentage test could still qualify if it met the classification test.[225] As a general rule, ERISA provides that a plan may not exclude by reason of age or service any employee who has attained age twenty-five and completed one year of service.[226] Thus, the five-year minimum service condition for purposes of the percentage test was replaced by a mandatory one-year rule. Additionally, a new condition is imposed, and the exclusion of part-time and seasonal employees is no longer permitted, except to the extent such employees have not completed a "year of service."[227] ERISA also provides a maximum age rule. A covered plan, whether tax-qualified or nonqualified, may not exclude an employee because he is too old, unless the plan is a defined benefit plan or a target benefit plan, and the employee is within five years of normal retirement age.[228]

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221. ERISA § 3001; INT. REV. CODE OF 1954, § 7476.

222. ERISA § 4043, 29 U.S.C.A. § 1340 (Supp. 1975).

223. Int. Rev. Code of 1954, ch. 1, § 401(a)(3)(A), 68A Stat. 134.

224. *Id.*

225. *Id.* § 401(a)(3)(B).

226. ERISA § 202, 29 U.S.C.A. § 1052 (Supp. 1975); ERISA § 1011, INT. REV. CODE OF 1954, § 410(a)(1)(A).

227. A "year of service" is defined as a 12-month period during which the employee has not less than 1,000 hours of service. A special rule for the maritime industry defines 125 days of service as 1,000 hours of service. Special rules for seasonal industries and the definition of an hour of service are to be determined by regulations of the Secretary of Labor. *See* ERISA § 202(a)(3), 29 U.S.C.A. § 1052 (Supp. 1975); ERISA § 1011, INT. REV. CODE OF 1954, § 410(a)(3).

228. ERISA § 202(a)(2), 29 U.S.C.A. § 1052 (Supp. 1975); ERISA § 1011, INT. REV. CODE OF 1954, § 410(a)(2). The term "defined benefit plan" is defined in ERISA § 3(35), 29 U.S.C.A. § 1002(35) (Supp. 1975); ERISA § 1015, INT. REV. CODE OF 1954, § 414(j). The term

B. Vesting Requirements

ERISA was also the first attempt to legislate specific vesting rules of general application. Under prior law, unless the plan covered an owner-employee, an employee could work forty years with one employer, be laid off at age sixty-four, and discover that he had no pension.[229] In general, the failure to require vesting under prior law interfered with the mobility of labor, to the asserted detriment of the economy.[230] To remedy these problems, both the labor and tax provisions of ERISA contain minimum vesting standards.[231] As a general rule, plans covered by ERISA must provide for full vesting upon attainment of normal retirement age and must provide for immediate vesting of benefits derived from employee contributions. With respect to benefits derived from employer contributions, plans must satisfy the requirements of one of three alternative vesting schedules. One of the schedules provides for full vesting after ten years of service;[232] if every employee who has at least ten years of service has a nonforfeitable right to one hundred percent of his accrued benefit derived from employer contributions, vesting under the plan is adequate. The second schedule provides for "graded" vesting. To satisfy this standard, an employee who has completed at least five years of service must have a nonforfeitable right to at least twenty-five percent of his accrued benefit derived from employer contributions.[233] From the fifth through the tenth years of service, at least an additional five percent a year must be vested in the employee; from the tenth to the fifteenth years, at least ten percent a year more must vest. Thus, the employee must be fully vested after no more than fifteen years of service. The third schedule allows an employer maintaining a plan to provide for vesting according to the employee's age and years of service. Under this "Rule of 45," each employee must have a nonforfeitable right to at least fifty percent of his accrued benefit when the sum of his age and years of service equals or exceeds forty-five. If the employee contin-

"target benefit plan" is to be defined in Treasury regulations. ERISA, § 202(a)(2)(A)(ii). INT. REV. CODE OF 1954, § 410(a)(2)(A)(ii). "Normal retirement age" is defined in ERISA § 3(24), and INT. REV. CODE OF 1954, § 411(a)(8) (for purposes of § 411).

229. *See generally*, R. NADER & K. BLACKWELL, YOU AND YOUR PENSION (1973).

230. H.R. REP. No. 807, 93d Cong., 2d Sess. 12 (1974).

231. ERISA § 203, 29 U.S.C.A. § 1053 (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411.

232. ERISA §§ 203(a)(3)(A), 29 U.S.C.A. § 1053(a)(3)(A) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411(a)(2)(A).

233. ERISA § 203(a)(2)(B), 29 U.S.C.A. § 1053(a)(2)(B) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954 § 411(a)(2)(B).

ues in the service of the employer maintaining the plan, every year of service thereafter will entitle him to at least an additional ten percent of vested benefits.[234]

In addition to these three schedules, the Joint Explanatory Statement of the Committee of Conference provided another vesting schedule, which is the most significant in the quest for parity.[235] As indicated above, there is a relationship between the minimum vesting standard and the antidiscrimination rule.[236] Under ERISA a plan that meets the vesting requirements outlined above will not be considered discriminatory with respect to vesting unless there is a pattern of abuse under the plan or there has been an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers or shareholders or are highly compensated.[237] Prior to the enactment of ERISA, the law in this area was administered on a case-by-case basis, with no uniform results in fact situations of a similar nature.[238] For example, plans covering a small number of employees were generally required to vest more rapidly than plans covering a large number of employees. While the reason for small plan discrimination is difficult to pinpoint, the theoretical justification is based on the notion that the turnover of employees employed by small companies is greater than the turnover in large companies. During the conference committee deliberations on ERISA, the Treasury Department criticized this form of discrimination and argued for a uniform rule.

As a result, the Statement of Managers directed the Internal Revenue Service not to require a vesting schedule more stringent than forty percent after four years of employment, with five percent additional vesting for each of the next two years, and ten percent additional vesting for each of the following five years.[239] In addition, this more rapid vesting was not to be required except in cases where the rate of probable turnover for officers, shareholders, or highly compensated employees was substantially less (perhaps as much as fifty percent less) than the rate of probable turnover for rank-and-file employees. In addition, the Joint Pension Task Force, established under ERISA, was directed to examine carefully the interrelationship of the vesting and antidiscrimination rules, and the Treasury Department was asked to supply information on patterns

234. ERISA § 203(a)(2)(C), 29 U.S.C.A. § 1053(a)(2)(C) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411(a)(2)(C). In any event, after 10 years of service the employee must be 50% vested.

235. H.R. REP. No. 1280, 93d Cong., 2d Sess. 276 (1974).

236. *See* notes 147 and 148 *supra* and accompanying text.

237. ERISA § 1012, INT. REV. CODE OF 1954, § 411(d)(1).

238. H.R. REP. No. 1280, 93d Cong., 2d Sess. 276 (1974).

239. *Id.* This directive did not apply to cases of abuse.

of benefit loss for different categories of plans under the minimum vesting standards.[240] The experimental rules outlined above are intended to apply only until the responsible congressional committee can review the situation upon receiving the report of the Task Force Study Group. Unfortunately, theoretical and statistical studies will probably not provide an answer to this vexing problem beyond requiring one hundred percent vesting of accrued benefits derived from employer contributions.[241]

Since the viability of minimum standards for vesting is dependent in the case of defined benefit plans on the accrued benefits to which these minimum vesting percentages are applied, ERISA also establishes three alternative standards for the computation of accrued benefits.[242] Under a "three percent test," for each year of participation at least three percent of the benefit payable under the plan must accrue to a participant who begins participation at the earliest possible entry age and serves continuously until age sixty-five, or normal retirement age under the plan, whichever is earlier.[243] Under a "133 1/3 percent test," a plan qualifies if the accrual rate for any participant for any later year is not more than 133 1/3 percent of his accrual rate for the current year.[244] Finally, under a "pro rata test," the retirement benefit is computed as though the employee will continue to earn the same rate of compensation annually that he earned during the years that would have been taken into account under the plan, had the employee retired on the date in question. This amount is then to be multiplied by a fraction whose numerator is the employee's total years of active participation in the plan, up to the date for which the computation is being made, and whose denominator is the total number of years of active participation he would have if he were to continue his employment until normal retirement age.[245]

C. Funding Requirements

A statistical study conducted during the period leading up to

240. ERISA § 3022(a)(1), 29 U.S.C.A. § 122(a)(1) (Supp. 1975).

241. Under the so-called "fiscal drag" theory, tax-qualified plans receive favorable tax treatment as long as a significant number of rank-and-file employees are covered. *See* ERISA § 1016(a)(2)(A), INT. REV. CODE OF 1954, §§ 401(a)(3), 410(b). Coverage, however, is irrelevant unless employees vest in the accrued benefit derived from employer contributions. Nondiscriminatory vesting can only be achieved through immediate 100% vesting.

242. *See* H.R. REP. No. 807, 93d Cong., 2d Sess. 21 (1974).

243. ERISA § 204(b)(1)(A), 29 U.S.C.A. § 1054(b)(1)(A) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411(b)(1)(A).

244. ERISA § 204(b)(1)(B), 29 U.S.C.A. 1054(b)(1)(B) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411(b)(1)(B).

245. ERISA § 204(b)(1)(C), 29 U.S.C.A. § 1054(b)(1)(C) (Supp. 1975); ERISA § 1012, INT. REV. CODE OF 1954, § 411(b)(1)(C).

the passage of ERISA indicated that a significant number of pension plans were not adequately funded; that is, that assets held by retirement plans were not adequate to pay promised benefits.[246] This result was attributed in part to the failure of the Code to contain adequate funding standards. While minimum funding standards were developed administratively under the Code for tax-qualified plans, the sanctions imposed for violations were inadequate, and no standards existed for nonqualified plans. Under Treasury Regnlations contributions to a tax-qualified pension plan had to be sufficient to pay the liabilities created currently (normal cost) plus the interest due on unfunded, accrued pension liabilities (past service liabilities).[247] This tended to keep the amount of unfunded pension liabilities from growing larger but did not require additional contributions to amortize the principal amount of the unfunded liabilities. To increase the solvency of pension funds, ERISA establishes minimum funding standards that require the funding over thirty years of past service liabilities, although the existing past service liabilities and past service liabilities of multi-employer plans can be funded over forty years. Experienced losses must be amortized over fifteen years, except for multi-employer plans, which can amortize over twenty years.[248]

Even with the funding requirements, Congress recognized that compliance still would not insure that an employer would be able to pay all vested benefits should a retirement plan be terminated. Therefore, after considerable legislative debate, despite Administration opposition—but with strong union support—Congress established in ERISA a program of plan termination insurance for pension plans that terminate without being able to pay vested benefits.[249] To administer the new program, the Pension Benefit Guaranty Corporation was created, headed by the Secretaries of Labor, Treasury, and Commerce, and administered within the Labor Department.[250] The program insures an individual's pension benefits up to the lesser of $750 per month or one hundred percent of a person's average wages during his most remunerative five years of participation in the plan. Additional limits were placed on the amount of insurance to be provided a "substantial owner."[251] Initially, the insurance program is financed by a premium of one dollar per plan participant for single employer plans and fifty cents per

246. S. REP. No. 383, 93d Cong., 1st Sess. 3 (1973).

247. Treas. Reg. § 1.401-6(c)(2)(ii) (1963).

248. ERISA § 302-05, 29 U.S.C.A. § 1082-85 (Supp. 1975); ERISA § 1013, INT. REV. CODE OF 1954, § 412.

249. ERISA § 4001-82, 29 U.S.C.A. §§ 1301-81 (Supp. 1975).

250. ERISA § 4002, 29 U.S.C.A. § 1302 (Supp. 1975).

251. *Id.* at § 4022, 29 U.S.C.A. § 1322 (Supp. 1975).

plan participant for multi-employer plans.[252] After one or two years on this basis, the Pension Benefit Guaranty Corporation will be permitted to set up its own premium schedule, within prescribed limits.[253] Some controls were placed on both employer and government-initiated terminations that would trigger the payment of insurance benefits. Once a termination does occur, however, and insured benefits are paid out by the Pension Benefit Guaranty Corporation, the employer will be liable, under a government lien procedure, to the Pension Benefit Guaranty Corporation for the amount of insured benefits up to thirty percent of his net worth.[254]

In an additional step to provide security for employees, ERISA established rules governing the conduct of plan fiduciaries under the labor provisions,[255] and rules governing the conduct under the tax laws of persons not qualified for a pension plan.[256] The labor provisions deal with the structure of plan administration, including requirements that a plan be established pursuant to a written instrument[257] and that all assets of any employee benefit plan be held in trust and controlled and managed exclusively by one or more trustees.[258] In addition, a federal standard governing the conduct of fiduciaries is established,[259] and certain "prohibited transactions" for fiduciaries are listed.[260] The tax provisions include only the pro-

252. ERISA § 4006, 29 U.S.C.A. § 1306 (Supp. 1975).

253. *Id.*

254. ERISA § 4023, 29 U.S.C.A. § 1323 (Supp. 1975).

255. ERISA §§ 401-14, 29 U.S.C.A. §§ 1101-14 (Supp. 1975).

256. ERISA § 2003, INT. REV. CODE OF 1954, § 4975. The labor provisions contained similar rules governing the conduct of "parties in interest." ERISA § 406, 29 U.S.C.A. § 1106 (Supp. 1975).

257. ERISA § 402(a)(1), 29 U.S.C.A. § 1101 (Supp. 1975).

258. ERISA § 403(a), 29 U.S.C.A. § 1103 (Supp. 1975). Exceptions are provided in ERISA § 403(b), 29 U.S.C.A. § 1103 (Supp. 1975) for

(1) assets of a plan which consist of insurance contracts,

(2) assets of, or held by, an insurance company,

(3) plans which cover self-employed individuals,

(4) individual retirement accounts,

(5) custodial accounts purchased under § 403(b) of tbe Internal Revenue Code, and

(6) plans exempted by the Secretary of Labor that also are exempted from the participation, vesting, funding, and termination insurance requirements of ERISA. Notably absent from the list of exceptions are plans funded by custodial accounts pursuant to § 401(f) of the Code when self-employed individuals do not participate. This is a clear violation of parity.

259. ERISA § 404(a)(1), 29 U.S.C.A. § 1104 (Supp. 1975). This federal standard preempts state standards. ERISA § 514, 29 U.S.C.A. § 1144 (Supp. 1975).

260. ERISA § 406, 29 U.S.C.A. § 1106 (Supp. 1975). This section prohibits a fiduciary (defined in ERISA § 3(21), 15 U.S.C.A. § 78f (Supp. 1975)) from engaging in a transaction if he knows or should know that such transaction constitutes a direct or indirect—

(A) sale or exchange, or leasing, of any property between the plan and a party in interest (defined in ERISA § 3(14), 45 U.S.C.A. § 151 (Supp. 1975)).

(B) lending of money or other extension of credit between the plan and a party in interest;

hibited transactions and apply only to disqualified persons, other than persons acting in a fiduciary capacity.[261]

D. *Limits on Benefits and Contributions*

Although the principal purpose of ERISA is to protect the rights of employees to receive promised benefits, many unjustifiable differences in the treatment of retirement plans also were eliminated. Members of the Senate Committee on Finance and the House Committee on Ways and Means recognized that in the past virtually no limit had been placed on the amount of contributions that could be made to tax-qualified plans, except that contributions made with respect to self-employed individuals and shareholder-employees of subchapter S corporations were limited to the lesser of ten percent of earned income or $2,500.[262] Excess contributions made on behalf of an owner-employer could result in penalties,[263] while a shareholder-employee who was subject to the same limits merely had to take excess contributions into income.[264] It also was

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(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan;

(E) acquisition, on behalf of the plan, of any employer security or employer real property (defined in ERISA § 407(d)(1), (2), 29 U.S.C.A. § 1107 (Supp. 1975). In addition, a fiduciary is prohibited from—

(F) dealing with the assets of the plan in his own interest or for his own account,

(G) acting in any transaction involving the plan on behalf of a party whose interests are adverse, or

(H) receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan. However, there are numerous exceptions from these broad prohibitions. *See* ERISA §§ 407-08, 29 U.S.C.A. §§ 1107-08 (Supp. 1975). Violation of these prohibitions can give rise to injunctive relief or a claim for damages by the Secretary of Labor, a participant, or a beneficiary. ERISA §§ 409(a), 502, 29 U.S.C.A. §§ 1109, 1132 (Supp. 1975).

261. The tax provisions apply to "prohibited transactions." Excise taxes are payable by any disqualified person (defined in ERISA § 2003, INT. REV. CODE OF 1954, § 4975(e)(2)) who participated in the prohibited transaction, other than a fiduciary acting only as such. The taxes are at the rate of 5% per year of the amount involved. ERISA § 2003, INT. REV. CODE OF 1954, § 4975(a). An additional tax at the rate of 100% of the amount involved is imposed if the transaction is not corrected within the correction period. ERISA § 2003, INT. REV. CODE OF 1954, § 4975(b). Prohibited transactions are defined to include any direct or indirect transaction listed in paragraphs (A)-(D) of note 260, and to any direct or indirect—

(E) act whereby a disqualified person who is a fiduciary deals with the income or assets of the plan in his own interest or for his own account; or

(F) receipt by a disqualified person who is a fiduciary of any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. Again, there are numerous exceptions from these broad prohibitions. *See* ERISA § 2003, INT. REV. CODE OF 1954, §§ 4975(c)(2), (d).

262. H.R. REP. No. 807, 93d Cong., 2d Sess., 4 (1974); S. REP. No. 383, 93d Cong., 1st Sess. 4 (1973).

263. Int. Rev. Code of 1954, § 401(e)(2), Pub. L. No. 87-792, § 2(3), 76 Stat. 816.

264. Int. Rev. Code of 1954, § 1379(b)(1), Pub. L. No. 91-172, § 531(a), 83 Stat. 655.

recognized that individuals who were not covered by a tax-qualified plan had no opportunity to set aside income for their own retirement under the favorable tax treatment accorded to individuals covered by such plans. Those not covered could save for their retirement only from income remaining after taxes. Additionally, the distinction between the tax treatment of certain lump sum distributions to regular corporate employees and similar distributions to self-employed individuals was recognized.[265] To eliminate these differences ERISA imposes limitations on benefits and contributions under tax-qualified plans,[266] increases the deductible or excludable contributions that can be made by a self-employed individual or a shareholder-employee,[267] provides for a retirement savings deduction,[268] and eliminates the principal distinctions in the tax treatment of lump sum distributions under tax-qualified plans.[269]

Section 415 of the Internal Revenue Code, as amended in ERISA, imposes new limitations on benefits and contributions under tax-qualified plans. In general, the annual benefit that a pension plan can pay to a participant is limited to the lesser of $75,000 or one hundred percent of the participant's average compensation for his most remunerative three years of his employment.[270] In the case of a profit-sharing plan, a money purchase pension plan, or a target benefit plan, the annual additions for the year must not exceed the lesser of $25,000 or twenty-five percent of the participant's compensation from the employer.[271] When an employer has two or more plans, the general limit must be computed by aggregating similar plans to determine if the limitation for that type of plan was met on an overall basis.[272] For example, all defined benefit plans maintained by the same employer are treated as one plan, and the benefit that is allowable under that aggregated plan is limited to the lesser of $75,000 or one hundred percent of compensation received. If an employer maintains a defined benefit plan and a defined contribution plan, each is subject to the limit appropriate to that type

265. H.R. REP. No. 1280, 93d Cong., 2d Sess. 351 (1974).

266. ERISA § 2004, INT. REV. CODE OF 1954, § 415.

267. ERISA § 2001, INT. REV. CODE OF 1954, §§ 404(e), 1379(b)(1).

268. ERISA § 2002, INT. REV. CODE OF 1954, § 219.

269. ERISA § 2005, INT. REV. CODE OF 1954, § 402(e).

270. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(b).

271. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(c). The term "annual addition" is defined as the sum of

(A) employer contributions,

(B) the lesser of—

(i) the amount of the employer contributions in excess of 6% of his compensation, or

(ii) one-half of his employer contributions, and

(C) forfeitures. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(c)(2).

272. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(f).

of plan. In addition, if the plans cover the same employee, the two plans must be combined in computing the overall limitation. To achieve this, ERISA prescribes a formula under which a defined benefit plan fraction for the year is added to a defined contribution plan fraction for that year.[273] Each fraction indicates what portion of the maximum benefit limit for the kind of plan involved the participant has used. If the sum of these fractions exceeds 1.4, then one or more of the plans may be disqualified.[274]

In Code sections 404 and 1379, amended by ERISA, the maximum deductible contributions on behalf of self-employed individuals and the maximum excludable contributions on behalf of subchapter S corporation shareholder-employees has been increased to the lesser of fifteen percent of earned income or $7,500.[275] In applying these limitations, not more than $100,000 of compensation may be taken into account.[276] This $100,000 rule insures that a self-employed individual or a shareholder-employee who wishes to use the maximum tax allowance for his own contributions must provide a significant contribution for his regular employees.[277] In any event, a minimum of $750 is deductible by self-employed individuals, subject to section 415 of the Code.[278] This provision was intended to enable the self-employed individual to set up tax-qualified plans

273. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(e).

274. For example, assume that an employee "A" is employed at age 40 and immediately becomes a participant in a tax-qualified pension plan that accrued a benefit annually equal to 2% of his high three years of compensation (adjusted for the cost of living). His annual rate of compensation is $150,000. At age 45, he becomes a participant in a tax-qualified, profit-sharing plan of his employer. "A's" projected benefit under the pension plan, assuming he works until the normal retirement age of 65, would equal 50% of his average high three years of compensation, or $75,000. Since $75,000 is the maximum amount of the annual benefit payable from a pension plan (assuming no increase in the cost of living) contributions could be made for "A" under a profit-sharing plan, if the defined contribution fraction did not exceed four tenths (.4). "A" could therefore receive profit-sharing plan annual additions of .4 times $25,000, or $10,000 per plan year. Assuming that the pension plan was amended to provide that future accruals would equal 1% of compensation($1,500 per year in "A's" case), his projected benefit under the pension plan would then equal $45,000—30% of his high three years of compensation (whicb equals 60% of his $75,000 limitation). Tbis would mean tbat 80% of his overall limitation could be provided under the profit-sharing plan, raising the annual addition limitation to $20,000. If more tban $20,000 were contributed, either the pension plan or the profit-sharing plan would be disqualified. ERISA § 2004(a)(2), INT. REV. CODE OF 1954, § 415(e).

275. ERISA § 2001, INT. REV. CODE OF 1954, §§ 404(e), 1379(b)(1).

276. ERISA § 2001(c), INT. REV. CODE OF 1954, § 401(a)(17).

277. H.R. REP. No. 807, 93d Cong., 2d Sess. 113 (1974). For example, as the Committee Report points out, a self-employed person with $200,000 of earned income would have to contribute at a 7.5% rate for his employees in order to obtain the maximum deduction of $7,500 (i.e., 7.5% x $100,000) for himself.

278. ERISA § 2001(a)(3), INT. REV. CODE OF 1954, § 404(e)(4).

without having to confront complex record-keeping and administrative problems, and to help each self-employed individual to save a minimum amount each year for his retirement, although his earned income in a particular year is relatively low.[279]

The increase to $7,500 or fifteen percent was accompanied by a modification in the treatment of excess contributions on behalf of an owner-employee. The special penalty sanctions discussed above[280] were replaced by an excise tax of six percent, payable by the employer maintaining the plan.[281] Although Congress was aware of the existing distinction in the treatment of excess contributions by owner-employees and shareholder-employees,[282] the excise tax was not applied to the latter category. This distinction is hard to justify; the excise tax arguably should apply to excess contributions under all plans. If the excise tax approach works well with respect to the self-employed, it probably should be extended across the board.

E. Individual Retirement Plans

In order to provide a tax incentive for individuals not covered by a tax-qualified plan, ERISA creates a concept in retirement planning whereby an individual (including a self-employed individual) who is not an active participant in a tax-qualified plan or a government plan can make deductible annual contributions to his own retirement savings plan.[283] Under this plan a deduction from gross income is allowed for amounts paid in cash during the taxable year to an individual retirement account,[284] for an individual retirement annuity,[285] or for a retirement bond.[286] Payments may be made by the individual, by an employer for his employees, or by a labor union for its members.[287] The deduction is available to each eligible individual without regard to marital status, the application of community property law, or the filing of a joint tax return.[288] The em-

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279. H.R. REP. No. 807, 93d Cong., 2d Sess. 113 (1974). The regular 25% limit of § 415(c)(1)(B) of the Code is applicable, however. Proposed Treas. Reg. § 1.404(e)-1A(b)(3)(i)(C), (c)(4), 26 Fed. Reg. 17576 (1975).

280. *See* text accompanying notes 151-57 *supra*.

281. ERISA § 2001(f)(1), INT. REV. CODE OF 1954, § 4972. This tax is not deductible. ERISA § 1016(a)(1), INT. REV. CODE OF 1954, § 275(a).

282. H.R. REP. No. 807, 93d Cong., 2d Sess. 116 (1974).

283. ERISA § 2002(a)(1), INT. REV. CODE OF 1954, § 219. *See* note 132 *infra* and accompanying text.

284. ERISA § 2002(b), INT. REV. CODE OF 1954, § 408(a).

285. ERISA § 2002(b), INT. REV. CODE OF 1954, § 408(b).

286. ERISA § 2002(c), INT. REV. CODE OF 1954, § 409.

287. ERISA §§ 2002(a), (b), INT. REV. CODE OF 1954, §§ 219(a), 408(c).

288. ERISA § 2002(a), INT. REV. CODE OF 1954, § 219(c)(2).

ployee's interest in all contributions and the increments thereon must be fully vested.[289]

E. Lump Sum Distributions

As indicated above,[290] the modification in the tax treatment of certain lump sum distributions from tax-qualified plans included the elimination of most distinctions under prior law in the treatment of distributions to regular corporate employees and to self-employed individuals. Under Code section 402(e), the taxable portion of a lump sum distribution attributable to post-1973 years is taxed separately from the taxpayer's other income, and it is treated as ordinary income subject to ten-year averaging. The portion of the payment attributable to the pre-1974 period is taxed as long-term capital gain.[291] To qualify for this special treatment, a lump sum distribution or payment to an employee must be made within one taxable year, it must become payable only on the occurrence of certain enumerated events, and it must come from a trust that forms part of a plan described in section 401(a) and which is exempt from tax under section 501 or from a plan described in section 403(a).[292] The previously noted distinction that existed under prior law was eliminated by defining the term "employee" to include self-employed individuals.[293]

IV. Justifiable and Unjustifiable Distinctions in the Current Regulatory Structure

A. Types of Distinctions

There are many types of retirement plans or arrangements, for which the only theoretical limitation is the imagination of the individual desiguing it. Federal regulation, however, forces retirement plans and arrangements into molds. Under the tax law, there are three basic alternatives—tax-qualified plans, nonqualified plans, and retirement savings arrangements. Under ERISA's labor provisions there are two basic alternatives—plans subject to ERISA requirements and plans not subject to those requirements.[294]

289. ERISA §§ 2002(b), (c), Int. Rev. Code of 1954, §§ 408(a)(4), 409(a)(5).

290. *See* text accompanying note 269 *supra*.

291. ERISA §§ 2005(b)(1), (2), Int. Rev. Code of 1954, § 402(a)(2), 403(a)(2).

292. ERISA § 2005(a), Int. Rev. Code of 1954, § 402(e)(4)(A).

293. ERISA § 2005(a), Int. Rev. Code of 1954, § 402(e)(4)(f).

294. For example, under the Internal Revenue Code a corporation may use a custodian instead of a trustee. ERISA § 1022(d), Int. Rev. Code of 1954, § 401(f). The labor provisions of ERISA, however, do not permit this. ERISA §§ 403(a),(b), 29 U.S.C.A. §§ 1103(a),(b) (Supp. 1975). If an attorney advised bis client that the use of a custodian was permissible, the client would be subject to suit by either the Labor Department or a private party. *See*

The first tax category, tax-qualified plans, includes pension, profit-sharing, stock bonus, bond purchase and annuity plans.[295] Employer contributions to any of these plans may be supplemented by, or conditioned on, either voluntary or mandatory employee contributions. Although tax-qualified plans are the most desirable from a tax standpoint, taxes are only one of several considerations, and nonqualified plans, which are the second tax category, may provide a viable alternative. The new participation, vesting, and funding requirements of ERISA have made many nonqualified plans impractical. The third tax category, retirement savings arrangements,[296] may be sponsored by an employer for the benefit of his employees, by the employee himself, or by employee organizations. Typically, they are arrangements between an employee or an employer and a bank, an insured credit union, a regulated investment company, an insurance company, or the United States Government.

Although the basic requirements for the three tax categories are delineated in the Internal Revenue Code, the characteristics of the various plans and arrangements are not specified there. Comprehensive definitions are provided for tax-qualified plans in the income tax regulations and in published revenue rulings and procedures, however, and to a lesser extent, nonqualified plans and retirement savings arrangements also are or will be shaped by regulations and rulings. These definitions have been developed by the Treasury Department and the Internal Revenue Service virtually out of whole cloth, presumably to comport with commercial understanding of the

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ERISA § 502, 29 U.S.C.A. § 1132 (Supp. 1975).

295. There are two fundamental types of plans, defined contribution plans and defined benefit plans. A defined contribution plan is a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, any income, expenses, gains or losses, and any forfeitures of accounts of other participants allocated to that participant's account. ERISA § 3(34), 29 U.S.C.A. § 1002(34) (Supp. 1975); ERISA § 1015, INT. REV. CODE OF 1954, § 414(i). Plans of this type include profit-sharing, thrift and savings, target-benefit, stock bonus and employee stock ownership plans. Any plan that is not a defined contribution plan or an individual account plan is a defined benefit plan. ERISA § 3(35), 29 U.S.C.A. § 1002(35) (Supp. 1975); ERISA § 1015, INT. REV. CODE OF 1954, § 414(j). Pension, certain thrift and savings, bond purchase and annuity plans are defined benefit plans. Whether a plan is a defined contribution plan or a defined benefit plan is critically important since profit-sharing plans do not have to satisfy the minimum funding standards and are not covered by termination insurance. ERISA §§ 301(a)(8), 29 U.S.C.A. § 1081(a)(8) (Supp. 1975); ERISA § 1013(a), INT. REV. CODE OF 1954, § 412(h)(91); ERISA § 4021(b), 29 U.S.C.A. § 132(b)(1) (Supp. 1975). Pension plans, however, are not excepted from these provisions. *See* ERISA § 301(a), 29 U.S.C.A. § 1081(a) (Supp. 1975); ERISA § 1013, INT. REV. CODE OF 1954, § 412(h); ERISA § 4021(a), 29 U.S.C.A. § 1321(a) (Supp. 1975).

296. "Arrangement" is used in lieu of the word "plan" because individual retirement accounts, individual retirement annuities, and retirement bonds are not technically considered plans under the Internal Revenue Code.

terms. Justifiable and unjustifiable distinctions exist among the various types of plans and arrangements in each category.

The complexity of the problem facing the designer of a plan or arrangement is compounded by an additional tier of distinctions. Congress and the Treasury Department have traditionally focused on tax-qualified plans established and maintained by a single business corporation unrelated to any other corporation and whose employees are not represented by a collective bargaining unit. The form in which businesses are conducted and the nature of the employer-employee relationship, however, are not always consonant with this model. For example, a sole proprietor, partner, or shareholder in a subchapter S corporation may be an employee, while the employer may be a tax-exempt organization, a government, or a church. Moreover, several employers may maintain a joint plan, such as a collectively bargained plan,[297] plans of controlled groups of corporations,[298] proprietorships, partnerships and corporations under common control,[299] or a multi-employer plan.[300] Since a model based on a single business corporation employing common-law employees is too narrow, distinctions were drawn as adjustments were made in the regnlatory scheme to comport with reality. Unfortunately, however, in many cases form governs substance.

B. *Distinctions Among Types of Plans and Arrangements*

(1) Tax-Qualified Plans

According to Treasury regnlations, a tax-qualified pension plan is one established and maintained by an employer to provide systematically for the payment of definitely determinable benefits to his employees over a period of years after retirement.[301] Contributions and benefits under a plan of this type must not depend upon profits.[302] Forfeitures of benefits by terminating employees may not increase the benefits of the remaining employees; instead, they must reduce future employer contributions.[303] A pension plan may provide for a disability pension and for incidental death benefits. It may not, however, provide layoff benefits or benefits for sickness, accident, hospitalization or medical expenses.[304] The plans may be

297. ERISA § 1014, INT. REV. CODE OF 1954, § 413(a).
298. ERISA § 1015, INT. REV. CODE OF 1954, § 414(b).
299. ERISA § 1015, INT. REV. CODE OF 1954, § 414(c).
300. ERISA § 1015, INT. REV. CODE OF 1954, § 414(f).
301. Treas. Reg. § 1.401-1(b)(1)(i) (1972).
302. *Id.*; Treas. Reg. § 1.401-1(a)(2)(i) (1972).
303. INT. REV. CODE OF 1954, § 401(a)(8); Treas. Reg. 1.401-1(b)(1)(i) (1972); Treas. Reg. 1.401-7(a) (1963).
304. There are limited exemptions for retired employees. INT. REV. CODE OF 1954, §

either the money-purchase type, in which contributions are fixed and benefits are equal to the amount in the employee's account, or the defined benefit type, in which benefits are fixed and contributions are equal to the amount necessary to fund those benefits.

A tax-qualified profit-sharing plan is defined in the regulations as one established and maintained by an employer to enable his employees to participate in his profits pursuant to a definite formula for allocating contributions and distributing accumulated funds.[305] An employer cannot contribute to a general fund and subsequently determine how the fund will be divided; rather, contributions must be made pursuant to either a definite or discretionary formula.[306] If the plan has a definite contribution formula, for example, ten percent of net profits, contributions must be made according to the formula for the plan to maintain its tax-qualified status. If the plan has a discretionary formula, such as an annual specification by the employer of the portion of net profits to be contributed, contributions must be made with some regularity or the Internal Revenue Service will consider that a permanent discontinuance of contributions has occurred, resulting in full vesting.[307] Contributions allocated to the account of a participating employee may be used to provide incidental life or accident or health insurance,[308] and distributions from the plan may be made prior to retirement, for various reasons.[309]

The definitions of pension plans and profit-sharing plans present some curious distinctions. For example, if the employer maintaining the plan earns profits, there is virtually no distinction between a money-purchase pension plan that provides for annual contributions equal to ten percent of each employee's compensation

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401(h); Treas. Reg. § 1.401-1(b)(1)(i) (1972); Treas. Reg. § 1.401-14(a) (1964).

305. Treas. Reg. §§ 1.401-1(b)(1)(ii), 1.401-1(a)(2)(ii) (1972).

306. It is necessary to distinguish an allocation formula from a contribution formula, since only the former is generally required. An allocation formula establishes the shares that the participants will have in the employer's contributions (and earnings thereon). A contribution formula, on the other hand, establishes what contributions must be made. Prior to July 2, 1956, the Internal Revenue Service required a tax-qualified profit-sharing plan to have not only a definite allocation formula, but also a definite contribution formula. In other words, a profit-sharing plan was required to provide that a particular percentage of profits or a particular dollar amount out of profits would be contributed to the plan in each year. *See* note 168 *supra* and accompanying text.

307. ERISA § 1016(a)(2)(C), INT. REV. CODE OF 1954, § 401(a)(7); ERISA § 1012(a), INT. REV. CODE OF 1954, § 411(d)(3); ERISA § 1006(a)(3), INT. REV. CODE OF 1954, § 404(a)(2); ERISA § 2004(c)(2), INT. REV. CODE OF 1954, § 405(a).

308. Treas. Reg. § 1.401-1(b)(1)(ii) (1972).

309. *Id.* Distributions may be made after a fixed number of years, the attainment of a stated age, or the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance from employment. The term "fixed number of years" means at least 2 years. Rev. Rul. 71-295, 1971-2 CUM. BULL. 184.

and a profit-sharing plan that provides for annual contributions equal to ten percent of each employee's compensation out of profits. In fact, it is possible to draft a money-purchase pension plan and a profit-sharing plan that are identical except for the additional phrase "out of profits" in the profit-sharing plan. While these words may make no practical difference to either the employer or the employee, their addition changes the requirements for tax-qualification. With this phrase, benefits may be distributed before retirement, forfeitures may be applied to increase benefits, the contribution formula may be discretionary, and accident or health insurance may be provided for employees and their families.

Another distinction arises out of the requirement that a profit-sharing plan provide for the participation of employees in the employer's "profits." One species of the tax-qualified plan in common use is a "thrift" plan, under which each employee has the option to contribute a percentage of his salary to the plan. The employer then contributes an amount equal to a percentage of the employee's contributions. Amounts contributed under a thrift plan usually may be withdrawn before retirement in the case of emergencies, such as large medical expenses. Because benefits may not be paid prior to retirement under pension plans, these plans are drafted to meet the requirements applicable to profit-sharing plans. In the case of a profit-earning employer, however, there is no real profit-sharing; employees will receive the same benefits whether profits are high or low. Because these thrift plans are technically profit-sharing plans, a nonprofit organization, described in section 501(c)(3) of the Internal Revenue Code, that adopts such a plan may find either that the plan does not qualify or that the organization has lost its tax exemption. This distinction appears to be unjustified; if the thrift plan of a profitable, taxable employer deserves to be tax-qualified, it is difficult to understand why a thrift plan of a tax-exempt organization should be treated differently.

A similar problem arises when a tax-exempt organization such as a hospital attempts to establish a tax-qualified plan as an incentive for employees to improve productivity. A taxable organization may establish such a plan in the form of a typical profit-sharing plan, but it is not at all clear that a hospital may establish a similar "productivity" plan in which contributions are made out of reduced costs.

The regulations define a tax-qualified stock bonus plan as one established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer do not necessarily depend upon profits and benefits

must be distributed in stock of the employer company.[310] Stock bonus plans are governed by the same rules as profit-sharing plans, but contributions are not necessarily profit related. Thus, an employer who wishes to adopt a tax-qualified plan that requires fixed contributions independent of profits and permits distributions prior to retirement can do so only through a stock bonus plan, which must provide for distribution of benefits in stock of the employer company. If the combination of fixed contributions and early distributions is acceptable in a plan that distributes benefits in employer stock, the combination also should be acceptable in plans that distribute benefits by other means.

ERISA creates a new category of tax-qualified plans—the employee stock-ownership plan. Under this type of plan, a stock bonus trust borrows money from a bank and uses the funds to purchase from the employer securities in the employer's company. The loan is secured by the stock and guaranteed by the employer, and future employer contributions under the plan are used to repay the loan. In a rising market, the employees do very well under such a plan because they have, in effect, a leveraged investment. Since employers look at the plan as a way to borrow money with the repayment of principal being deductible,[311] the plans have increased in popularity during the past few years.[312]

As indicated above, ERISA prohibits tax-qualified plans from engaging in certain transactions with parties in interest or disqualified persons, like the employer who maintains the plan.[313] Among the prohibited transactions is any direct or indirect lending of money or extension of credit.[314] Under the typical financing arrangement in employee stock-ownership plans, the employer's guarantee of a loan to the trust would constitute an indirect extension of credit to the plan, subject the trustee to personal liability for any loss,[315] and subject the employer to an excise tax equal to five percent of the amount involved.[316] Those who lobbied for the continued viability of this type of financing argued that an exception from the prohibited transaction rules was justified, because employee stock ownership plans help increase employee productivity and provide a vol-

310. Treas. Reg. § 1.401-1(b)(1)(iii) (1971).

311. They seem not to realize that a substantial amount of equity in the corporation is being transferred to employees.

312. *See* Miller & Williams, *Stock Bonus Plans Have Enchanced Utility in Light of the Pension Reform Laws*, 42 J. TAX. 87 (1975).

313. *See* notes 255-56 *supra* and accompanying text.

314. ERISA § 406(a)(1)(B), 29 U.S.C.A. § 1106 (Supp. 1975); ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(c)(1)(B).

315. ERISA §§ 409(a), 502, 29 U.S.C.A. §§ 1109, 1132 (Supp. 1975).

316. ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(a).

untary means for diffusing equity ownership among employees. The ERISA Conference Committee was persuaded by this line of reasoning, and, as a result, provided an exception to the prohibited transaction rules for any loan to an "employee stock ownership plan" if the loan is primarily for the benefit of participants and beneficiaries of the plan, is at a reasonable rate of interest, and is secured only by securities of the employer.[317]

Assuming that this exception serves a public purpose, it is difficult to justify the stock bonus plan as the sole type of plan receiving preferential treatment. As a result of thusly limiting the exception, benefits must be distributed in the form of employer securities, and the employee will often be left with securities for which there is no market. If the exception is necessary, it should have been made available to other types of tax-qualified plans as well.

While retirement bonds may be purchased under a tax-qualified pension or profit-sharing plan,[318] the Internal Revenue Code also contemplates tax-qualified bond purchase plans, under which contributions must be used "solely" to purchase United States Retirement Bonds issued under the Second Liberty Bond Act.[319] This type of plan is defined in the regulations as a definite written program or arrangement established and maintained by an employer to purchase and distribute retirement bonds to his employees or their beneficiaries that satisfies the Code and regulatory requirements generally applicable to a tax-qualified pension or profit-sharing plan.[320] These retirement bonds must provide for payment of interest or investment yield only upon redemption. Furthermore, they must be purchased in the name of the individual on whose behalf contributions are made, cease to bear interest or provide investment yield within five years after the death of the registered owner, and be redeemable before the owner's death only if he is age fifty-nine and one half or older or is disabled.[321] The plan need

317. ERISA § 408(b)(3), 29 U.S.C.A. § 1108 (Supp. 1975); ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(d)(3). An employee stock-ownership plan is defined as a defined contribution plan that is a tax-qualified stock bonus plan, or a tax-qualified stock bonus plan and money-purchase pension plan designed to provide for investment in employer securities and that meets other requirements to be delineated in treasury regulations. ERISA § 407(d)(6), 29 U.S.C.A. § 1107 (Supp. 1975); ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(e)(7).

318. Treas. Reg. § 1.405-1(a) (1962).

319. INT. REV. CODE OF 1954, § 405(a)(2).

320. INT. REV. CODE OF 1954, § 405(a)(1); Treas. Reg. §§ 1.405-1(b)(1), 405-1(c) (1962). A tax-qualified bond purchase plan must meet the requirements of § 401(a)(3)-(8), (16), (19) and, if the plan covers self-employed individuals, the requirements of § 401(a)(9)-(10) and of § 401(d) (other than paragraphs (1), (5)(B), and (8)).

321. INT. REV. CODE OF 1954, § 405(b). *See* TREASURY DEP'T CIRCULAR, PUBLIC DEBT SERIES No. 1-63 (1963).

not, however, prohibit the distribution or redemption of the bonds until the employee retires.[322]

Bond purchase plans, in addition to satisfying the requirements applicable to either a tax-qualified pension plan or profit-sharing plan, must meet the other requirements mentioned in the preceding paragraphs. This distinction, however, is not particularly troublesome, since an employer who wishes to provide retirement benefits in the form of retirement bonds can do so by establishing either a tax-qualified pension, a profit-sharing, or a bond purchase plan. The fact that employees may not receive benefits until age fifty-nine and one half under a bond purchase plan, except in cases of disability or death, is not troublesome, since an employer who wishes to distribute earlier may establish a profit-sharing plan funded in part with bonds. If a requirement is necessary for a pension or profit-sharing plan, however, it should also be necessary for a bond purchase plan. Thus, there is no good reason why a bond purchase plan should not provide for distribution to an employee, unless he otherwise elects within the time specified for other tax-qualified plans,[323] and why a bond purchase plan covering owner-employees or shareholder-employees should not contain the $100,000 discrimination rule applicable to all other tax-qualified plans covering such persons.[324] The failure to extend these ERISA requirements to bond purchase plans was presumably a legislative oversight.

A tax-qualified annuity plan is defined as a pension plan[325] under which retirement benefits are provided in annuity or insurance contracts without a trust.[326] The annuity plan differs from a pension plan in one respect. A requirement of a pension plan is that benefits are not payable before retirement; although an annuity plan has the same requirement in form, benefits can be received

322. Treas. Reg. § 1.405-1(c)(2). As a result, a tax-qualified bond purchase plan designed as a pension plan need not provide systematically for the payment of "definitely determinable" benefits.

323. INT. REV. CODE OF 1954, § 401(a)(14). The time specified is not later than the sixtieth day after the latest of the close of the plan year in which—

(A) the date on which the participant attains the earlier of age 65 or the normal retirement age specified under the plan,

(B) the tenth anniversary of plan participation occurs, or

(C) termination of service occurs. Most, but not all, bond purchase plans will be required to have this provision anyway, under the labor provisions of ERISA. ERISA § 206(a), 29 U.S.C.A. § 1056 (Supp. 1975).

324. ERISA § 2001(c), INT. REV. CODE OF 1954, § 401(a)(17). *See* notes 276-77 *supra* and accompanying text.

325. It is interesting to note that in 1954 the House Ways and Means Committee decided to allow annuity plans to qualify as profit-sharing plans. H.R. REP. No. 1337, 83d Cong., 2d Sess. 43 (1954). This approach was abandoned in the Senate, however.

326. Treas. Reg. § 1.404(a)-3(a) (1972).

earlier in fact because annuity contracts may be surrendered to the insurance company for their cash surrender value. This questionable distinction is the product of state law requirements that annuity contracts have a cash surrender value and the successful argument of insurance companies that annuity plans should permit employees to have custody of the contracts.[327]

The distinctions between pension and profit-sharing and stock bonus plans developed as a result of different deduction limits under the 1942 Revenue Act. After 1974, the reason for these distinctions became less compelling because of the overall limits on contributions and benefits imposed by section 415 of the Internal Revenue Code; at the same time, the distinction between defined contribution plans and defined benefit plans became more important.[328]

Tax-qualified plans are normally funded primarily by employer contributions. However, employees may contribute to the qualified plans, and many plans require employee contributions. In fact, some plans are funded solely by employee contributions. Plans under which no employer contributions have been made after September 2, 1974, are recognized by ERISA as a separate category and are excluded from the participation standards of section 410 of the Internal Revenue Code, provided they meet the old coverage test of section 401(a)(3) as it read before ERISA.[329] Strangely, the comparable participation standards in section 202 of ERISA provide a more limited exclusion, applying only to plans established and maintained by a labor organization described in section 501(c)(5) of the Internal Revenue Code or by a society, order, or association described in section 501(c)(8) or (9) of the Code.[330] Similarly, the minimum vesting standards of section 411 of the Internal Revenue Code do not apply to plans funded solely by employee contributions after September 2, 1974, if they satisfy the old discrimination and termination rules of sections 401(a)(4) and 401(a)(7) as they read prior to ERISA, but the labor exclusion applies only to the more limited category of plans described above.[331]

327. A subcategory of this type of plan is an "insurance contract plan." A plan is an insurance contract plan if it is funded exclusively by the purchase of individual or group insurance contracts, the contracts provide for level annual premium payments and the plan and the contracts meet certain other requirements. ERISA § 301(b), 29 U.S.C.A. § 1081(b) (Supp. 1975); ERISA § 1013, INT. REV. CODE OF 1954, § 412(i). These plans are exempt from the minimum funding standards, provided that premiums are paid. ERISA § 301(a)(2), 29 U.S.C.A. § 1081(a)(2) (Supp. 1975); ERISA § 1013, INT. REV. CODE OF 1954, § 412(h)(2). While annuity plans are nontrusteed, an insurance contract plan theoretically can be trusteed.

328. *See* note 295 *supra*.

329. ERISA § 1016(a)(2)(A), INT. REV. CODE OF 1954, § 401(a)(3).

330. ERISA §§ 201(3)(a), (4), 29 U.S.C.A. §§ 1051(3)(A), (4) (Supp. 1975).

331. ERISA § 1012(a), INT. REV. CODE OF 1954, §§ 411(e)(1)(C), (D); ERISA § 201(4),

With respect to the ERISA funding standards, both the labor provisions and the tax provisions contain the same broad exemption, except that the tax exemption is conditioned on meeting the pre-ERISA requirement of full vesting upon complete discontinuance of contributions under the plan.[332] Finally, the broader exemption applies to termination insurance. The exemptions from the minimum funding standards and the termination insurance provisions are justifiable because there is no employer to stand behind the plan, but the participation and vesting exemptions appear to be unjustifiable. Since only employees contribute to the plan, they should all be able to participate, and they should also be completely vested. It may be possible, however, to explain the exemption in terms of the legislative concern over certain existing plans sponsored by labor organizations in which application of the vesting standards would result in extremely high costs. The exemption was drawn more narrowly in the labor than in the tax provision.

Section 501(c)(18) of the Internal Revenue Code, added in 1969, provides an income tax exemption for another special category of tax-qualified plans—trusts created before June 25, 1959, under pension plans funded by employees only. If these plans are nondiscriminatory, they need not meet any other requirements of tax-qualified plans except the reporting, disclosure, and fiduciary responsibility standards of ERISA's labor provisions.[333] Again, the distinction is hard to justify; no attempt to justify it was made in the ERISA Committee Reports—in fact, it was not even mentioned.

(2) Nonqualified Plans

Plans that either by design or through inadvertance fail to meet the requirements for tax-qualification form the second category of retirement programs under ERISA—nonqualified plans. These plans need not meet any of the Internal Revenue Code standards. Unless a specific exclusion exists, however, they still must meet the reporting and disclosure, participation, vesting, funding, and fiduciary responsibility standards of ERISA's labor provisions, and they are subject to termination insurance. An important exclusion from these requirements is recognized, however, for unfunded plans maintained by an employer for the purpose of providing deferred compensation for a select group of employees. Before ERISA, nondiscrimination was the principal condition precedent to favorable tax treatment, on the theory that the highly paid people who man-

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29 U.S.C.A. § 1051(4) (Supp. 1975).

332. ERISA § 1013(a), INT. REV. CODE OF 1954, § 412(h)(5); ERISA § 301(a)(5), 29 U.S.C.A. § 1081(a)(5) (Supp. 1975).

333. ERISA §§ 4, 401, 29 U.S.C.A. §§ 1003, 1101 (Supp. 1975).

aged the employer would be induced to establish plans for all or most employees if the tax benefits to the highly paid were sufficient. After ERISA, various other conditions must be met in order to obtain tax benefits, and these new conditions were made mandatory for employee benefit plans whether or not they qualified for tax benefits. This was a basic change of philosophy, in which the quest for tax parity in pensions became a quest for pension parity.

The taxation of unfunded, nonqualified plans is simple; the employee is taxed when he receives his benefits, actually or constructively, and the employer is entitled to a deduction at the same time. The taxation of funded, nonqualified plans is more complicated; employees are subject to tax under section 83 of the Internal Revenue Code on the fair market value of their interests in the plan at the time their rights first are transferable or no longer subject to a substantial risk of forfeiture.[334] An employee, however, may elect to report the contribution as income at the time it is made.[335] As a general rule, employers are entitled to deductions at the time employees are taxed and in the amount employees include in income. If more than one employee participates in the plan, however, the employer is not entitled to a deduction unless separate accounts are maintained for each employee.[336]

For both unfunded and funded nonqualified plans, no special lump-sum tax benefits or estate or gift tax benefits are provided, but the $5,000 death benefit exclusion is available unless the employee was a self-employed individual.[337] Income of the fund under a nonqualified plan is subject to tax; whether the tax is at corporate or trust rates, however, is not clear. If annuity or insurance contracts are used as the funding medium, the regular rules for taxation of insurance companies apply. It is surprising that a question as basic as the tax treatment of the fund of a nonqualified plan is still open to question. The results differ substantially depending on whether the corporate tax rates or the trust rules apply. If the trust rules apply, the rates will be very high during an accumulation period for a large trust, but the fund's income may be tax-free when the current distributions exceed the current trust income.

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334. INT. REV. CODE OF 1954, § 83(a).

335. *Id.* § 83(b).

336. This rule is very harsh, but without separate accounts it is difficult to determine the amount on which to tax the employee. When a plan that had been considered a qualified one is found to have been nonqualified for several years, it is not clear whether the employer can save himself by establishing separate accounts retroactively.

337. INT. REV. CODE OF 1954, § 101(b)(3).

(3) Retirement Savings Arrangements

A third tax category, retirement savings arrangements, includes individual retirement accounts, individual retirement annuities, and retirement bonds. Section 219 of the Internal Revenue Code permits an individual to deduct the lesser of fifteen percent of compensation or $1,500 for contributions to an individual retirement account described in section 408(a), for an individual retirement bond described in section 408(b), or for a retirement bond described in section 409. The individual may set up an individual retirement trust or custodial account, or purchase an individual retirement annuity or retirement bond without any cooperation from his employer, as long as the individual is not an active participant in a tax-qualified pension, profit-sharing, stock bonus, annuity or bond purchase plan, or a plan established by a governmental unit, and as long as his employer is not contributing amounts for a section 403(b) annuity.[338] The employer, however, may set up and maintain an individual retirement trust account for his employees and make contributions to it on their behalf if he wishes. Similarly, he can purchase individual retirement annuities or retirement bonds for his employees or arrange for their purchase. He may also arrange for the safekeeping of the bonds and annuities and perform various incidental services for his employees. Thus, an employer-sponsored individual retirement account, annuity, or bond plan is, in effect, an alternative type of tax-qualified plan under ERISA.

The employer-sponsored individual retirement account, annuity, or bond plan, must meet several requirements not applicable to other types of tax-qualified plans. Many of these additional requirements are similar to requirements imposed on plans covering self-employed individuals. For example, in an employer-sponsored individual retirement account, the trustee or custodian must be a bank or other person who demonstrates that he will administer the trust or account consistent with the requirements of section 408. Additionally, no part of the funds may be invested in life insurance contracts, and the employees' interests must be one hundred percent vested. Benefits must begin no later than at age seventy and one-half and must be distributed within five years after death. Finally, distributions made prior to age fifty-nine and one-half are subject to a ten percent excise tax, except in cases of disability or death.

The first of three basic reasons for these additional requirements is the focus of the statutory concept and structure on arrange-

338. ERISA § 2002(a)(1), INT. REV. CODE OF 1954, § 219(b)(2).

ments established by the individual himself and the problems attendant thereto. For example, the requirement of total vesting reflects the fact that individually established plans will always be completely vested. The life insurance prohibition is designed to simplify the accounts by avoiding the necessity for split-funding[339] present in pension and profit-sharing plans unless endowment contracts are purchased. Split-funding was thought to be too complicated for individual accounts, and endowment contracts are already included in the definition of the term "individual retirement annuity." The requirements of a special trustee, distribution beginning no later than age seventy and one-half, and accelerated distribution after death were thought necessary to avoid possible abuse of the plan. The excise tax on distributions prior to age fifty-nine and one-half except in cases of disability or death is intended to insure that the funds are set aside for retirement purposes. Pension plans similarly must provide that no distributions may be made before retirement or severance from employment. An arbitrary age limit is used in the case of individual accounts that are not employer-sponsored, because severance or retirement from a particular employer is irrelevant, and permanent retirement from all employment or self-employment is difficult to determine administratively.

The second reason for these additional requirements is that only these requirements govern the status of individual retirement accounts. Since there are no participation or discrimination requirements, an employer may sponsor and make deductible contributions to an individual retirement account for one highly paid employee only. This is justifiable since his other employees can set up their own accounts with the same characteristics, but the potential for abuse suggests the necessity of additional controls.

Thirdly, when the individual retirement account concept was developed, some proponents argued that these requirements should be applied to all tax-qualified plans. The proponents did not have the political power to extend the requirements to existing plans, but they did succeed in applying them to individual retirement accounts.

If an employer contributes to an individual retirement annuity, slightly different requirements apply. The contract must be nontransferable, the employees' interests must be one hundred percent vested, and benefits must begin no later than age seventy and one-

339. Split-funding is the term commonly used to describe the situation in which part of the funds held under a plan are represented by insurance contracts, and the rest of the funds consist of something else. For interpretation of the incidental requirement, see I.R.S. Pub. 778(2-72), pt. 2(n).

half and accelerate in the event of death. Redemption prior to age fifty-nine and one-half is subject to a ten percent additional tax, except in cases of disability or death. Thus, the individual retirement annuity is virtually the same as the individual retirement account. The special trustee requirement of the individual retirement account, of course, translates into an insurance company requirement. Group contracts may be available, but with full vesting and separate accounting, a group contract presumably would be much the same as a group of individual contracts.

If an employer makes contributions for a retirement bond, the bond must be part of a special U.S. Government issue similar but not identical to retirement plan bonds. Bonds in this issue are nontransferable, pay interest only on redemption—and then only if not redeemed within twelve months after issue—and cease to bear interest either when the employee attains age seventy and one-half or five years after his death.[340] The bonds are available only in registered form in denominations of $50, $100, and $500,[341] and redemption of the bonds prior to age fifty-nine and one-half is subject to a ten percent additional tax, except in cases of disability or death.[342]

Bonds purchased under a tax-qualified bond purchase plan and individual retirement bonds differ in several respects. The former may not be redeemed before age fifty-nine and one-half, except in cases of disability or death, while the latter may be redeemed before. The latter cease to bear interest when the employee attains age seventy and one-half, while the former continue to bear interest until five years after death. The age fifty-nine and one-half restriction was written into bond purchase plans because Internal Revenue Code section 405 was part of the same legislation that permitted self-employed persons to set up tax-qualified plans, and self-employed persons who are owner-employees may not receive benefits under tax-qualified pension or profit-sharing plans before age fifty-nine and one-half, except in cases of disability or death.[343] The age fifty-nine and one-half restriction was not written into the individual retirement bonds because Internal Revenue Code section 409 was part of the Act that permitted the establishment of individual retirement accounts and annuities. That Act contains no requirement that individual retirement trust accounts prohibit distributions prior to age fifty-nine and one-half, although a ten percent tax

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340. Regulations were issued January 3, 1975, setting forth the terms of this bond issue. Treas. Reg. § 346 (1975). The current interest rate is 6% compounded semiannually. *Id.* § 346.1(a).

341. *Id.* § 346.1(c).

342. ERISA § 2002(c), INT. REV. CODE OF 1954, § 409(c).

343. ERISA § 2001(h)(1), INT. REV. CODE OF 1954, § 401(d)(4)(B).

is due unless the amount received is transferred to another individual retirement account, annuity, or bond.[344]

When the individual retirement account, annuity, and bond provisions were written, the penalty provision for early distribution to owner-employees also was changed to a ten percent additional tax, instead of the more complicated 110 percent rule.[345] Although there is now no distinction between the penalties applicable to premature distributions to owner-employees from tax-qualified plans and the penalties applicable to premature distributions from individual retirement accounts, annuities, and bonds, the governing instruments still differ.[346] Pension or profit-sharing plans covering owner-employees, by their terms must prohibit early distributions, but because the Internal Revenue Service has taken the position that a violation of the prohibition will not disqualify the plan, this distinction is without substance. The Service's presumed reasoning is that Congress enacted a specific penalty for early distributions and, therefore, did not intend a disqualification sanction. No particular reason is apparent, however, why retirement plan bonds also should not be redeemable prior to age fifty-nine and one-half, and their premature redemption subject to a ten percent additional tax. This would be a relatively noncontroversial change, but since there is virtually no political pressure for technical changes of this type, it seems unlikely that Congress will ever make it.

The age seventy and one-half restriction was written into the individual retirement bonds because that age restriction simultaneously was being written into individual retirement accounts and annuities. The restrictions, however, are not identical; the individual retirement bond not only ceases to bear interest at age seventy and one-half, but it must be included in gross income unless it is redeemed prior to age seventy and one-half;[347] individual retirement accounts and annuities merely require that distributions must commence by age seventy and one-half, not that distributions must be completed by that time.[348] As a practical matter, however, the owner of an individual retirement bond can virtually eliminate this distinction by redeeming his retirement bond prior to the close of the taxable year in which he attains age seventy and one-half and rolling over the proceeds to an individual retirement account or

344. ERISA § 2002(b), INT. REV. CODE OF 1954, §§ 408(d)(3), (f).

345. ERISA § 2001(g)(1), INT. REV. CODE OF 1954, § 72(m)(5)(B).

346. There is no similar requirement with respect to shareholder-employees of subchapter S corporations. INT. REV. CODE OF 1954, § 1379.

347. ERISA § 2002(c), INT. REV. CODE OF 1954, § 409(b)(1).

348. ERISA § 2002(b), INT. REV. CODE OF 1954, § 408(b)(3).

annuity.[349] Since this requires foresight and sophisticated tax planning, it is unfortunate that the draftsmen of section 409 could not develop a simple solution to this problem, but none of the possible solutions appear to be simple.

When individual retirement accounts, annuities, and bonds are compared with qualified pension, profit-sharing, stock bonus, annuity, and bond purchase plans, apparent differences are as numerous as similarities. On the one hand, individual retirement accounts seem overly restrictive in that contributions are sharply limited, with penalties for early or late distributions. No special tax treatment is provided for lump sum distributions, and no special estate or gift tax exemptions apply. On the other hand, individual retirement accounts are free of many restrictions, such as nondiscrimination tests and regular contribution requirements. Distributions after age fifty-nine and one-half and before seventy and one-half may be made whenever the individual desires, and assets may be held in custodial accounts as well as trusts. The complaint is raised on the one hand that contributions to an individual retirement account cannot be nearly as great as contributions under other tax-qualified plans, while on the other, the individual retirement account is attacked as a tax shelter, a tax-free savings account for the rich.

ERISA attempted to balance these competing considerations. That the individual retirement account is attacked for being both too much and too little may indicate that the balance reached was not too far off. An employer or a self-employed individual may rely on individual retirement accounts for retirement security if his contributions are limited. He may rely alternatively on other tax-qualified plans, but a nondiscriminatory group of employees must participate in those plans. The individual retirement account rules are not perfect, however. For example, if $1,500 is the correct limitation on contributions, there is no justification for failing to make that limitation subject to the same cost of living adjustment applicable to the $25,000 defined contribution limit and the $75,000 defined benefit limit under regular tax-qualified plans.[350] Furthermore, individual retirement accounts arguably should not be denied to persons covered by other plans if the contributions under those plans are less than the maximum deductible limits under individual retirement accounts.[351]

349. ERISA § 2002(c), INT. REV. CODE OF 1954, § 409(b)(3)(C).

350. See note 406 *infra* for the similar problem which exists with the $7,500 limit applicable to owner-employees.

351. The extension of individual retirement accounts to persons covered by inadequate plans was proposed by the Administration in 1971 and 1973. *See* note 200 *supra*. It was also

Related to individual retirement accounts in practical effect are salary reduction plans, referred to in section 2006 of ERISA.[352] They consist of pension, profit-sharing, stock bonus, bond purchase, or annuity plans in which employer contributions are made under an arrangement by which the contribution is made only if the employee elects to receive a reduction or forego an increase in his compensation, or under an arrangement by which the employee may elect to receive part of his compensation in one or more alternative forms, if one of those forms would result in the inclusion of amounts received in income. Prior to ERISA it was not clear whether employees were subject to tax on the portion of their compensation that went into the tax-qualified plan. If not, employees who participated in those plans could achieve many of the same benefits available in an individual retirement account, but without most of the limitations. Under section 2006 of ERISA, a holding action to allow time for Congress to consider these plans further, employees are subject to tax on those contributions until January 1, 1977, unless the plan was in existence on June 27, 1974.

C. *Variations from the Norm*

Prior to the enactment of ERISA, plans maintained by more than one employer were not specifically authorized by the Internal Revenue Code. The basic qualification section, 401(a), referred to a stock bonus, pension, or profit-sharing plan "of *an* employer for the exclusive benefit of *his* employees or their beneficiaries." [Italics added] Section 401(a)(2) required that it be impossible under the trust instrument for any part of the corpus or income to be used for or diverted to, purposes other than "the exclusive benefit of *his* employees or their beneficiaries." [Italics added] This language suggested a restriction to only one employer per plan—or at least that a plan of more than one employer must have separate accounting with respect to the employees of each employer. The existence of plans maintained by more than one employer, however, was contemplated by the regulations under section 401,[353] and by some particularized benefits afforded these plans under sections 401(i) and 404(a)(3)(B). As a result, a plan could be tax-qualified even though several corporations made contributions to it. The provisions relating to qualification under section 401(a), as well as the provisions relating to deductions, were applicable to each employer sepa-

part of the original Keogh-Reed proposal. *See* note 125 *supra*. It was not adopted by Congress because of the additional revenue cost and because of administrative complexities.

352. *See generally* H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 355 (1974).

353. Treas. Reg. § 1.401-1(d) (1956).

rately,[354] regardless of the employers' affiliation.[355] Therefore, each plan maintained by more than one employer was no more than an aggregation of separate plans for purposes other than administration and investment. Since separate accountability was required for each employer, amounts forfeited by terminating employees of one employer generally were not allocable to the benefit of employees of other employers.

The prohibition against joint plans was not applied to collectively bargained multi-employer plans, for which the Code appeared to contemplate joint plans. Section 401(i) provided a special rule waiving certain qualification requirements under specified conditions for trusts created pursuant to a collective bargaining agreement between employee representatives and one or more employers. The statute also contemplated plans maintained by more than one employer when the employers were members of an affiliated group. In a profit-sharing or stock bonus plan of an "affiliated group" of employers as defined in section 1504 of the Code, if any member of the group was prevented from making a contribution due to insufficient current or accumulated earnings and profits, the contribution could be made and deducted by other members of the group.[356]

ERISA provides for several categories of plans with more than one employer: collectively bargained plans,[357] plans maintained by more than one employer,[358] plans of controlled groups of corporations,[359] plans of partnerships, proprietorships, and corporations under common control,[360] and multi-employer plans.[361] The new provisions have not yet been amplified by regulations or rulings, but the legislative intent was merely to codify existing law.[362] Under ERISA a collectively bargained plan will be viewed as a unit to determine if the participation, discrimination, exclusive benefit, vesting and funding requirements, and the deduction limitations are met; thus all employees will be treated as if they were employed by a single employer. Plans maintained by more than one employer are treated similarly, for example, multi-employer plans, plans of controlled groups, and plans of entities under common control. The

354. *Id.*; Rev. Rul. 69-250, 1969-1 CUM. BULL. 116.

355. I.R.S. Pub. 778 (2-72), pt. 2(e).

356. INT. REV. CODE OF 1954, § 404(a)(3)(B). The deduction limits were computed as if the employer corporation had made the contribution. Treas. Reg. § 1.404(a)-10 (1956).

357. ERISA § 1014, INT. REV. CODE OF 1954, § 413(a)(1).

358. ERISA § 1014, INT. REV. CODE OF 1954, § 413(c).

359. ERISA § 1015, INT. REV. CODE OF 1954, § 414(b).

360. ERISA § 1015, INT. REV. CODE OF 1954, § 414(c).

361. ERISA § 1015, INT. REV. CODE OF 1954, § 414(f).

362. H.R. REP. No. 1280, 93d Cong., 2d Sess. 384 (1974).

general rule is not objectionable from a policy standpoint, since the Code merely recognizes an integrated economic unit as a single employer.

Some of the special rules, however, are not justified. For example, collectively bargained plans are entitled to a special exception from the limitations on employer deductions: plans that are fully funded because of a plan amendment may continue to make deductible contributions equal to normal costs, less ten year amortization of the overfunded amount,[363] although in general, deductions are not allowed for contributions to fully funded plans. When employees' pensions are fully paid for, there is no reason to give a tax deduction to employers and thus allow tax-free accumulation of income. A continuing plan that is fully funded today, however, will not necessarily remain fully funded indefinitely, because additional pension liabilities accrue each year. When a once fully funded plan ceases to be fully funded, deductible contributions may resume. Although this suspension of deductible contributions during a period of full funding makes sense from a tax equity point of view, it makes no sense from the point of view of the employer's financial planning or reporting to shareholders. If the employer must delete the plan contribution item from its budget for a period of years and then reinsert it, earnings per share will go up during the suspension period and then fall. Arguments of this kind convinced the conferees to allow the deductible contributions described above. Although this rule is sensible, it should not be limited to collectively bargained plans that become fully funded by a plan amendment. The reason for the distinction is discouraging but obvious: only those involved in the above plans who were worried about benefit reductions in future plan amendments were concerned about this problem and had the political clout to influence the conferees.

The special rule also applies to a subcategory of collectively bargained plans that are fully funded by reason of increases in social security benefits.[364] The conditions under which these rules are applicable are so restrictive that it is generally understood that the rule applies only to AT&T. Any industry in which rates are regulated with reference to profits has a special problem in this area, however; when contributions are suspended, rates will go down, and the industry may have difficulty raising the rates again when contributions recommence. For that reason, the application of this special provision to only AT&T is not justifiable.

363. ERISA § 1013(c)(1), INT. REV. CODE OF 1954, § 404(a)(1)(B).

364. ERISA § 1013(c)(1), INT. REV. CODE OF 1954, § 404(a)(1)(C).

Government and church plans also were given special attention in the 1974 reform. Before ERISA, government plans were treated like all other plans with no special tax benefits.[365] The Labor Committees, however, brought with them a tradition of regulating private industry separately from government, and most of the labor pension bills did not apply to government plans. As the labor and tax bills were merged, the government exclusions generally survived in the new requirements of ERISA. Government plans are defined to include plans of the United States, any state or political subdivision, any agency or instrumentality of any of the foregoing, or certain international organizations.[366] These plans are excluded from the new participation standards of Internal Revenue Code section 410, provided they meet the old coverage test of section 401(a)(3).[367] Similarly, government plans are excluded from the new vesting standards of section 411, provided they meet the vesting requirements in effect before ERISA—the old discrimination and termination rules of sections 401(a)(4) and 401(a)(7).[368] Government plans are not required to meet the minimum funding standards of section 412, but they are subject to the previous requirement of full vesting upon termination under section 401(a)(7).[369] Government plans further are exempt from the requirements of section 401(a)(11), (12), (13), (14), (15), and (19),[370] filing a statement with respect to terminated employees to be kept by the social security administration,[371] and from the excise tax on prohibited transactions.[372] They are not subject to the reporting and disclosure and fiduciary responsibility standards of ERISA;[373] they also are excluded from the requirement of termination insurance.[374] In general, the distinction between pri-

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365. *But see* INT. REV. CODE OF 1954, § 122.

366. ERISA § 1015, INT. REV. CODE OF 1954, § 414(d); ERISA § 3(32), 29 U.S.C.A. § 1002 (Supp. 1975).

367. ERISA § 1011, INT. REV. CODE OF 1954, § 410(c)(1)(A). They are also excluded from the new participation standards of ERISA § 202. ERISA § 4(b)(1), 29 U.S.C.A. § 1003(Supp. 1975).

368. ERISA § 1013(a), INT. REV. CODE OF 1954, § 411(e)(1)(A). They are also excluded from the new vesting standards of ERISA § 203. ERISA § 4(b)(1), 29 U.S.C.A. § 1003 (Supp. 1975).

369. ERISA § 1013(a), INT. REV. CODE OF 1954, § 412(h)(3). They need not meet the new funding standards of ERISA §§ 301-06. ERISA § 4(b)(1), 29 U.S.C.A. § 1003 (Supp. 1975).

370. ERISA § 1016(a)(2)(A), INT. REV. CODE OF 1954, § 401(a). They also are exempt from the corresponding requirements of ERISA § 206. ERISA § 4(b)(1), 29 U.S.C.A. § 1003 (Supp. 1975).

371. ERISA § 1031(a), INT. REV. CODE OF 1954, § 6057.

372. ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(d).

373. ERISA § 4(b)(1), 29 U.S.C.A. § 1003 (Supp. 1975).

374. ERISA §§ 4021(b)(2), (10), 29 U.S.C.A. § 1321 (Supp. 1975).

vate tax-qualified plans and government plans cannot be justified on policy grounds. Nevertheless, since the minimum funding standards are designed to insure solvency, that exception for government plans may be supportable in view of governmental taxing power to meet plan obligations.[375]

The conferees recognized that the governmental distinctions were questionable, but concluded only that the question should be studied further. Section 3031 of ERISA calls for a study of government retirement plans by the four committees, with a report to the Congress not later than December 31, 1976, to include an analysis of the adequacy of current participation, vesting and financing arrangements, and of existing fiduciary standards, as well as the necessity for new federal legislation and standards with respect to government plans. The legislative study appears to point toward a continuation of government plan distinctions, since its task is to assess the "necessity" for regulating governmental plans, suggesting that the focus of the study will not be to eliminate unjustifiable distinctions, but to continue the distinctions unless it finds substantial abuses justifying regulation. The study also specifically calls for consideration of the taxing power of the government suggesting that distinctions in at least the funding area will be retained.

Because government plans are exempt from the funding requirements of ERISA, it is possible to set up a completely separate category of nonqualified plans that have most of the advantages of tax-qualification without some of the disadvantages. A government may enter into an arrangement in which each of its employees elects to have any portion of his compensation placed in a custodial account to be held for his benefit upon retirement. If the account is subject to claims of the government's creditors, the employee is not taxed until amounts in the account are paid to him actually or constructively, and the income of the account is tax exempt. Such arrangements are not subject to any participation, vesting, funding, or discrimination standards. Moreover, there are no limits on benefits or contributions, and contributions may be made on an *ad hoc* basis for any one or more employees. A disadvantage of these plans is the lack of any special gift or estate tax exemption, and the special lump sum distribution benefits are not available. This category of plans seems objectionable on policy grounds since it allows government employees a tax break not available to employees generally.

Churches receive even more benefits than governments under

375. The inflationary effect of promising now but taxing later also should be considered.

ERISA. Church plans have the same exemptions from the participation, vesting, funding, reporting and disclosure, fiduciary, and termination insurance provisions as government plans.[376] They may make an irrevocable election, however, to become subject to those requirements.[377] The election has the obvious disadvantage of making additional requirements applicable, but it has the advantage of allowing the exclusion of collective bargaining unit employees and nonresident aliens from the coverage test of section 410(b) of the Code. Churches may also adopt plans like the special category available to governments, described in the preceding paragraph. Church plans are not on the statutory list of items for committee study, but hopefully, the committees will consider church plans along with government plans, since a secretary who works for a church should be entitled to as much retirement security as the secretary who works for a government or for a corporation.

A completely separate category of tax-qualified plans is permitted for employers who are public schools or are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.[378] These plans must have one hundred percent vesting and are limited to investment in annuity contracts or to custodial accounts invested in stock of regulated investment companies. They are not subject to the funding requirements of section 412 of the Code or section 302 of ERISA, or to the participation requirements of section 410 of the Code, or section 202 of ERISA, or to the discrimination requirements of section 401(a)(4) of the Code. Contributions may be made on an *ad hoc* basis for any one or more employees. Deductions are irrelevant for employers in this category since their income is tax exempt, but each employee may exclude the contributed amounts from his income as long as the contributions for the taxable year do not exceed the "exclusion allowance" for the employee for that year.[379] This category of plans must meet the normal limitation on contributions or benefits under section 415 unless the plan is a defined contribution plan maintained by an educational institution, hospital, or home health service agency. Under that plan an employee participant may elect

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376. ERISA §§ 1001, 1012(a), 1013(a), INT. REV. CODE OF 1954, §§ 410(c)(1)(B), 411(e)(1)(B), 412(h)(4). ERISA, §§ 4(b)(2), 4021(b)(3), 29 U.S.C.A. §§ 1003(b)(2), 1321(b)(3) (Supp. 1975).

377. ERISA § 1011, INT. REV. CODE OF 1954, § 410(d).

378. INT. REV. CODE OF 1954, § 403(b)(1)(A).

379. An employee's exclusion allowance is equal to the excess of (1) 20% of current compensation times his year of service over (2) the aggregate amounts excluded in prior years. ERISA § 2004(c)(4), INT. REV. CODE OF 1954, § 403(b)(2).

either of two limitations as an alternative to the section 415 limitations or may elect to have his exclusion allowance equal to the section 415 limitation.[380] This category of plans has no special gift or estate tax exemption, and the lump sum distribution benefits are not available.

The reason for special treatment of section 501(c)(3) organizations and public schools is largely historical; these organizations traditionally have been treated favorably, largely because of the lower prevailing wage levels in past years. In addition, these organizations initially were afforded favorable treatment,[381] and while the Congressional trend has been to cut back rather than to expand their benefits,[382] it is difficult to cut back. Organizations establish plans based on existing limitations, and both employers and employees rely on this continuation. Although the goal of the quest for parity should be to eliminate such distinctions, achieving that goal may take a long time and many small steps.

Section 401(c)(1) of the Code defines the term "employee" to include a self-employed individual. Thus, a self-employed individual may participate in a tax-qualified plan, but if he does, the plan becomes subject to additional requirements. Contributions for a self-employed individual under a defined contribution plan are limited to the greater of (1) the lesser of fifteen percent of his earned income or $7,500, or (2) the lesser of one hundred percent of his earned income or $750. Benefits for a self-employed individual under a defined benefit plan are limited to an amount specified in the regulations, which is reasonably comparable to the maximum retirement benefits available under defined contribution plans.[383] Distributions to a self-employed individual must commence not later than the taxable year in which he attains the age of seventy and one half years, except in a bond purchase plan.[384] Only the first $100,000 of the self-employed individual's earned income may be taken into account under the plan[385] unless it is a bond purchase

380. ERISA §§ 2004(a)(2), (c)(4), INT. REV. CODE OF 1954, §§ 415(c)(4), 403(b)(2)(B). There is also a special participation rule for plans maintained exclusively for employees of an educational institution which has a regular faculty, curriculum, and student body. Such a plan may condition participation upon attainment of any age up to 30, rather than 25, if it provides for 100% vesting after one year of service. ERISA § 1011, INT. REV. CODE OF 1954, § 410(a)(1)(B)(ii); ERISA § 202(a)(1)(B)(ii), 29 U.S.C.A. § 1052(a)(1)(B)(ii) (Supp. 1975).

381. I.T. 1810, II-2 CUM. BULL. 70 (1923), *revoked*, I.T. 4041, 1951-1 CUM. BULL. 5.

382. *See* 56 Stat. 798 (1942); 68A Stat. 3 (1954); Pub. L. No. 85-866, 72 Stat. 1606 (1958); ERISA, § 2004 *adding* INT. REV. CODE OF 1954, § 415.

383. ERISA § 2001(d)(2), INT. REV. CODE OF 1954, § 401(j).

384. Under such a plan, if the bonds are held in a trust or custodial account, they must be distributed by age 70-½.

385. ERISA § 1016(a)(2)(C), INT. REV. CODE OF 1954, § 401(a)(17).

plan.[386] The portion of a lump sum distribution to a self-employed individual that relates to years before 1974 is not subject to long-term capital gains treatment unless the recipient elects to compute his tax on the rest of the distribution under the special ten-year averaging method. Common-law employees, however, get long-term capital gains treatment for the earlier portion whether or not they make the election. The gift and estate tax exclusions available to common-law employees are not available to self-employed individuals, nor is the $5,000 death benefits exclusion available to them.[387]

A set of requirements becomes applicable if any self-employed person covered by the plan is an "owner-employee"—defined by section 401(c)(3) as an employee who owns more than ten percent of the capital or profits interest in the employer. In an owner-employee plan, the trustee of any trust, or the custodian of any custodial account, must be a bank or a person who demonstrates that he will administer the trust or account consistent with the requirements of section 401.[388] All employees with three years of service must participate,[389] and their rights must be fully vested.[390] If the plan is a profit-sharing plan, it must have a definite formula for determining contributions.[391] In addition, benefits may not be paid to the owner-employee prior to age fifty-nine and one half unless he is disabled.[392] The plan cannot be integrated with social security unless it meets special, more stringent requirements,[393] and if it is a defined benefit plan, it may not be integrated with social security at all.[394] Nondeductible contributions by the owner-employee are limited to the lesser of ten percent of earned income or $2,500,[395] and may not be made at all unless the plan covers at least one common-law employee[396] or is a qualified bond purchase plan.[397] Excessive contributions are subject to a special excise

386. ERISA § 2004(c)(2), INT. REV. CODE OF 1954, § 405(a)(1). This is presumably a mistake.

387. INT. REV. CODE OF 1954, § 101(b)(3).

388. INT. REV. CODE OF 1954, § 401(d).

389. ERISA § 1022(b)(2), INT. REV. CODE OF 1954, § 401(d)(3)(A). Certain nonresident alien employees or collective bargaining unit employees need not participate. ERISA § 1022(b)(2), INT. REV. CODE OF 1954, § 401(d)(3)(B).

390. INT. REV. CODE OF 1954, § 401(d)(2)(A).

391. INT. REV. CODE OF 1954, § 401(d)(2)(B).

392. ERISA § 2001(h)(1), INT. REV. CODE OF 1954, § 401(d)(4)(B).

393. INT. REV. CODE OF 1954, §§ 401(a)(10)(A), 401(d)(6). *See* note 170 *supra* and accompanying text.

394. ERISA § 2001(d)(2), INT. REV. CODE OF 1954, § 401(j)(4).

395. ERISA § 2001(f)(1), INT. REV. CODE OF 1954, § 4972(c).

396. INT. REV. CODE OF 1954, § 401(d)(5)(B).

397. ERISA § 2004(c)(2), INT. REV. CODE OF 1954, § 405(a)(1). The exception for bond purchase plans was presumably made because retirement bonds can be purchased by anyone,

tax,[398] and distribution must be accelerated at death in certain cases.[399]

The basic contribution limit for self-employed individuals under defined contribution plans also applies to shareholder-employees of subchapter S corporations under defined contribution plans. Instead of being subject to an excise tax, however, contributions in excess of the limit are merely included in the shareholder-employee's income,[400] whether or not the interest of the shareholder-employee is vested.[401] In a regular stock bonus or profit-sharing plan, forfeitures may be applied either to reduce contributions or to increase benefits, but in a stock bonus or profit-sharing plan covering shareholder-employees of a subchapter S corporation, forfeitures may not increase benefits of shareholder-employees.[402] The benefits of shareholder-employees in a defined benefit plan are subject to the same limits on annual accruals as the benefits of self-employed individuals.[403] In contrast to plans covering owner-employees, however, the plan may be integrated with social security under the normal rules.

Traditionally, most self-employed persons are assumed to be more prosperous than most employees. Self-employed persons are generally thought of as rich doctors and lawyers, while employees are thought of as deserving blue collar workers. This, of course, is not true; many rich doctors and lawyers have made themselves into employees by incorporating their practices, and many carpenters are self-employed. A primary reason why professional people have become employees is to avail themselves of more favorable tax-qualified plans.[404] The Treasury Department attempted to fight that practice by attacking the professional corporation as a sham,[405] but it lost, and incorporation has become the norm. One reason for raising the limit on deductible contributions on behalf of self-employed individuals from ten percent to fifteen percent and from $2,500 to $7,500 was to stem the tide of incorporation. The increased limits may make some difference, but the much more favorable benefits of corporate tax-qualified plans will still be responsible for many incorporations. It is possible to argue that, since sole proprietorships and partnerships do not bear the burden of double taxation

without reference to any plan, subject to an overall per-person limit of $2,500 per year.

398. ERISA § 2001(f)(1), INT. REV. CODE OF 1954, § 4972.

399. INT. REV. CODE OF 1954, § 401(d)(7).

400. ERISA §§ 2001(b)(1), (2), INT. REV. CODE OF 1954, § 1379(b).

401. INT. REV. CODE OF 1954, § 1379(b)(3).

402. INT. REV. CODE OF 1954, § 1379(a).

403. ERISA § 2001(d)(2), INT. REV. CODE OF 1954, § 401(j).

404. *See* Thies, *Keogh Plan v. Qualified Corporate Plan: An Analysis of the Respective Advantages*, 42 J. TAX. 9 (1975).

405. *See* note 131 *supra*.

of earnings that corporations bear and pay lower overall social security tax, they should receive correspondingly lower tax benefits for retirement plans. Whatever validity that argument possesses, however, is not enough to justify the distinction in treatment.[406]

The limits should not necessarily be the same in percentage terms, however, since a fundamental difference exists in the income against which the percentage is applied. If a one-man corporation earns $125,000 net of expenses other than retirement plan contributions, his maximum contribution to a defined contribution plan of $25,000 will be twenty-five percent, since he will be able to afford only a $100,000 salary. However, if the man were self-employed, a $25,000 contribution would be a twenty percent contribution. Because of this difference, and assuming that the applicable limits are unchanged, pension parity would require that the self-employed limit on contributions to defined contribution plans be the lesser of twenty percent of earned income or $25,000.

The Finance Committee in 1973 attempted to stem the tide of incorporation by placing limits on incorporated partnerships. The Committee proposed to limit the pensions of "proprietary-employees" of corporations.[407] A strong lobbying effort dampened the enthusiasm of the Committee, but much to everyone's surprise, the proposed limits were extended to all employees of all corporations on the floor of the Senate.[408]

Additionally, three special categories of plans not discussed above should be mentioned: those for air pilots, the maritime industry, and the United Mine Workers. Plans covering air pilots may exclude all employees except air pilots in applying the coverage tests of section 410(b) of the Code. More precisely, this rule applies to plans established or maintained pursuant to a collective bargaining agreement with air pilots, which provide contributions or benefits only for employees whose principal duties are customarily performed aboard aircraft in flight. This special rule is the legislative response to a special problem: air pilots are highly paid, have a fairly rich retirement package, are required to retire early, are unionized, and are key employees in a key industry. Together, these

406. Particularly unjustifiable is the failure to provide a cost of living adjustment for owner-employees. For a discussion of the similar problem which exists with respect to the $1,500 limit under individual retirement accounts see note 350 *supra* and accompanying text. Note, however, that owner-employees have an unjustifiable advantage in that their plans may use a custodial account instead of a trust. ERISA § 1022(d), INT. REV. CODE OF 1954, § 401(f); ERISA, §§ 403(a), (b), 29 U.S.C.A. §§ 1103(a), (b) (Supp. 1975).

407. S. 1179, 93d Cong., 1st Sess. (1973). *See* notes 270-82 *supra* and accompanying text.

408. 119 CONG. REC. S 16853 (daily ed., Sept. 19, 1973).

factors created a substantial problem because air pilots typically negotiate for high benefits at an early age and embody their plan in a collective bargaining agreement as part of an overall wage package. Because air pilots are highly paid employees, their plans alone do not cover a nondiscriminatory group within the meaning of what is now section 410(b) of the Code. Therefore, their plans qualify only if other employees have higher or roughly comparable benefits through other plans, so that the plans together cover a nondiscriminatory group. Because the comparability issue is difficult and cannot be resolved with the Internal Revenue Service under the time demands of the collective bargaining process, the special exception removes the necessity for comparing pilot's benefits with plans of other employees. Although this special rule may be justifiable, its application appears to be too narrow. It should therefore either be repealed or extended to other employee groups with similar problems.

A special rule applies to the maritime industry in the participation and vesting areas. The term "year of service" is defined for purposes of the participation and vesting standards as a twelve-month period during which the employee has at least 1,000 hours of service. However, for the maritime industry, 125 days of service are treated as 1,000 hours of service,[409] an apparently reasonable rule since 125 days at eight hours a day equal 1,000 hours.

The United Mine Workers' special rule is in section 404(c) of the Code, which applies to plans that provide medical or pension benefits established prior to 1954 as a result of an agreement between employee representatives and the federal government. The agreement must have been concluded during a period of government operation under seizure powers of a major part of the productive facilities of a mine industry,[410] and it is understood that this provision applies only to the United Mine Workers. Contributions under these plans are deductible if they meet the requirements of section 162 relating to trade or business expenses, and the deduction limits of section 404 are irrelevant.

The problem with the application of the normal requirement for tax-qualified plans to the United Mine Workers' plan is that the plan provided both medical and pension benefits. A medical plan can qualify under section 501(c)(9) of the Internal Revenue Code, and a pension plan can qualify under section 401(a), but a medical pension plan is not tax-qualified. The solution to the UMW problem was section 404(c). In theory, there should also be a problem with

409. ERISA §§ 1011, 1012(a), INT. REV. CODE OF 1954, §§ 410(a)(3)(D), 411(a)(5)(D).
410. ERISA § 2007, INT. REV. CODE OF 1954, § 404(c).

the taxation of the trust income; however, until recently, the trust corpus has been held in noninterest bearing accounts. Also, in theory, employees should be subject to tax when their interests vest; however, it is understood that there was no vesting prior to retirement, and until 1969 there was no tax on employees under non-qualified plans until the time of vesting.[411] There seems to be no policy reason why this special exception should not have been made more general since there seems to be no policy against permitting tax-qualified plans to provide both medical and pension benefits.[412]

V. Reflections on the Quest for Parity—Conclusion

Progress in the quest for pension parity is sometimes made, but the steps backward can be as great as the steps forward. Unfortunately, our legislative process is not designed to help. The essence of the democratic process is that Senators and Congressmen respond to the needs of their constituents. Inevitably, the powerful and vocal constituents receive the most attention, and inevitably, compromises made in the heat of battle by harried legislators are not wholly logical or fair when subjected to analysis.

The retirement system in the United States is exceedingly varied and complex, and the federal regulation of the system reflects this fact. The law provides a few basic rules but adds a vast number of special exceptions. Typically, as the law develops, someone in the Administration, a Congressman, a Senator, or a staff member conceives of an idea for a basic principle of the law. Then, someone who would be hurt by that principle comes in to complain. Ideally, the idea would either be unchanged, altered to take care of the problem in a nondiscriminatory way, or abandoned. However, all too often an exception is created, designed to apply to the complainant and to as few other people as possible.

Revenue considerations complicate matters, because the elimination of unjustifiable distinctions usually costs money. It is much easier to liberalize the rules than to tighten them, particularly in the area of retirement plans, which by their very nature are long term arrangements. When people have established and maintained particular retirement plans in reliance on provisions in the law, fairness may require that rules be changed only after extended adjustment periods.

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411. *See* notes 190-93 *supra* and accompanying text.

412. The technical reasons are that Treas. Reg. § 1.401-1(b)(1)(i) provides that pension plans must have definitely determinable benefits and Proposed Treas. Reg. § 1.501(c)(9)-1(b)(3)(v) provides that voluntary employees' beneficiary associations cannot provide retirement benefits.

The Employee Retirement Income Security Act of 1974 has made some much-needed and long overdue changes in pension law, many of which eliminate previous inequities. This complex act, however, not only retains a number of unjustifiable distinctions but also creates some of its own. In spite of complicated revenue considerations and the problems of fairness that appear to be inherent in the legislative process, the quest for retirement equality should not end with the current scheme. ERISA is a move in the proper direction but it should by no means be considered the last step.