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NEW MINIMUM STANDARDS UNDER THE PENSION REFORM ACT OF 1974†

Isidore Goodman*

I. Introduction

The Pension Reform Act of 1974,¹ officially designated as the Employee Retirement Income Security Act of 1974 (ERISA), enacted September 2, 1974, effected the most far-reaching changes in the pension and profit-sharing area since 1921, when provision was first made for special tax treatment of stock bonus and profit-sharing plans. Compared with the less than 13 lines in § 219(f) of the Revenue Act of 1921, the new law is over 200 pages, and the explanatory report by the Joint Conference Committee is 131 pages in length.

Provisions affecting the Internal Revenue Code constitute only one part of the four title Act. Title I deals with the protection of employee benefit rights, which are largely under the jurisdiction of the Department of Labor. Various provisions in Title I have their tax counterparts in Title II, which relates to the treatment of retirement plans under the Internal Revenue Code. Title III prescribes the rules as to jurisdiction, administration, and enforcement, and provides for the establishment of a Joint Pension Task Force for various studies, and for the enrollment of actuaries. Title IV provides for plan termination insurance through the establishment of the Pension Benefit Guaranty Corporation.

This article primarily discusses the more significant provisions of the new minimum standards in Title II, and touches upon other provisions only to the extent relevant to these standards. The new law prescribes minimum standards for participation and vesting for tax-qualified plans generally, and for funding of certain types of defined benefit plans.

II. Minimum Participation Standards: § 410

A. General Restrictions

A qualified plan may not require as a condition for participation that an employee complete a period of service extending beyond the later of (A) the date on which the employee attains the age of 25, or (B) the date on which he completes one year of service. A three-year service requirement, instead of one, however, may be imposed where the plan provides for 100 percent vesting in each participant's accrued benefit in not more than three years of service. Also, the age requirement may be raised from 25 to 30 in the case of a plan of

† This article is taken from an address delivered at the Annual Notre Dame Estate Planning Conference on Sept. 12, 1975.
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The views expressed herein are not necessarily those of the Internal Revenue Service.


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an exempt educational institution if the plan provides for full vesting in a participant's accrued benefit after at least one year of service. This latter exception does not apply where a three-year service requirement is imposed with full vesting in such time.

B. Maximum Age

Employees who were within five years of normal retirement age when hired may be excluded from participation in a defined benefit plan or a target benefit plan. Employees may not be excluded from other types of plans, however, because they had already attained a specified age.

C. Years of Service

For the purpose of determining whether an employee has completed the service requirement for participation, the term "year of service" means a 12-month period during which the employee has not less than 1,000 hours of service. In the case of a seasonal industry where the customary period of employment is less than 1,000 hours, a "year of service" will be determined under regulations to be prescribed by the Secretary of Labor, and the term "hours of service" will also be determined under such regulations. In the maritime industry, 125 days of service will be treated as 1,000 hours of service and may be further defined by regulations.

D. Time of Participation

The plan must provide that an employee who meets the minimum age and service requirements and is otherwise eligible to enter the plan is to commence participation no later than the earlier of (A) the first day of the first plan year beginning after the date on which he satisfied such requirements, or (B) six months after he satisfied such requirements. Of course, where the employee separates from the service prior to the time in point, neither provision is applicable.

E. Breaks in Service

As a general rule, all years of service with the employer or employers maintaining the plan are to be taken into account in computing the period of service for participation. In the case of a participant who does not have a vested right to an accrued benefit derived from employer contributions, years of service before a break in service need not be taken into account if the number of consecutive one-year breaks in service equals or exceeds the aggregate number of the years of service before the break. The aggregate number of years of service does not include any years of service not required to be taken into account by reason of any prior break in service. In the case of a participant with some vested right to the employer derived accrued benefit, all years of service, regard-
less of the number of breaks in service, must be taken into account. In either
case, such prebreak service need not be recognized until the participant has a
year of service subsequent to the break in service.

F. Eligibility

The eligibility requirements set forth in § 401(a)(3) of the Code prior to
ERISA have been amended to require that a qualified plan satisfy the minimum
participation standards of the new § 410. In the main, the old 70 and 80 per-
centage requirements, § 401(a)(3)(A), and the nondiscriminatory classifi-
cation alternative, § 401(a)(3)(B), have been transferred to § 410, with
appropriate modifications. Instead of the former exclusion of short service
employees (those working no more than 20 hours a week, no more than five
months a year, or not completing a minimum period of service not exceeding
five years), only those employees who have not satisfied the new minimum age
and service requirements may be excluded before applying the 70 and 80 per-
cent tests. In the classification alternative, there still must be no discrimination
in favor of upper-echelon employees, but supervisors have been removed from
that category since many are really part of the working force and those in upper
levels would be included in the “highly compensated” group.

G. Exclusions

In determining compliance with either the 70 and 80 percent or nondis-
criminatory classification requirements, however, employees in three categories
may be excluded from consideration. These are: (1) employees excluded from
the plan but who are in a unit covered by a collective bargaining agreement if
there is evidence that retirement benefits were the subject of good faith bargain-
ing between employee representatives and the employer or employers; (2) air-
line employees who are not covered by a collective bargaining agreement be-
tween pilots and one or more employers, but such exclusion does not apply in
the case of a plan which provides contributions or benefits for employees whose
principal duties are not customarily performed aboard aircraft in flight; and
(3) employees who are nonresident aliens and who receive no earned income
from the employer which constitutes income from sources within the United
States.

H. Collective Bargaining Unit

The exclusion of employees in a unit covered by a collective bargaining
agreement has long been a troublesome issue. Various administrative rulings
have been published as to the effect of such exclusion and several cases have
been litigated on the issue.

1. Rulings and Litigation Prior to ERISA
Union preference to keep its membership out of a plan was not an exception to the coverage requirements prior to ERISA. The requirement for a non-discriminatory classification could not be disregarded solely for the reasons that some of the employees: (1) were unionized; (2) had the power to bargain collectively for participation in the employer's plan but did not choose to do so; or (3) decided against being included in that or any other plan.²

Where separate plans are maintained for different groups of employees the problem of comparability may arise if each plan does not in and of itself satisfy the coverage tests. For this purpose, only benefits under a plan of deferred compensation are used in making comparisons. The cost of providing other benefits, such as vacation, health and welfare, and current cash distributions are not considered.³ In Rev. Rul. 70-183,⁴ the employer contributed four percent of payroll to a union-negotiated pension plan for his hourly-rated employees, plus an additional five percent to a separate fund to provide the employees with vacation, health, and welfare benefits. He then established a profit-sharing plan for salaried employees and made contributions to the plan up to 15 percent of compensation. Only the four percent to provide pension benefits for the hourly-rated employees could be compared with 15 percent for the salaried employees, who were in the upper-echelon category. The profit-sharing plan was thus deemed discriminatory and nonqualified.

John Duguid & Sons, Inc. v. United States⁵ involved a pension plan covering a company's president, vice president, and a supervisory employee, but excluding all other full-time employees who were hourly-rated, and also excluding transient workers. The company contended that under the federal labor laws, complications could arise with unions if a select few—the steadily employed but excluded hourly-rated employees—were allowed to participate, but the transient workers were excluded. The court, however, found that there was nothing in the record of the case to prove that such apprehension had a basis in fact so as to justify the exclusion provisions of the plan. The only participants were three upper-echelon employees while six full-time hourly-rated employees were excluded. This resulted in prohibited discrimination, and the plan was held not to qualify.

Ed & Jim Fleitz, Inc.⁶ involved the exclusion of unionized employees. There the court observed:

The plain meaning of a statute is that a classification which is limited to salaried employees might or might not be discriminatory, depending upon who the salaried employees are . . . . In short, the question of whether or not discrimination exists is a question of fact . . . which must first be determined by the Commissioner, and his determination should not be set aside unless it is found to be arbitrary or an abuse of discretion. However, under the facts of this case where only the three employees in the prohibited

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⁶ 50 T.C. 384 (1968).
group, out of a permanent annual work force of 13 to 15 employees are covered, the Commissioner's determination of discrimination cannot be arbitrary.\footnote{Id. at 390.}

The issue of comparability arose in Peter F. Mitchell Corp.\footnote{1969 P-H Tax Ct. Mem. 449.} The company established a profit-sharing plan for its salaried employees, three officer-shareholder employees and a bookkeeper, to which the company made contributions of 15 percent of compensation. It also made contributions to two separate negotiated plans for hourly-rated employees who were members of trade unions. Considering the three plans as a unit, the coverage requirements were met. All employees, except nine nonunion members and six short-service employees were included in one of the three plans. As separate plans, however, only the union plans could qualify; the plan for salaried employees was found to be discriminatory. On a projection of benefits to compensation, the rate was found to be 19.2 for members of the Laborers' Union, 9.65 for members of the Operators' Union, and 42.4 for the salaried employees. This favoritism toward the highly paid salaried employees resulted in the finding of prohibited discrimination.

A "projection of benefits" test was applied in Loper Sheet Metal, Inc.\footnote{53 T.C. 385 (1969).} This case involved a profit-sharing plan under which the employer contributed 15 percent of compensation for each of two officer-stockholder employees, and also made contributions of 2.46 percent to 2.94 percent under a negotiated plan for hourly-rated employees. Benefits that could be generated from contributions under the profit-sharing plan, by projection of contributions with interest to normal retirement age, were shown to equal 8.9 percent of compensation for one of the stockholder-employees and 8.1 percent for the other, but only 2.592 percent for the hourly-rated employees. Thus, although coverage was satisfactory when both plans were considered as a unit, discrimination existed in contributions and benefits under the profit-sharing plan; the plan, therefore, failed to qualify.

Moreover, where a company contended that dealings with employees excluded from a pension plan for salaried employees were controlled by a collective bargaining agreement, and that the union representing these employees elected to forego a pension plan, it was nevertheless held that the plan was discriminatory and nonqualified.\footnote{Loevsky v. Commissioner, 471 F.2d 1178 (3d Cir. 1973), aff'd 55 T.C. 1144 (1971).} In its decision, the Tax Court stated:

However, despite the harshness of the result in this case and the potential harshness of the future application of our decision here, it is properly the function of Congress and not this Court to make any appropriate adjustments to the law in this area.\footnote{55 T.C. at 1151.}

A similar result was reached in Container Service Co. v. United States,\footnote{478 F.2d 770 (6th Cir. 1973).} a case in which a company established a profit-sharing plan for salaried employees, covering five out of 20 employees. Four of the five included employees

\footnotesize{\bibliography{references}}
were officers and supervisors, while the excluded employees were unionized and thus not provided with any benefits of deferred compensation. The company contended that the union, as a matter of negotiation strategy, withdrew demands for inclusion in a profit-sharing or pension plan in favor of immediate wage benefits. It therefore asserted that it would have been an unfair labor practice for it to have included union members in the profit-sharing plan by unilateral action, and the union's refusal to seek inclusion justified this exclusion of such members from the plan. The plan, nevertheless, was held to be discriminatory and nonqualified. This result was sustained on appeal, but the appellate court emphasized that by its decision it neither made nor implied any ruling as to the effect of a union's refusal of an offer of inclusion in an employer's plan.

2. Changes Initiated by ERISA

ERISA made a significant change with respect to employees in a unit covered by a collective bargaining agreement. Where there is evidence that retirement benefits were the subject of good faith bargaining between employee representatives and the employer or employers maintaining the plan, the employees in the unit may be excluded from participation. This obviates the troublesome issue encountered in cases previously litigated in which the union did not elect to accept the company plan, or in which the benefits or contributions under such plan were higher than those under a separate union plan.

The union may not want a plan of deferred compensation offered by the employer. It may prefer instead salary increases, or welfare benefits, or improved working conditions, or may have other reasons for declining participation in the employer's plan.

What is good faith bargaining remains to be established on the basis of the facts in the cases involved. ERISA provides that before issuing an advance determination letter as to the qualification of a plan, the Secretary of the Treasury shall require the applicant to provide, in addition to any material and information necessary for such determination, such other material and information as may reasonably be made available at the time of application to the Secretary of Labor under Title I. Further, the applicant is to furnish evidence that he notified each employee who qualifies as an interested party of the application for a determination letter.

The Internal Revenue Code also provides that an application as to qualification of a plan, exemption of an organization or account under a plan, papers in support of an application, and any letter or document issued by the Service dealing with qualification or exemption shall, under certain circumstances, be open to public inspection. However, information from which the compensation of any individual may be ascertained shall not be so disclosed.

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14 *Act § 3001(a).*
16 *Int. Rev. Code of 1954, § 6104(a).*
ERISA further provides that whenever an application for a determination letter is made as to the qualification of a plan, the Secretary of the Treasury shall upon request afford an opportunity for comment at any time within 45 days after receipt of the application to (1) any employee or class of employees qualifying as an interested party, (2) the Secretary of Labor, and (3) the Pension Benefit Guaranty Corporation.

I. Exceptions

Certain plans are treated as meeting the new minimum participation standards under §410, for the purposes of §401(A), if they meet the requirements of §401(A)(3) as in effect on the day before the enactment of ERISA, September 2, 1974. These are (a) governmental plans, (b) plans which have not at any time after the date of enactment of ERISA provided for employer contributions, (c) plans of fraternal beneficiary societies, orders, or associations, and of voluntary employees' beneficiary associations, and (d) church plans, unless the church or convention or association of churches which maintains the plan makes an irrevocable election to comply with the new requirements.

III. Minimum Vesting Standards: §411

ERISA prescribes new rules for vesting which require a qualified plan to provide that:

(1) An employee's right to his normal retirement benefits is nonforfeitable upon the attainment of normal retirement age, which is the earlier of the time the participant attains such age in accordance with the provisions of the plan, or age 65, and completion of 10 years of participation;

(2) An employee's right to his accrued benefit derived from his own contributions is nonforfeitable; and

(3) An employee's right to his accrued benefit derived from employer's contributions must be nonforfeitable no later than the time determined under any one of the following alternatives —

(a) Ten year vesting—100 percent upon completion of 10 years of service;

(b) Five-to-fifteen year vesting—25 percent upon completion of five years of service, five percent for each additional year thereafter through the 10th year, at which time the benefits are to be at least 50 percent vested, and an additional 10 percent for each year from the 11th through the 15th year, at which time the benefits are to be 100 percent vested; or

(c) Rule of 45—50 percent for an employee who has not separated from the service and has completed at least five years of service, provided that the sum of his age and years of service equals or exceeds 45, and 10 percent for each additional year of service thereafter through the tenth year, at which time the benefits are to be 100 percent vested, but any employee who has completed at least 10 years of service must have a nonforfeitable right to no less than 50 percent of his accrued benefit.

17 Act § 3001(b) (1).
derived from employer contributions plus an additional 10 percent for each additional year of service thereafter.\textsuperscript{18}

A. 4-40-11 Rule

Generally, a plan complying with any of the three rules described above satisfies the vesting requirements for accrued benefits derived from employer contributions. Where, however, there is a pattern of abuse under the plan, such as the firing of employees before their accrued benefits vest, or there has been, or there is reason to believe that there will be, an accrual of benefits or forfeitures tending to discriminate in favor of upper-echelon employees, earlier vesting may be required.

The Conference Committee Report accompanying ERISA points out that in the past the law in this area has been administered on a case-by-case basis, without uniform results in fact situations of a similar nature. Consequently, except in cases where actual misuse of the plan occurs in operation, the Internal Revenue Service is directed not to require a vesting schedule more stringent than 40 percent vesting after four years of employment, with additional vesting of five percent for each of the next two years, and 10 percent for each of the following five years, resulting in 100 percent after 11 years.

This provision for more rapid vesting in the earlier years, however, would generally not be required where the rate of likely turnover for the upper-echelon employees was substantially less, perhaps as much as 50 percent less, than the rate of likely turnover for rank and file employees. Of course, where there is a pattern of firing employees to avoid vesting, the indicated limits would not apply.\textsuperscript{19}

The conferees also indicated that it is generally not intended that any plan, or a successor plan of an existing plan, which is presently under a more rapid vesting schedule should cut back its vesting as a result of the views expressed in the Conference Report. The 4-40-11 rule is intended as an experiment and is to apply in appropriate cases only until responsible congressional committees can review the situation after receiving a report from the joint task force study group and the evaluation of related material.

B. Vesting Subject to Divestiture

Prior to ERISA, qualified plans were permitted to contain certain "bad boy" clauses under which an employee who would otherwise be vested would forfeit his rights upon engaging in activities detrimental to the employer. Thus, for example, a discontinuance of benefits could have occurred by the employee taking a position with a competitor of the employer or divulging the employer's trade secrets to competitors.\textsuperscript{20} Under the minimum vesting standards, however, such forfeitures are no longer permissible, but the plan may provide for a for-

\textsuperscript{18} Act § 203(a)(2); Int. Rev. Code of 1954, § 411(a)(2).


\textsuperscript{20} IRS Publication 778 (2-72), "Guides for Qualification of Pension, Profit-Sharing, and Stock Bonus Plans," Pt. 5(c)(3), at 17.
forfeiture or suspension of an employee's right to accrued benefits derived from employer contributions upon the occurrence of any of the following events:

1. forfeiture upon the death of the participant, except where a survivor annuity is payable;
2. suspension of benefits for such period as the employee is employed, after the payment of benefits commences, by the employer who maintains the plan or, in the case of a multiemployer plan, in the same industry, the same trade or craft, and in the same geographic area covered by the plan as when the benefits commenced;
3. a right to an accrued benefit derived from employer contributions shall not be treated as forfeitable solely because amendments to the plan may be given retroactive effect for the purpose of the minimum funding standards; and
4. forfeiture upon withdrawal of any amount attributable to mandatory employee contributions where the participant does not have a nonforfeitable right to at least 50 percent of his accrued benefit derived from employer contributions, but the amount forfeited shall be restored upon repayment of the amount withdrawn and, in the case of a defined benefit plan, with interest.\(^2\)

C. Included Service for Determination of Nonforfeitable Percentage

In computing an employee’s period of service under the plan for the purpose of determining his nonforfeitable interest, all service with the employer or employers maintaining the plan is counted except:

1. service before age 22, but if the 10-year or five- to 15-year vesting rules are not used, the plan may not disregard any year of service during which the employee was a participant;
2. service during the time that the employee declined to contribute under an employee contributory plan;
3. service during the time the employer did not maintain the plan or a predecessor plan;
4. under certain circumstances, service before a break in service may be ignored;
5. years of service prior to January 1, 1971, unless the employee has had at least three years of service after December 31, 1970; and
6. years of service before the first plan year to which ERISA applies if the service would have been disregarded under the plan with regard to breaks in service as in effect on the applicable date.\(^2\)

D. Accrued Benefit

A participant's accrued benefit depends on the type of plan involved. In the case of a defined contribution plan, the accrued benefit is the balance in the employee's account. In a defined benefit plan, it is the benefit specified in

\(^2\) Act § 203 (a)(3); INT. REV. CODE OF 1954, § 411 (a)(3).
\(^2\) Act § 203 (b)(1); INT. REV. CODE OF 1954, § 411 (a)(4).
the plan but expressed in the form of an annual benefit commencing at normal retirement age.

Statutory rules are prescribed for controlling the rate of accrual of benefits in defined benefit plans. Otherwise, accrued benefits may be defined in the plan in a way that the greatest portion would accrue in the last few years of participation, and proportionately insignificant accruals in the early years. Thus, a participant might be fully vested on a percentage basis, but only a small part of the benefits would be available because he had not yet begun to accrue significant benefits. The rate of accrual of benefits is highly important in assuring a meaningful accrual commensurate with the percentage attained. The Code therefore provides that the accrued benefit under a defined benefit plan must meet one of three rules prescribing the rate of accrual: 23

(1) Three percent rule—Under this rule, it is necessary to determine the benefit that would be payable if the participant entered the plan at the earliest possible age permitted under the plan and served continuously until the earlier of age 65 or the normal retirement age stated in the plan. The accrued benefit is no less than three percent of such benefit for each year of participation, not in excess of 33 1/3 years.

(2) One hundred and thirty-three and a third percent rule—This rule requires that the rate of accrued benefit in any year be no more than 133 1/3 percent of the rate prior to the plan year.

(3) Fractional rule—Under this rule, a participant's benefit is first determined on the basis of employment to normal retirement age. The benefit so determined is then proportioned ratably over the actual period of participation.

E. Applicable Rule

The purpose of these rules is to prevent a lag in the rate of accrual of benefits in early years and bunching up in later years. The suitability of the rule depends on the type of plan involved.

The three percent rule would work out satisfactorily in a plan that provides benefits that are not geared to years of service, such as a fixed benefit plan. It might also be used in a unit benefit plan if benefits are not provided for more than 33 1/3 years. It is therefore not readily adaptable to a career average type of plan or to a plan providing benefits based on compensation averaged over a period in excess of 10 years, since no more than 10 years of compensation may be averaged in projecting the normal retirement benefit.

The 1331/3 percent rule is suitable to a unit benefit plan, regardless of how compensation is averaged in computing benefits. The accrual for the plan year is merely limited to 133 1/3 percent of the rate in the prior year. This rule might also serve well in some types of fixed benefit plans, such as 30 percent at normal retirement age being equivalent to one percent per year of service for an employee who has worked for 30 years.

The fractional rule might be applied in a case involving a combination of formulas, such as different rates for minimum and maximum benefits. It is not,

however, readily adaptable to a career average benefit formula, or to a plan in which compensation is averaged over a period in excess of 10 years.

F. Service Prior to September 2, 1974

The new rules apply to plan years beginning after enactment of ERISA on September 2, 1974, but plans in existence on January 1, 1974, have until plan years beginning after December 31, 1975, to comply. The question, however, arises as to the accrual of benefits for service before the effective date. In this respect, a participant’s accrual benefit may be no less than the greater of either his accrued benefit determined under the plan as it existed prior to September 2, 1974, or 50 percent of the accrued benefit to which he would have been entitled if the new rules had applied to such years of participation.24

G. Allocation of Accrued Benefits

In an employee contributory plan, it is necessary to allocate the accrued benefits between employee and employer contributions. Amounts attributable to employee contributions are always 100 percent vested. The rate of vesting in employer contributions, however, depends on the provisions in the plan, but subject to compliance with the minimum vesting standards.

In a defined contribution plan, where separate accounts are maintained for employee contributions, the portion of accrued benefits attributable to the employee's contributions is the balance in the separate account maintained for such contributions. Where separate accounts are not maintained, the portion of the accrued benefit attributable to the employee's contribution is that portion of the account which his contribution bears to the total of employee and employer contributions.

In a defined benefit plan providing for voluntary contributions, the accrued benefit attributable to an employee's contributions is the balance in the separate account maintained for his voluntary contributions. The accrued benefit from employer contributions would be determined in accordance with the provisions of the plan applicable to such contributions.

Where employee contributions in a defined benefit plan are mandatory and an annual benefit in the form of a single-life annuity is provided, the accrued benefit derived from employee contributions is the amount of the annual benefit from his accumulated contributions, multiplied by a conversion factor to be determined by regulations, but fixed at 10 percent at age 65. The amount so determined is to be subtracted from the employee's total accrued benefit to determine his accrued benefit derived from employer contributions.

IV. Minimum Funding Standards: § 412

A. Rules Prior to ERISA

Prior to ERISA, § 401(A)(7) of the Code required that a qualified plan

must provide that upon its termination, or complete discontinuance of contributions thereunder, the rights of all employees to benefits accrued to the date of such termination or discontinuance be nonforfeitable to the extent then funded, or credited to the employees' accounts. Problems arose as to the effect of a suspension of employer contributions which could ripen into a discontinuance.

The Income Tax Regulations accordingly provided that in the case of a pension plan, a suspension of contributions will not constitute a discontinuance if (A) the benefits to be paid or made available under the plan are not affected at any time by the suspension, and (B) the unfunded past service cost at any time, inclusive of the unfunded prior normal cost and unfunded interest on any unfunded cost, does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment. Generally, this consisted of meeting at least the normal cost for each year and the interest on the unfunded past service liability.

Recurring and substantial contributions are required in a profit-sharing plan. Where a suspension of a profit sharing plan is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year for which a substantial contribution was made under the plan.

B. New Rules

New funding requirements are now imposed under ERISA and are to be administered by both the Department of Labor and Internal Revenue Service. Labor may enforce compliance through civil suits, and IRS through the imposition of excise taxes on the employer responsible for contributing to the plan. The new rules apply to the first full plan year beginning after September 2, 1974, but plans in existence on January 1, 1974, have until plan years beginning after December 31, 1975. Furthermore, in the case of union-negotiated plans, the new rules apply to plan years beginning after the agreement in effect on January 1, 1974, terminates, or plan years beginning after December 31, 1980, whichever is earlier.

1. Applicability

The new rules have been established for the purpose of requiring pension and annuity plans to accumulate sufficient assets within a reasonable time to pay benefits to covered employees when they retire. Contributions, of course, may generally be greater than those required under the minimum standards, but deductions may be limited if the plan is overfunded.

These new funding rules are generally not applicable to profit-sharing or

28 Act §§ 301-306, and 1013.
stock bonus plans, governmental plans, certain church plans, plans with no employer contributions, and certain insured plans. Once a plan qualifies for tax purposes, the minimum funding requirements apply, and continue applicable even if it later loses its qualified status although different deduction rules apply to employer contributions.

2. Minimum Annual Contribution

The employer's minimum annual contribution to a defined benefit pension or annuity plan generally consists of the normal costs of the plan, plus amortization of past service liabilities, experience losses, and similar charges. Subject to certain exceptions, minimum amortization payments are calculated on a level basis, consisting of interest and principal, over stated periods of time and are based on all accrued liabilities.

The general rule is that the initial past service liability, and past service liabilities arising under plan amendments, are to be amortized over a period of 30 years, but in the case of existing plans with past service liabilities on September 2, 1974, the period of amortization is 40 years. Experience gains and losses are to be amortized over a period of 15 years, but such gains and losses need not be calculated more often than every three years. In the case of a multiemployer plan, the period of amortization for past service liabilities is 40 years, and 20 years for experience losses.

To illustrate the applicability of the amortization requirement, assume that the past service liability is $1,000,000 at the time a plan is established. Then the minimum level payment that is to be made each year, for 30 years, with interest at six percent per annum, is $68,537, if contributions are made at the beginning of each year. In addition, the normal cost would have to be met each year.\footnote{House Comm. Rep. No. 93-807, 93rd Cong., 2d Sess. 77 (1974).}

In the case of a money purchase pension plan, the minimum annual employer contribution is the amount prescribed by the plan formula. For the purpose of this rule, a so called "Taft-Hartley plan" which provides an agreed level of contributions during the contract period is not to be considered a money purchase plan if the employer or his representative participated in the determination of the benefits. On the other hand, a "target benefit plan" is to be treated as a money purchase plan for the purpose of the minimum funding rules.

3. Funding Standard Account

A qualified pension or annuity plan is required to establish and maintain a funding standard account. The account is charged with liabilities accruing during the plan year and is credited with employer contributions and certain other offsets. The balance at the end of the year indicates whether or not the funding requirements have been met.

The account is charged with:

(1) the normal cost of the plan for the plan year;
(2) the amount necessary to amortize in equal annual installments—

(a) in the case of a plan in existence on January 1, 1974, the unfunded past service liability on the first day of the first plan year to which the new rules apply over a period of 40 years;

(b) in the case of a plan established after January 1, 1974, the unfunded past service liability on the first day of the first plan year, over a period of 30 years (40 years in the case of multiemployer plan);

(c) separately, with respect to each plan year, any net increase in unfunded past service liabilities arising from plan amendments adopted in such year over a 30-year period (40 years in the case of a multiemployer plan);

(d) separately, with respect to each plan year, any net experience loss over 15 years (20 years in the case of a multiemployer plan); and

(e) separately, with respect to each plan year, any net loss resulting from changes in actuarial assumptions used under the plan, over a period of 30 years;

(3) the amount necessary to amortize any waived funding deficiency for each prior year, over a period of 15 years; and

(4) in the year of a switch from the alternate funding standard back to the basic funding standard, the excess of any credit balance in the basic funding account over any credit balance in the alternate funding account, is to be amortized over a period of five years.

The account is to be credited with:

(1) the amount contributed by the employer to or under the plan for the plan year;

(2) the amount necessary to amortize in equal annual installments—

(a) separately, with respect to each plan year, any net decrease in the unfunded past service liability arising from plan amendments adopted during the year, over a period of 30 years (40 years in the case of a multiemployer plan);

(b) separately, with respect to each plan year, any net experience gain, over a period of 15 years, (20 years in the case of a multiemployer plan); and
(c) separately, with respect to each plan year, any net gain resulting from changes in actuarial assumptions, over a period of 30 years;

(3) the amount of any waived funding deficiency for the plan year; and

(4) in a year in which, a plan switches back to the basic funding standard from the alternate funding standard, the excess of any debit balance in the basic funding account over any debit balance in the alternate funding account.

The account is also credited with any cumulative balance, or charged with any cumulative deficit, from prior years. Interest is also charged to the account on any deficit, or credited on any surplus, at a rate equal to the rate used under the plan to determine costs. If after all charges and credits are entered for a plan year, the account at the end of the year shows a cumulative deficiency, it is underfunded; if a credit, the minimum funding requirement is met.\(^{31}\)

4. Alternate Minimum Funding Account

A plan which uses a funding method calling for annual contributions equal to those required under the entry age normal funding method may elect to use the alternate minimum funding standard account for any plan year.

The account is charged with:

(1) the lesser of normal cost under the plan’s funding method or normal cost determined under the unit credit method;

(2) the excess of the present value of accrued benefits over the fair market value of the plan’s assets; and

(3) any excess of credits to the alternate account for all prior years over charges to the account for all such years.

The account is credited with the employer’s contribution for the year. It is also charged, or credited, with interest consistent with the rate used to determine plan costs.\(^{32}\)

5. Waiver in Case of Substantial Business Hardship

If an employer or 10 percent or more of the contributing employers, in the case of a multiemployer plan, cannot satisfy the minimum funding standard for a plan year without substantial business hardship, and if application of the standard would be adverse to the interests of the plan participants in the aggregate, the Internal Revenue Service may waive all or part of such requirement for a plan year, including employer contributions for normal cost and amortiza-
tion of payments for past service costs and experience losses. The amortization of previously waived contributions, however, may not be waived.

In determining whether business hardship exists, the Service will consider situations such as:

(1) the employer is operating at an economic loss;

(2) there is substantial unemployment or underemployment in the trade or business and in the industry concerned;

(3) the sales and profits of the industry concerned; and

(4) it is reasonable to expect that the plan will be continued only if the waiver is granted.

Waivers as to all or part of the funding requirements are limited to no more than five years of any 15 consecutive plan years, and the amount waived is to be amortized over no more than 15 years.

The plan may not be amended to increase its liabilities while a waiver or extension applies, or if a retroactive amendment was made in the preceding 12 months (24 months for multiemployer plans). Reasonable de minimis amendments that would increase liabilities during the period that a waiver is in effect may be permitted.

Amendments specifically prohibited during the waiver or extension period are those that would increase liabilities through increasing benefits, or changing the rate at which benefits become nonforfeitable. If the plan is amended contrary to this requirement, the waiver will not apply to any plan year ending on or after the day on which such amendment is adopted. In such case, the amount waived but not yet amortized would become part of the current minimum funding requirement in the year in which the contrary action is taken. Such amount would therefore be charged to the funding standard account for that year.

6. Insured Plans

Plans that are funded exclusively with individual insurance contracts, such as individual retirement income or annuity contracts, are not subject to the minimum funding requirements if:

(1) such contracts provide for level annual premium payments to be made from the first day of an individual's participation on the plan, and from the time any increases in benefits become effective, not beyond the individual's retirement age;

34 Act § 304(b); Int. Rev. Code of 1954, § 412(f).
(2) benefits under the plan must be equal to the benefits provided by the individual contracts at normal retirement age and must be guaranteed by an insurance company licensed to do business in the state where the plan operates;

(3) premiums for all plan years must have been paid before there is a lapse, or the policy is reinstated;

(4) no rights under the contracts have been subject to a security interest; and

(5) no policy loans are outstanding at any time during the plan years.

A plan funded exclusively through group insurance contracts determined to have the same characteristics as individual contracts described above, are to be accorded similar exemption.\(^\text{35}\)

7. Excise Tax for Underfunding

Excise taxes are imposed on the employer for deficiencies in funding, unless a waiver is obtained.\(^\text{36}\) The initial tax is five percent of the accumulated funding deficiency at the end of the plan year and is imposed for each plan year in which the deficiency is not corrected. If the deficiency is not corrected within 90 days after the Internal Revenue Service mails a notice of deficiency with respect to the initial five percent tax, plus any extension of time that may be granted by the Service, the employer is subject to an additional tax of 100 percent of the accumulated funding deficiency. Such excise taxes are not deductible from gross income.

In the case of a collectively bargained plan, each employer's liability for the excise taxes is to be determined under regulations to be promulgated, on the basis of its failure to make contributions and its liability for contributions under the plan. The tax is imposed on those employers who are delinquent in their payments to the plan.

Special rules will also be provided for applying the excise tax to controlled groups of corporations.\(^\text{37}\)

8. Provisions for Deductions

Meeting the minimum funding requirements may necessitate contributions in excess of the usual deduction limitations. Accordingly, the Code has been amended,\(^\text{38}\) repealing the old five percent limitation and providing for a deduction equal to the greater of:

1. the amount necessary to satisfy the minimum funding standard, or

\(^{35}\) \text{Int. Rev. Code of 1954, § 412(i).}
\(^{36}\) \text{Int. Rev. Code of 1954, § 4971.}
\(^{37}\) \text{Int. Rev. Code of 1954, § 413(b).}
\(^{38}\) \text{Int. Rev. Code of 1954, § 404(a).}
(2) either of the following as applicable, consisting of:

(A) the amount necessary to provide all employees with their remaining unfunded past and current service credits, distributed as a level percentage of compensation, over the remaining future service of each employee, but at least five years if more than 50 percent of the total is required for any three individuals; or

(B) the normal cost of the plan, plus the amount necessary to amortize past service liabilities and other supplemental pension or annuity credits over ten years.

V. Conclusion

ERISA brought about important changes in many areas of deferred compensation. An attempt has been made here to describe merely the minimum standards for participation, vesting, and funding. These standards are designed to remedy the situations in which the greatest abuses have been found to exist and to provide new safeguards for employees by insuring them with at least the minimum benefits specified.