Pensions (1967 folder) ✓

PRIVATE PENSION PLANS

A Statement of NAM Position on Major Current Issues

NAM National Association of Manufacturers
Industrial Relations Department

This paper has been prepared by a Task Force of the NAM Employee Benefits Committee in response to growing proposals for further government regulation and control of private pension plans.

Industrial Relations Department
National Association of Manufacturers
277 Park Avenue, New York, N.Y. 10017

PRIVATE PENSION PLANS

A Statement of NAM Position on Major Current Issues

Private pension plans are making an important contribution to the retirement security of millions of Americans. In addition, pension funds are a significant source of the capital needed to sustain the continued growth of our economy. The National Association of Manufacturers seeks to encourage the expansion and improvement of private plans with their flexibility to adapt to the tremendously varied requirements of employers and employees.

Private pension plans have been in existence for many years, a number of them dating back more than fifty years. The greatest growth in these plans has occurred since 1940, spurred by union interest in negotiated pension plans and encouraged by the flexibility which has been permitted in private plans qualified under the Internal Revenue Code. In 1940, 3.7 million people were participants in private pension programs. Today the total is over 25 million. Since 1940, annual payments into private pension funds have increased from $3 million to an estimated $7 billion. Benefits paid have moved upward even more rapidly–from $1.4 million per year in 1940 to over $3 billion currently. Reserves in private pension funds are now estimated to exceed $90 billion.[1]

The growth of private pension plans has attracted increased attention to their role in the furnishing of retirement benefits. In spite of the growth in such plans and their many beneficial effects, they are currently being subjected to considerable critical review. While the pension plan system has become of such importance that examination of all its aspects is warranted, there is a danger that antagonistic or exaggerated criticism, no matter how well intentioned, can in itself weaken private pension plans and discourage their improvement and expansion.

It is the purpose of this paper to review the scope of present regulation of pension plans and to state briefly the position of NAM on a number of major issues raised by current proposals for further government regulation and control.

Present Regulation

Private pension plans have for many years been subject to a number of federal statutes and regulations. The rules relating to qualified pension plans are contained in the Internal Revenue Code and in Internal Revenue Service regulations and rulings. For a plan to be qualified, the regulations under the Internal Revenue Code now provide:

1. There must be a trust, contract, or other legally binding arrangement.
2. The plan must be in writing and communicated to employees.
3. There must be a permanent and continuing program.
4. The plan must provide definitely determinable benefits.
5. The plan must be for the exclusive benefit of employees and funds must not be used other than for the benefit of employees and their beneficiaries.
6. The plan must not discriminate in favor of officers or highly-compensated employees.
7. The funds must be held by an insurance company or a trustee acting under a properly constituted trust.
8. Funding must be within the minimum and maximum amounts established by regulations.

The Federal Welfare and Pension Plans Disclosure Act requires detailed reporting and disclosure of pension plan provisions and operations. It contains requirements for the bonding of administrators, prohibition of theft, embezzlement or concealment of facts, and it grants investigatory and rule-making authority to the Secretary of Labor coupled with penal sanctions for fraud, dishonesty, concealment or other willful violation. A new annual reporting form (D-2), effective December 31, 1966, has greatly expanded disclosure requirements.

Pension plans jointly administered by labor and management are subject to Section 302 of the Labor Management Relations Act, as amended by the Labor-Management Reporting and Disclosure Act, under which (1) payments must be held in trust for the exclusive benefit of the employees or their dependents, (2) the detailed basis on which payments are to be made must be specified in a written agreement, (3) employers and employees must be equally represented in administration, (4) there must be provision for a neutral person to break deadlocks and (5) there must be an annual audit which shall be available for inspection by interested persons. There are criminal penalties for willful violation, and federal courts are given jurisdiction to restrain violations.

In addition, various aspects of pension plans are regulated by federal and state laws covering banking, insurance, securities, disclosure, and trusts.

Beyond government regulation, rules recently adopted by the Accounting Principles Board of the American Institute of Certified Public Accountants, relating to such matters as accounting and actuarial cost methods, funding, and disclosure, will have an additional regulatory effect on corporate accounting for the cost of pensions.[2]

Position on Current Issues

Proposals relating to private pension plans, many of which arose out of discussions of the 1965 Cabinet Committee Report,[3] range from proposals for study of particular aspects of plans to suggestions that plans be required to contain specified benefit and funding provisions or be insured against termination.[4] There are even proposals that private plans be eliminated altogether.[5] The major issues raised by these proposals are discussed below.[6]

NAM believes that, in general, private pension plans are now subjected to adequate regulation and control. Additional government control, in the absence of proven need to correct a particular abuse, would be contrary to sound public policy because such control would reduce the important contribution being made by private plans to employees' retirement security and to capital formation.

Although some of the objectives sought by proponents of further pension plan regulation are worthy, there is serious question as to the wisdom of seeking to attain them by compulsion. Independence and flexibility are essential both in plans unilaterally established by employers and in those resulting from the collective bargaining process where pensions are intimately involved with other economic issues. To impose rigid formulas by law would discourage the establishment of new plans and increase the costs of present plans and, as explained below, would tend to do so at the expense of older workers. To meet the divergent needs and circumstances of various firms and industries and their employees, and to be consistent with concepts of a free economy, the widest possible latitude—subject, of course, to disclosure and prohibition of any dishonest practice—should be permitted in the establishment and operation of private pension plans.

Some proponents of more restrictive legislation have alleged that private pension plans receive favored tax treatment or a tax subsidy and, for that reason, should be controlled by government.[7] There are three tax aspects which apply to pensions. First, the employer's contribution is deductible as a business expense and constitutes an irrevocable payment solely for the benefit of employees. As a business expense, it is immaterial to the employer whether the amount is paid as a pension contribution or as wages. Such a deduction is no more a tax subsidy than is a deduction allowed for a wage payment. Second, taxing the employee only at the time he receives a benefit in cash is reasonable and far from a subsidy. In the case of wage compensation, the employee receives immediate spendable income in cash. Since the employee receives no current income when the employer makes a pension contribution, he is not and should not be taxed at that time. Clearly, no subsidy is involved here. Finally, while earnings on contributions to a qualified trust are not taxable to the trust, they are fully taxable as income to the beneficiaries when received by them. The treatment of private pensions thus follows a consistent rule of taxation. The rule is that the proper time to apply a tax is when income is received, just as the time to deduct an expense is when the expense is incurred. The forbearance of tax until income is received is a matter of tax timing, not of tax exemption. In any case, justification for additional regulation should be based on reasons relating to the subject matter involved rather than to tax factors.

Although many proponents of further regulation and control give as their objective the protection of employees' interests, most of their proposals would, for the reasons stated below, be adverse to the interests of employees and detrimental to the national economy.

Additional Disclosure and Audits

The Welfare and Pension Plans Disclosure Act requires that detailed information concerning pension plan operations be filed with the Department of Labor. The prescribed form (D-2) for such disclosure has recently been greatly expanded.

Adequate disclosure of pension plan operations is desirable, but a number of the proposals for further disclosure would unnecessarily burden plan administrators and the government agencies involved without serving any useful purpose.

The Advisory Council to the Secretary of Labor under the Disclosure Act, whose members represent insurance, banking, management, labor, and other interested groups, has unanimously recommended that: "The new D-2 Report Form be given an opportunity to prove itself before further burdening plan administrators, beneficiaries, and government agencies with a mass of additional regular filing of detailed data of a more marginal, generally less meaningful or of a less useful nature."[3]

All employee benefit funds which are not subject to periodic examination by insurance or banking regulatory agencies should, as recommended by the Advisory Council, be audited annually by independent certified public accountants.

Vesting

Vesting is the granting of a right to an employee, who has met a specified age or length of service requirement, to receive a pension benefit in the future upon reaching normal retirement age. There are a number of proposals which would require that every pension plan have a specified minimum vesting provision. The government Inter-Agency Staff Committee has, for example, proposed that every plan provide vesting aften ten years' service even though that "minimum" would equal the maximum generally applicable in even the most mature plans.[4]

Vesting provisions in private pension plans are desirable. The issue raised by several current proposals, however, is whether vesting, which is costly, should be required by law at the expense of more adequate regular plan benefits for older employees who are nearing retirement and other desirable plan features such as provisions permitting early retirement.

When a plan is being established, the primary concern is naturally to provide the best possible benefits for those employees who are close to retirement. As plans become more mature, vesting and other provisions which were not feasible when the plans were established are customarily added. As a result, over two-thirds of private pension plans now have vesting in some form. Vesting provisions are constantly being added and liberalized.[9] It does not follow, however, that anything which would be desirable as an employer determination or in labor-management negotiations should be made mandatory by legislation.

To impose mandatory vesting provisions by law would inhibit both the establishment of new plans and the expansion and improvement of existing plans, and would reduce desirable flexibility. It would take from employers and employees (who are in the best position to make a determination) the right and responsibility to decide whether available funds should be used for vesting provisions or for some other benefits, including other pension benefits.

Proponents of mandatory vesting sometimes argue that absence of vesting might restrict worker mobility. However, even though one purpose in establishing a private pension plan is to encourage employees to remain with their employer, such factors as compensation, seniority rules, working conditions, and the tendency for many reasons for an employee to remain in his home area are far more important restrictions on worker mobility.[10] It is unlikely that pension vesting, or the lack of it, is a material mobility consideration among younger employees to whom most vesting proposals would be applicable.

Portability

Portability would require that, upon termination of employment by an employee with vested benefits, assets equal to the value of his vested pension should be transferred to another pension plan, to a government fund, or to a central clearing house.

In addition to the fact that the portability proposal must assume mandatory vesting, which is undesirable, there are many other reasons why legislated portability would be even more undesirable. Vesting is increasingly prevalent and, to the extent that it exists, there is no real need for portability; employees who leave can be given a formal statement of the pension benefits they will be entitled to receive upon reaching retirement age.

Portability would ultimately require rigid regulation of private pension plans, describing incidents of funding, investment practices, actuarial assumptions and methods, and perhaps even uniform benefits.

Also, portability would create serious investment problems and would interfere with sound investment policies, because an employer might be required at any time to transfer funds out of his plan to another plan or to a central fund. It would be necessary to have funds invested in securities readily convertible to cash and thereby forego the consideration of long-term yield, which helps to reduce the cost of benefits or make higher benefits possible. No suggestion has been made which would overcome technical difficulties such as determining the present value of a vested pension transferred to another fund whose earning experience will inevitably be different.

Portability would force an employer to allocate funds to meet the portability obligations for his short-service employees who leave, which could adversely affect long-service employees who stay with him to retirement by reducing their retirement security and the funds available for them.

Portability would also duplicate record keeping and thereby add greatly to administrative costs.

Funding

Although advance or pre-retirement funding of future pension liabilities is desirable, a number of proposals have been made which would unduly increase the extent of funding required by law. The present Internal Revenue Service requirement with respect to minimum funding of a qualified plan is that unfunded costs cannot at any time exceed their initial amount at the time the plan was adopted, plus supplementary amounts added by subsequent plan amendments. This means that, in general, minimum funding must equal current service costs plus interest on past service costs. Even in years in which a company contributes at this minimum rate, the plan's financial solvency will be improved since for each such year payment of current service costs fully funds benefits accrued for that year. Compliance with the recent Accounting Principles Board Opinion[2] could well result in better pre-retirement funding.

Most corporate pension plans are funded in excess of minimum requirements, and studies indicate that most plans are adequately funded today. But narrowing further the amount of latitude permitted in funding by qualified plans would discourage the adoption or continuation of plans or benefit improvements.

Establishing a pension plan involves an obligation to pay benefits when due. The answers to when and how best to provide funds to meet that obligation will vary widely among companies, each of whose circumstances is different. The pension can be purchased from an insurance company or it can be provided through a trust. In determining the ultimate cost of pensions, numerous actuarial assumptions must be made, including assumptions as to mortality, turnover, levels of compensation and benefits, and anticipated earnings of the pension trust fund. To require by law that plans be funded in accordance with a rigid statutory method would necessitate the use of uniform assumptions and policies which would be inappropriate, unrealistic, and not applicable to any particular plan.

Insurance Against Plan Terminations

Various proposals have been made to establish a federal program to which all pension funds would be required to contribute and which would insure against a partial or complete termination of any pension plan in the event of business failure or unavailability of assets needed to pay plan benefits.

Any federal program to insure benefits under private pension plans would either fail or lead to drastic curtailment of the private pension plan system in this country. There are a number of reasons for this,[11] among which are the following:

(1) A business operation may terminate as a result of bankruptcy, seriously declining operations, or a decision to discontinue operations for any other reason. It would not be feasible to vary premiums appropriately with the risk of different businesses.

(2) Protection against losses on investments raises equally difficult problems. Pension costs would be greatly increased if plan administrators were restricted in their investments so as to make insurance against losses feasible. On the other hand, if they were not so restricted, administrators would be induced to take excessive risks because the insured losses would be subsidized by others.

(3) An essential element in any insurance is that the risk insured against be beyond the control of the insured. The insurance of pension expectations would be within the control of the insured in three important areas. First, the pension expectations are determined by the employer, either unilaterally or by agreement with a union, and especially at the outset are based on nothing more than a statement of intent. Even such an important matter as the crediting of service rendered prior to the establishment of the plan would be within the discretion of the insured. Second, the insured would determine in many instances whether a certain business operation will go out of existence. Thus, the insured could control both the establishment and the amount of insured liability, as well as the event which results in the payment of the liability. Third, the insured determines investment policy which would have an important bearing on the creation of insurance liability.

(4) Pension plan insurance would discourage adequate funding of private plans, and a lack of adequate funding would lead to a greater number of

terminations. As a result of the high cost of subsidizing the terminated plans, the soundness of the remaining plans would be reduced.

(5) In a pension plan insurance program, an attempt to overcome some of the foregoing objections would lead to pressure for fixed standards to measure the liability insured, to assure adequate funding and safe investment practices, and even to fix benefits. Such standards would not only fail to accomplish these purposes, but would be inappropriate and incorrect for any particular plan. They would remove the flexibility which is essential to the continued success of existing plans and to the establishment of new plans.

(6) Any comparison with federal bank deposit insurance is not valid because that insures assets in being, while pension benefits are to be paid in the future out of contributions which have not yet been made.

Fiduciary Responsibility

There is general agreement that administrators of pension funds should observe the highest standards of fiduciary responsibility. However, largely as a result of disclosure of some isolated cases of irresponsible management of labor-management welfare funds, a number of proposals for the enactment of federal fiduciary standards for pension and other employee benefit plans have been made.[12]

Clearly defined standards of fiduciary responsibility for all persons in control of employee benefit funds are desirable. A number of current proposals make it necessary, however, to emphasize that any federal fiduciary standards should not (1) cause confusion by inconsistency with the extensive existing body of federal and state trust law or the "prohibited transactions" rules of the Internal Revenue Service, (2) impair the ability of administrators to meet changing investment conditions, or (3) furnish the basis for control by government agencies of the plan provisions or investment policies of private plans.

It is also necessary to point out that federal standards of fiduciary responsibility should not impair the ability of profit sharing plans to invest most or all of their funds in stock of the employer corporation, since the purpose of such plans is to offer to employees an opportunity to share in the ownership of the company.

As the Advisory Council to the Secretary of Labor, referred to above, unanimously concluded: "If existing state law is inadequate and cannot be reasonably expected in the near future to provide assurance of enforcement of satisfactory fiduciary performance, a Federal statute setting forth a Federal fiduciary responsibility in the handling of the assets of welfare and pension plans should be enacted."

Specifically, the Council suggested that a so-called prudent man rule be considered: "Such a statute would specify that every organization or person who exercises any substantial control or authority with respect to any welfare or pension plan is a fiduciary and should be held accountable for discharging his duties with respect to such plans with at least the same degree of care and skill as a man of ordinary prudence." The Advisory Council recognized that special provisions applicable to banks and insurance companies might be required. The Council further noted its belief that "any Federal fiduciary responsibility statute should be appropriately enforced directly by court action" and that "there is sufficient legal precedent for the adequate enforcement of such a Federal statute within existing Federal court procedures and systems."[18]

Impact of Social Security

A. *Integration with private pension plans*

A private pension plan which takes into account, in calculating benefits, that an employee will receive part of his retirement benefits through Social Security is called an integrated plan. Such a plan may be qualified under the Internal Revenue Code if the total private and federal benefit provided by the employer is not greater as a percentage of pay for higher-paid employees than for lower-paid employees.

Internal Revenue Service regulations for many years provided that, based upon a number of assumptions, the value of the Social Security benefit not paid for by employee contributions is equal to a retirement benefit of 37½% of pay up to the $4,800 wage base in effect immediately prior to the Social Security Act amendments effective January 1, 1966, and that a private plan providing retirement benefits of up to 37½% of an employee's pay in excess of the wage base met the requirements of the Internal Revenue Code and was not discriminatory. This 37½% was converted to 1¼% for each year of service as the amount which could be provided on earnings above the wage base under plans in which the retirement benefit is related to length of service.

The Internal Revenue Service made a number of assumptions to arrive at the 37½% figure, one being that the portion of an employee's Social Security benefits attributable to his own contributions is 22%. Although retiring employees have in fact contributed about 12½% of their benefits, a proposal has been made that it be assumed that the portion of Social Security benefit attributable to an employee's own contributions is 50%.

In Treasury Announcement 66-58, published September 1, 1966, the Internal Revenue Service requested background information in developing a formula for integrating pension plans under the $6,600 Social Security wage base effective January 1, 1966. A mathematical formula contained in the Announcement demonstrated that the adoption of the 50% assumption, without offsetting changes in other assumptions, would reduce the 37½% to 24%.

The formula set forth in this Announcement would have had an adverse impact on integrated private pension plans by either requiring such plans to substantially reduce benefits to employees above the wage base, or to increase costs by increasing benefits to those below the wage base. Because of this impact upon existing plans and because of the deterrent effect on the establishment of new plans, the Treasury Department received over 2,000 written comments from employers, actuaries, and other interested parties, objecting to the proposed change in formula. Their position in general, with which NAM concurs, was that Treasury should retain a percentage at or near the historical 37½% and that a simple benefit approach should be taken which would not be related to ratios of Social Security taxes and thus create recurring threats to the stability of private pension plans.[14]

B. *Expansion of Social Security*

Social Security should be a broad, basic retirement system which is self-financing and related to past work experience. It should not serve as or be encumbered with welfare programs supported by general revenues. Social Security taxes should not be increased so as to weaken or destroy the private pension system. As a simple matter of cost, the portion of each dollar of sales or personal income which can be appropriated to deferred compensation is not without limit if the economy is to remain healthy. A continual rise in Social Security taxes as a percentage of employees' wages is not only a growing burden on employers and employees but would lead inevitably to a slowdown in the expansion of private pension funds and individual savings, both of which are essential elements in financing basic national economic growth.[15]

Conclusion

Along with Social Security as an earned basic retirement benefit financed by employer and employee contributions, private plans should be permitted to integrate benefits in the long-established manner which is neither discriminatory among employees nor prejudicial to the plans.

Private plans are already subject to regulations and disclosure requirements which, with proper enforcement, are adequate. Even if tax subsidy were a justification for control, no tax subsidy in fact exists. Pension contributions and benefits are treated in a manner consistent with broad tax policy and are taxed in accordance with the nature of the transactions involved.

It is clear that private pension plans provide a desirable layer of retirement security, together with Social Security and individual savings. The vigor and effectiveness of private plans are demonstrated by their remarkable growth during the past 25 years. Encouragement for new plans, adequate vesting and funding, and security of private plans are certainly desirable objectives. Progress toward reaching those objectives has been steadily maintained in the past. Progress will best be effected in the future through voluntary action by employers and labor-management negotiations, rather than through the establishment of rigid formulas, controls, or dictation of plan provisions by government.

Notes

[1]For a review of pension plan growth, see "Private and Public Pension Plans in the United States," Institute of Life Insurance, March, 1967. For estimates of pension plan growth in future years, see Daniel M. Holland, "Private Pension Funds: Projected Growth," National Bureau of Economic Research, 1966.

[2]"Accounting for the Cost of Pension Plans," Opinion No. 8, issued by the Accounting Principles Board of the American Institute of Certified Public Accountants, November, 1966.

[3]"Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans" by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, January, 1965.

[4]Address by Assistant Secretary of the Treasury Stanley S. Surrey before the American Pension Conference, May 11, 1967, outlining proposals by an Inter-Agency Staff Committee.

Congressional bills in the 90th Congress, including Yarborough (S.1024) and Perkins (H.R.5741), an Administration bill on fiduciary responsibility and disclosure;

Javits (S.1103), a comprehensive bill on numerous aspects of pension plans; Hartke (S.1635) to require insurance against plan terminations; McClellan (S.1255) on fiduciary responsibility and disclosure; and approximately twenty others.

[5] "Old Age Income Assurance: An Outline of Issues and Alternatives," Materials Prepared by the Staff for the Congressional Subcommittee on Fiscal Policy of the Joint Economic Committee, November, 1966.

[6] For more complete NAM statements on private pension plan proposals, see NAM Taxation Committee "Tax Treatment of Private Pension Plans" (printed in NAM Reports in Depth, September 20, 1965); "NAM Employee Benefits Committee Views on Proposals to Regulate Pension Plans" (printed in NAM Reports in Depth, October 18, 1965); "Statement of National Association of Manufacturers on S.1575, Federal Reinsurance of Private Pension Plans Act" submitted to Senate Committee on Finance, August 31, 1966; "Commentary by the National Association of Manufacturers on Materials Prepared by the Staff of the Joint Economic Committee, Congress of the United States, Entitled 'Old Age Income Assurance: An Outline of Issues and Alternatives' ", June 29, 1967, and numerous articles in NAM Reports.

Among many important statements by others on private pension plan issues are: "The Future of Pension Plans—An Employer's Viewpoint" by Russell H. Hubbard, Jr., Tax Foundation Inc., January, 1967; "Social Security and Private Pensions at the Crossroads: Crisis or Compromise," April, 1967, and "Private Pension Plans," June 1, 1967, Machinery and Allied Products Institute; "An Employer Looks at Current Proposals on Pension Fund Legislation," by Robert S. Lane, The Trust Bulletin, American Bankers Association, March, 1967; "The Five Year Federal Buildup of Pension Issues" by Andrew A. Melgard, Chamber of Commerce of the United States, June, 1967; "Private Pension Plans and Public Policy," an address by Robert C. Tyson before the Council of State Chambers of Commerce, September 13, 1967, and "Private Pension Plans and the Public Interest," Financial Executives Institute, October, 1967.

[7] For a complete discussion of this matter, see "The Myth of Special Tax Concessions for Qualified Pension Plans" by Raymond Goetz in Iowa Law Review, vol. 51, page 562.

[8] Advisory Council on Employee Welfare and Pension Benefit Plans, Recommendations to the Secretary of Labor Pursuant to Section 14(b) of the Welfare and Pension Plans Disclosure Act, contained in the 1966 Annual Report of the Secretary of Labor to Congress on the Administration of the Act, page 21.

[9] "Labor Mobility and Private Pension Plans," U.S. Department of Labor BLS Bulletin No. 1407, June, 1964;

"1965 Study of Industrial Retirement Plans," Bankers Trust Company.

[10] "Labor Mobility and Private Pension Plans," supra; Social Security Bulletin, March, 1967.

[11] See National Association of Manufacturers Statement on S.1575, supra, and testimony by Preston C. Bassett, Vice President and Actuary, Towers, Perrin, Forster and Crosby, Inc., and Jean M. Lindberg, Senior Vice President, Pension Trust Division, Chase Manhattan Bank, at Senate Committee on Finance Hearing, August 15, 1966.

[12] The President's Consumer Message to Congress, February, 1967, and Yarborough, Perkins, McClellan and Javits bills, supra.

[13] Advisory Council on Employee Welfare and Pension Benefit Plans, Recommendations, supra, page 20.

[14] Letter dated November 30, 1966, from National Association of Manufacturers to Commissioner of Internal Revenue.

[15] For complete statements by NAM on proposed changes in Social Security, see "Statement at Hearings before the House of Representatives Committee on Ways and Means, April 4, 1967," and before the Senate Committee on Finance, September 20, 1967.

5-501–IRD-G-1267-000

The National Association of Manufacturers is a voluntary organization of industrial and business firms, large and small, located in every state, which vigorously support principles that encourage individual freedom and which through the Association develop and engage in sound programs for the advancement of the economic well-being and social progress of the American people.

NAM action for a growing America