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QUALIFIED PLANS UNDER ERISA: TAX SHELTER OR BUREAUCRATIC PAPER CHASE?

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I. INTRODUCTION: THE IMPACT OF ERISA ON EMPLOYEE BENEFIT PLANS

The enactment of the Employee Retirement Security Act of 1974[1] has had a profound and far-reaching impact upon existing employee benefit plans and upon those which have since been created. ERISA, as the act is commonly designated, is a comprehensive federal statute with strong consumer protection overtones which sets up strict requirements for regulating most aspects of the operation and administration of private employee benefit plans. Its primary goals are: (1) to protect benefit rights and to provide retirement security for the participants of employee benefit plans by setting out minimum standards for nondiscriminatory participation, vesting, benefit accrual, and funding; (2) to regulate the fiduciary conduct of plan administrators and trustees; and (3) to create a government insurance program to protect the participants of certain benefit plans which terminate prematurely.[2] Responsibility for implementation and enforcement of these goals is shared by a number of federal agencies including the Department of Labor, the Internal Revenue Service, the ERISA-created Pension Benefit Guaranty Corporation, and the Securities and Exchange Commission.[3]

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1. Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C. §§ 1001-381 (1979)) [hereinafter cited as ERISA § ___, the section number corresponding to the act section number rather than to the section number in 29 U.S.C.].

2. ERISA § 2.

3. For a discussion of the administrative problems resulting from the overlapping jurisdiction, *see* Lee, *"The Elaborate Interweaving of Jurisdiction:" Labor and Tax Administration and Enforcement of ERISA and Beyond*, 10 U. RICH. L. REV. 463 (1976). The ERISA Reorganization Plan introduced by the Carter administration and approved by Congress in 1978 has offered a solution for reducing some of these problems. *See* Sollee & Shapiro, *Pension Plans—Qualifications*, 351 TAX MNGM'T (BNA) A-2 (1979 & Supp. 1980).

One of the principal objectives of ERISA is to prevent discrimination in favor of the so-called "prohibited group"—officers, shareholders, and highly compensated personnel—who might well, and often did prior to ERISA, set up plans which benefited themselves over, or to the exclusion of, the rank and file employees. As a means of preventing such discrimination and of encouraging the adoption of its other sweeping changes, Title II of ERISA initiated a massive amendment to the Internal Revenue Code. By changing the requirements for qualification of employee benefit plans under section 401(a) of the Internal Revenue Code,[4] Congress set compliance with ERISA's standards as the price for obtaining section 401(a)'s favorable tax benefits. This article will examine the effects of ERISA upon plan qualification and set out the requirements which the basic types of employee benefit plan must now meet to acquire the tax advantages conferred upon "qualified plans."[5] In addition, it will point out some of the major effects such compliance has had upon an employer's choice of plan.

II. Classification of Employee Benefit Plans

Section 401(a) of the Internal Revenue Code refers to three types of deferred compensation plans which have the potential to qualify for favored tax benefits: (1) pension plans; (2) profit-sharing plans; and (3) stock bonus plans. The Regulations of the Commissioner of Internal Revenue define the pension plan as follows:

> A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.[6]

The profit-sharing plan is defined by the Regulations as:

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4. Citations are to the Int. Rev. Code of 1954 as amended [hereinafter cited as I.R.C. § __ or referred to as the Code].

5. There are several types of qualified plans under the Code other than those set out in I.R.C. § 401(a) which will not be discussed directly in this paper, although much of the discussion may be applicable to them. Aside from the pension, profit-sharing, and stock-bonus plans covered in I.R.C. § 401(a), there are annuity plans in § 403(a), bond purchase plans in § 405, Individual Retirement Accounts (IRA's) in § 408, and Employee Stock Ownership Plans (ESOP's) in § 409A.

6. Treas. Reg. § 1.401-1(b)(1)(i) (1976).

> a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.[7]

The third type of plan, the stock bonus plan is described as:

> a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.[8]

A comparison of these three definitions reveals that for most purposes, retirement plans that qualify for favored tax benefits may be classified as either pension plans or profit-sharing plans.

Although these two classifications were sufficient for pre-ERISA discussions of the law regarding qualification, ERISA introduced new terminology which, although not eliminating the Code's traditional classification, requires some explanation. In the definitional section of Title I, ERISA distinguishes between employee welfare benefit plans,[9] which include such non-retirement benefits as medical, hospital, accident, unemployment, and vacation benefits, and employee pension benefit plans,[10] which include any plans providing deferred compensation or retirement income to employees. Pension plans are further subdivided into two groups: (1) defined contribution plans and (2) defined benefit plans. A defined contribution plan is defined similarly in Title I of ERISA[11] and in the

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7. *Id.* § 1.401-1(b)(1)(ii).
8. *Id.* § 1.401-1(b)(1)(iii).
9. ERISA § 3.
10. *Id.* § 3(2).
11. *Id.* § 3(34).

Code[12] as "a [pension] plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and forfeitures of accounts of other participants which may be allocated to such participant's account." Thus, under this plan, there is no promise of a definite, fixed benefit to be received upon retirement; the participant will simply receive his account balance. As a result, defined contribution plans do not have to be bound to a fixed, mandatory contribution year after year and there is considerable flexibility. The payment of contributions may be conditioned upon the existence of earnings and profits so that the employer's contribution will vary from year to year or possibly even be omitted during a year in which there are no earnings or profits. Profit-sharing plans, money-purchase pension plans, and stock bonus plans are all defined contribution plans.

On the other hand, a defined benefit plan is simply any plan which is *not* a defined contribution plan.[13] It is, therefore, any benefit plan which defines from the outset the amount of benefits it will pay to the plan participants upon their retirement. The employer then contributes whatever is necessary to provide that benefit, basing his funding upon actuarial assumptions and plan experience. Annual contributions in the proper amounts are mandatory. Funding less than the mandatory amount will result in the imposition of penalties upon the employer.[14] This category includes pension plans and annuity plans which promise a specific benefit to the participants. There are also hybrid plans such as the target or assumed benefit plan and thrift and savings plans. These may be treated as defined benefit plans in some respects and as defined contribution plans in other respects. Similarly, the money purchase pension plan, although classified as a defined contribution plan because of its resemblance to a profit-sharing plan, is actually treated as a defined benefit pension plan for purposes of minimum funding requirements.

12. I.R.C. § 414(i).
13. *Id.* § 414(j); ERISA § 3(35).
14. For a discussion of the minimum funding standards and penalty taxes, *see* note 68 *infra* and accompanying text.

Although the lines between these classification systems are occasionally blurred, especially with respect to the hybrid plans, for the purposes of illustrating the basic rules governing plan qualification, it is helpful to use the pension plan as representative of the defined benefit plan and the profit-sharing plan as illustrative of the defined contribution plan. Knowledge of the classifications is not merely an aid for convenience of discussion, however, for many issues such as those involving the deductions for contributions, limitations on contributions and benefits, and funding will turn upon the category into which a plan fits.

III. Advantages of Attaining Qualified Plan Status Under Section 401(a)

Employee benefit plans are either qualified under I.R.C. section 401(a) or they are not. Before the particular qualification requirements are detailed, it is necessary to understand the consequences of achieving qualified plan status as such an understanding is crucial to choosing the most beneficial plan for a client.

The advantages of securing a plan's qualification are tax-related. The employer receives a deduction on his current income tax return for the contribution made during that year to the plan's trust.[15] There are statutory limits set on the amount which may be deducted by the employer in a given year.[16] Although such contribution to an employee is in the nature of compensation, the contribution, as well as any earnings on it, can be accumulated tax-free until the time of distribution[17] when the employee is usually in a lower tax bracket. The income tax impact of a lump sum distribution from a qualified plan may be lessened by utilization of special ten-year-forward averaging rules,[18] although a portion of the distribution may be treated as long term capital gains.[19]

If an employee participant makes an irrevocable election to have an annuity or other benefit payment made upon his death to a des-

15. I.R.C. §§ 404(a), 501(a).

16. *Id.* § 404(a)(1)-(3). For a discussion of the limits set on deductions, *see* note 46 *infra* and accompanying text.

17. *Id.* § 402(a)(1), 501.

18. *Id.* § 402(e)(1)(c).

19. *Id.* §§ 402(a)(2), 403(a)(2).

ignated beneficiary, there will be no gift tax consequences to the extent that the value of the annuity or other payment represents his employer's contributions to the plan.[20] Under section 101(b)(2)(B) of the Code, up to $5,000 of death benefits payable in a lump sum from a qualified plan are excluded from the beneficiary's income tax.

There is also preferential estate tax treatment of death benefits from qualified plans. Benefits constituting the employer's contribution which are unpaid at the employee's death, are payable to a beneficiary rather than to the employee's estate, and in a form other than a lump sum distribution are excluded from the deceased employee's gross estate.[21] If the death benefits are payable in lump sum form, estate tax exclusion may still be obtained provided the beneficiary elects to include the distribution in his gross income for income tax purposes and foregoes the benefits of ten-year-forward averaging.[22]

The tax advantages of a qualified plan to both the employer, the employee and his beneficiaries are obviously highly desirable; but, in selecting an appropriate plan the employer must balance these benefits against the restrictions, the high cost, and the administrative burden that satisfaction of the qualification requirements will impose upon him. In terms of his specific goals he will have to decide if the price is appropriate for the benefits he is to realize in return.

IV. Requirements of Qualification Under Section 401(a)

Section 401(a) of the Code sets out specific, formal requirements for qualification which are common to all plans whether profit-sharing, pension, stock-bonus plans or hybrids. Application of some of these requirements may vary, depending on whether the particular plan in question is classified as a defined contribution or

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20. *Id.* § 2517(a).
21. *Id.* §§ 2039(c), 2517(b).
22. *Id.* § 2039(f). For a comprehensive treatment of the income, estate, and gift tax consequences of lump sum distributions, *see* Mezzullo, *The Taxation of Distributions from Qualified Employee Benefit Plans*, 11 U. Rich. L. Rev. 233 (1977). *See generally* Damico, *Qualified Plans—Taxation of Distributions*, 370 Tax Mngm't (BNA) (1978 & Supp. 1980).

defined benefit plan.[23] Some of these requirements were established in the Code prior to ERISA; others have been modified or added by ERISA.[24] The following is a discussion of the more significant requirements.

A. *Basic Rules Regarding Form and Purpose of the Qualified Plan*

A qualified plan must be in the form of a definite written program which is established and maintained by the employer, communicated to the participants,[25] and intended as a permanent plan.[26] As a part of this plan which is to be operated for the exclusive benefit of the employees or their beneficiaries, there must be a qualified trust created or organized and maintained in the United States. The purpose of the trust is to receive and accumulate the employer's contributions and distribute corpus and income solely in accordance with the plan as a means of providing nondiscriminatory benefits upon retirement, death, disability, or other separation from service. Diversion of trust assets for purposes other than the exclusive benefit of the employees or their beneficiaries is prohibited, and benefits provided under the plan may not be assigned or alienated. A qualified plan must also assure the preservation of previously accrued benefits in the event of a merger or plan consolidation, and there are restrictions on forfeitures of contributions.[27]

There are also rules governing the timing and form of benefit payments from qualified plans. The plan must provide that unless the participant elects otherwise, benefits will begin not later than the sixtieth day after the close of the plan year in which the latest of these events occurs: (1) the participant reaches age 65 (or the plan's normal retirement date if other than 65); (2) ten years have elapsed from the time the participant began his participation in

23. There are additional qualification requirements for plans of employers with unincorporated businesses or subchapter S corporations or for plans which have been collectively bargained for or are maintained by more than one employer. For a survey of these areas, *see* CANAN, QUALIFIED RETIREMENT PLANS §§ 5.1-6.5 (1977 & Supp. 1979).

24. For a breakdown of pre-ERISA and post-ERISA requirements, *see* R. BILDERSEE, PENSION REGULATION MANUAL § 1.4 (rev. ed. 1979).

25. Treas. Reg. § 1.401-1(a)(2).

26. *Id.* § 1.401-1(b)(2).

27. I.R.C. § 401(a); Treas. Reg. §§ 1.401-1(a), -1(a)(3), -1(b)(4).

the plan; or (3) the participant terminates his service with the employer.[28] If a plan provides for the payment of benefits in the form of an annuity, the annuity benefits to a married participant must be in a "form having the effect of a qualified joint and survivor annuity"[29] unless the participant elects otherwise. There are additional stipulations pertaining to joint and survivor annuities which must be carefully followed to ascertain which plans may safely omit this benefit without jeopardizing qualification.

Some of the most stringent requirements imposed upon qualified employee benefit plans by section 401(a) are those involving nondiscrimination, participation, vesting, benefit accrual, funding, and limits on contributions and benefits. These areas deserve a more detailed analysis.

B. *Nondiscrimination Provisions*

The most important and pervasive of the requirements for qualification is that a plan must not discriminate in favor of officers, shareholders, or highly compensated employees either in terms of participation in the plan[30] or in terms of contributions and benefits made available to the participants.[31] There are no specific definitions for "officers, shareholders, or highly compensated employees." Employee status is a factual matter determined on a case by case basis. To determine whether an employee is highly compensated, one must consider the level of his compensation in relation to the compensation paid the other employees, whether covered by the plan or not.[32] Meeting the numerous requirements established to prevent favoritism toward the so-called "prohibited group" usually results in broader coverage and substantially greater contributions than might be the case under a non-qualified plan in which benefits can be designed entirely for such individuals to the exclusion of the rank and file employees. This is where the employer will have to judge whether the tax advantages of the qualified plan

28. I.R.C. § 401(a)(14); Treas. Reg. § 1.401(a)-14(a); ERISA § 206(a).
29. I.R.C. § 401(a)(11)(A); Treas. Reg. § 1.401(a)-11(a)(1); ERISA § 205(a).
30. I.R.C. § 401(a)(3); Treas. Reg. § 1.401-3.
31. I.R.C. § 401(a)(4); Treas. Reg. § 1.401-4.
32. Treas. Reg. § 1.410(b)-1(d)(1). Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390 (2d Cir. 1968) although a pre-ERISA case, gives insight into the factors considered.

justify the costs of meeting these requirements. To make such decisions he must have his objectives clearly in mind.

C. *Participation and Coverage Standards*

Under the minimum participation standards set out in I.R.C. section 410, with which I.R.C. section 401(a)(3) requires compliance, there are strict age and service rules as well as tests to determine which employees may be excluded without having the plan risk disqualification for discrimination. A qualified plan is not required to cover all of the company's employees, but it must pass certain tests designed "to insure that the plan will benefit a broad cross section of employees and therefore serve the social goal of enhancing adequate retirement security for employees at all income levels."[33] Section 410(b)(1) provides two tests: the mathematical test and the classification test. The mathematical or percentage test is met if (1) 70% or more of all employees are plan participants or (2) 70% or more are eligible to participate and at least 80% of those eligible do in fact participate. If neither of the percentage tests can be met, it is still possible for the plan to meet the overall participation standards by passing the classification test in I.R.C. section 410(b)(1)(B). This is a subjective test which is satisfied if the employer can demonstrate to the Internal Revenue Service that the classification under his plan does not in fact discriminate in favor of the prohibited group. The coverage requirements for either of these tests will be satisfied if the plan meets such requirements on at least one day in each quarter of the tax year.[34] Each of these tests must include all employees of corporations or trades or businesses which are members of a controlled group of corporations.[35] Entities under common control will be treated similarly.[36]

Certain employees may be excluded before the percentage and classification tests are applied. Union employees qualify for exclu-

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33. Canan & Rhodes, *Minimum Participation Standards and Coverage Requirements*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT-SHARING PLANS, 73, 86-87 (1977 & Supp. 1979).

34. I.R.C. § 401(a)(6); Treas. Reg. § 1.401-3(g).

35. I.R.C. § 414(b); Treas. Reg. § 1.414(b)-1.

36. I.R.C. § 414(c).

sion provided the employer can show that retirement benefits were the subject of good faith bargaining with the union's employee representatives,[37] or as in the case of airline pilots, if they are covered by a collectively bargained plan.[38] Employees who are nonresident aliens and who receive no earned income from sources within the United States may also be excluded.[39] Employees who have not satisfied the plan's minimum age and service requirements for participation are excluded from the percentage test calculations but are not excluded from the classification test.[40]

The minimum age and service rules state generally that a qualified plan may not exclude an employee from participation in the plan solely on the basis of age or service if he is at least 25 years old and has completed at least one year of service. A plan may, however, require three years of service and the reaching of age 25 if the plan provides for full and immediate vesting for its participants.[41] There are special minimum age rules for plans which provide exclusively for employees of educational institutions.[42] If there are minimum participation requirements, such as for age and length of service, the general rule requires that the employee must be admitted into the plan at the earlier of (1) the first day of the plan year after he has satisfied the participation requirements or (2) the date six months after the date on which he satisfied such requirements.[43]

The maximum age rules must be carefully noted as they can provide traps for the unwary. In general, there can be no maximum age at which an employee is excluded from participation in defined contribution plans. In defined benefit plans and target benefit plans, however, an employee initially hired within five years of a stated normal retirement date may be excluded. But if the normal

37. I.R.C. § 410(b)(2)(A); Treas. Reg. § 1.410(b)-1(c)(1). An affidavit from the president must be submitted to the I.R.S. to substantiate the good faith bargaining. For purposes of the exclusion it does not matter whether or not the bargaining resulted in any employer-supported retirement benefit program for the union employees.

38. I.R.C. § 410(b)(2)(C); Treas. Reg. § 1.410(b)-1(c)(3).

39. I.R.C. § 410(b)(2)(B); Treas. Reg. § 1.410(b)-1(c)(2).

40. I.R.C. § 410(b)(1)(A) and (B); Treas. Reg. § 1.410(b)-1(b)(1) and (2).

41. I.R.C. § 410(a)(1)(A) and (B); Treas. Reg. § 1.410(a)-3(a)-(b). For a discussion of vesting, *see* notes 60-64 *infra* and accompanying text.

42. I.R.C. § 410(a)(1)(B)(ii); Treas. Reg. § 1.410(a)-3(c).

43. I.R.C. § 410(a)(4); Treas. Reg. § 1.410(a)-4(b).

retirement date under such a plan is after ten years of service rather than at an age limit, the employee cannot be excluded from the plan.[44]

For purposes of determining the eligibility of employees to participate in a given plan, the plan drafter must pay particular attention to the Code's definitions of "hours of service," "years of service," and "breaks in service," as well as to the methods for measuring service and keeping proper records.[45] The formal written plan must provide these definitions as well. ERISA utilizes such rules to prevent discrimination against those persons who might otherwise be excluded from participation. For example, an employer could classify some workers as part time when in fact they had worked at least 1000 hours during a twelve month period which, under the Code and ERISA, would require the crediting of a full year's service.

D. *Limitations on Contributions and Deductions*

Section 401(a)(4) prohibits contributions and benefits which discriminate in favor of the prohibited group of employees. As a means of regulating against such discrimination section 2004 of ERISA established new overall limitations on the amount which can be contributed to and the amount which can be distributed from qualified plans. Section 415 of the Code, which sets out these restrictions, differentiates between defined benefit plans and defined contribution plans in imposing the limitations and establishes special rules for employers who offer more than one type of plan to their employees. If the limitations are exceeded, the plan is disqualified[46] and the plan's trust loses its tax exempt status under section 501(a) of the Code.

For a defined benefit plan, the highest annual benefit which can be paid out to a participant is the lesser of $75,000 or 100% of the

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44. I.R.C. § 410(a)(2); ERISA § 202(a)(2). *See also* the examples in Treas. Reg. § 1.410(a)-4(a). For further discussion, *see* BILDERSEE, *supra* note 24, at § 2.3.

45. I.R.C. § 410(a)(3), (5); Treas. Reg. § 1.410(a)-5(a) and (c); ERISA § 202. For further discussion, *see* BILDERSEE, *supra* note 24, at §§ 2.5 and 2.6; CANAN, *supra* note 23, at § 8.4; Offer, *Crediting Service* in INTRODUCTION TO QUALIFIED PENSION AND PROFIT-SHARING PLANS, 141 (1977 & Supp. 1979).

46. I.R.C. § 415(a)(1).

participant's average compensation for his three highest paid years of service.[47] The $75,000 figure is adjusted annually to reflect post-1974 cost of living increases; for 1980 the amount is $110,625.[48] The annual benefit limitation is based upon a benefit payable in the form of a straight life annuity with no incidental benefits provided. To the extent that a defined benefit plan provides for incidental benefits, the limits above will be reduced actuarially to reflect the increased benefits provided.[49] There are exceptions for defined benefit plans which have retirement benefits not in excess of $10,000 for a given plan year;[50] other exceptions to the benefit limitation are provided in I.R.C. section 415, as amended.[51]

The limitations on the amount which can be deducted under I.R.C. section 404 are: a defined benefit plan may deduct the amount necessary to satisfy the minimum funding standards imposed under I.R.C. section 412(a), in addition to any amount representing the normal cost of the plan, plus other adjustments for past and current service credits.[52]

Under a defined contribution plan, the "annual additions" to a participant's account cannot exceed the lesser of 25% of the participant's compensation or $25,000.[53] The $25,000 is adjusted each year to reflect cost of living increases; in 1980 the ceiling is $36,875.[54] "Annual additions" mean that all of the following are considered in arriving at the total, which is subjected to the above limitations: (1) the employer's contributions, (2) the lesser of (a) the amount by which the employee's contributions, if any, exceeded 6% of his compensation, or (b) one half of the employee contributions, and (3) forfeitures allocated to the participant.[55]

If am employer maintains two defined benefit plans or two defined contribution plans for the same employees, the two plans are treated as one for purposes of the overall contribution limitations

47. *Id.* § 415(b)(1).
48. *Id.* § 415(d)(1)(A); [1980] 3 PENSION PLAN GUIDE (CCH) ¶ 17,095R.
49. I.R.C. § 415(b)(2)(A) and (B).
50. *Id.* § 415(b)(4).
51. *Id.* § 415(b)(7).
52. *Id.* § 404(a)(1)(A).
53. *Id.* § 415(c)(1).
54. *Id.* § 415(d)(1)(B); [1980] 3 PENSION PLAN GUIDE (CCH) ¶ 17,095R.
55. I.R.C. § 415(c)(2).

set out above. Should an employer adopt a combination of one defined benefit and one defined contribution plan, there are special rules. In such a situation the sum of the defined benefit fraction and the defined contribution fraction, as defined in I.R.C. section 415(e)(2) and (3), may not exceed 1.4.[56]

The limitations on deductions under I.R.C. section 404 for defined contribution plans are not uniform. Although a non-contributory money purchase pension plan may deduct 25% of compensation paid to the plan (reduced accordingly if the plan is integrated with social security),[57] profit-sharing and stock bonus plans are limited to a deduction of 15% of the total compensation paid to their plan participants as a group.[58] A profit-sharing plan which had no specific contribution formula would have no deduction in a year in which its sponsor made no plan contribution because there were no earnings and profits.

Although section 401(a)(4) prohibits discrimination in contributions and benefits in favor of the prohibited group, I.R.C. section 401(a)(5) provides that certain classifications of employees will not be considered discriminatory within the meaning of section 401(a)(4) or section 401(b). An example of such a classification would be a plan which is integrated with social security. The rules for integrating a plan with social security are extremely complex, especially for defined benefit plans. The discussion here is limited to setting out the basic concept which is less complex than actual plan implementation in many cases.[59] In essence, integration allows the employer to get credit for the F.I.C.A. taxes he has already paid for each plan participant when he computes the allocation of his contribution among his participants. In 1980 an employer will contribute an amount equal to 6.13% of an employee's wages up to a ceiling of $25,900. As an example of one method of integration, a profit-sharing plan's contribution for 1980 could be allocated first to the participants whose salary exceeded the $25,900 wage base up

56. *Id.* § 415(e)(1); ERISA § 2004(k)(3).

57. For a discussion of integration, see note 59 *infra* and accompanying text.

58. I.R.C. § 404(a)(3)(A).

59. *See* Rev. Rul. 71-446 or [1971] 4 PENSION PLAN GUIDE (CCH) ¶ 19,093 for the basic rules. For a detailed discussion of integration of social security with qualified plans, *see* Woyke & Field, *Qualified Plans—Integration,* 356 TAX MNGM'T (BNA)(1978 & Supp. 1980) CANAN, *supra* note 23, at § 10.2, 10.3.

to the allowed maximum of 7% of that compensation which was in excess of $25,900. Allocation of the balance of the contribution would then be made to all participants in direct proportion to the total compensation each received for that year. Section 401(a)(5) of the Code provides that such a means of adjusting contributions is not discriminatory under the dictates of I.R.C. section 401(a)(4) even though its use does provide a means of maximizing benefits for highly compensated employees. This is considered not to be prohibited discrimination because the benefits for higher paid employees are not disproportionate to benefits for lower paid employees where the plan and social security are combined.

E. *Minimum Vesting Standards and Benefit Accrual Requirements*

Once an employee becomes eligible to participate in his company's plan and contributions are made either by him or on his behalf by his employer, or both, the employee begins to build up "accrued benefits" in the plan. Depending upon the schedule selected by the plan, he will gradually become "vested" in his accrued benefits as he builds up years of service with the company, meaning that his right to a percentage of the contributions which have been made over the years becomes nonforfeitable. If the employee leaves the company at any given time, the employer would be able to determine exactly what benefits, if any, are due him. As a further means of preventing discrimination which is forbidden under I.R.C. section 401(a)(4), section 401(a)(6) requires that the minimum vesting standards set out in section 411 must be satisfied in order for the plan's trust to qualify for tax exemption.

Section 411(a)(2) contains three alternative minimum vesting schedules for employer contributions to the plan: (1) 10-year vesting, (2) 5-to-15 year vesting, and (3) the "rule of 45."[60] Under the 10-year vesting or "cliff vesting" schedule, there is no vesting until an employee has been with the company for ten years at which point he is 100% vested in his accrued benefit. The 5-to-15 year schedule provides that an employee is 25% vested after five years of service and becomes vested in an additional 5% for each year

60. ERISA § 203. For a discussion of vesting *see* Mamorsky, *Vesting under ERISA*, 25 PRAC. LAW. 57 (March 1979); Bildersee, *supra* note 24, at §§ 3.1-3.13.

thereafter. After having been employed for 15 years, he is 100% vested. Under the "rule of 45" schedule, a participant who has completed at least five years of service must become vested in a certain percentage as soon as the sum of his age and his years of service equals or exceeds 45.

Section 411(d)(4) sets out a fourth schedule known as class year vesting. Under this schedule, an employer contribution made in one year becomes vested in the employee to a certain percent in each of the subsequent years and 100% vested in that contribution not later than the fifth year after the plan year for which the contribution was made. The class year schedule may be used only for those profit-sharing, stock bonus, or money purchase plans which provide for the separate nonforfeitability of the employee's right to employer contributions for each plan year.

If a plan complies with one of these minimum vesting schedules, section 411 provides that it will not be treated as violative of the antidiscrimination rules unless there has been a demonstrated pattern of abuse (*i.e.*, firing to avoid vesting) or an excessive turnover of lower paid employees whose forfeited benefits accrue to the prohibited group. In such cases of abuse, the Internal Revenue Service can impose a stricter vesting schedule on a plan. Although presumably the Service could impose 100% vesting, it has indicated that at least for purposes of determination letters, it will not impose a schedule more stringent than "4-40 vesting."[61] This schedule, which does not appear in the Code, requires 40% vesting after four years of service with 5% increases for each of the next two years, and 10% increases for each of the next five.

Section 411 also contains definitions and rules for determining how service is to be calculated for vesting and accrual purposes and acceptable bookkeeping methods to which an employer must subscribe.

The vesting schedules set out above apply only to the benefits derived from employer contributions to the plan. Section 411 also requires that benefits derived from the employee's contributions, if a plan provides for such, be 100% vested at all times if a plan is to

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61. *See* Rev. Proc. 75-49 and its amendments in Rev. Proc. 76-1, -11; Tamko Asphalt Products, Inc. v. Comm., 71 T.C. 824 (1979).

qualify. Bookkeeping is facilitated in defined contribution plans which maintain a separate account for each employee's contributions and an account for the employer's contributions as to that employee.[62] To solve the bookkeeping problem for defined contribution plans which commingle the employee and employer contributions, a formula is set out in the Code to properly allocate accrued benefits between the employer and employee contributions.[63]

Since separate accounts are kept for each defined contribution plan participant, determining accrued benefits for a participant at any point during his employment is merely a matter of looking up the balance in his account. In a profit-sharing plan, for example, a participant's accrued benefit would be the amount of contributions in his plan account adjusted for the gains, losses, and expenses attributable to it.[64] The extent to which he is vested in his accrued benefit will of course depend on the vesting schedule his plan has adopted and on the number of years of service with which he has been credited.

Section 411(a)(3) permits certain exceptions to the vesting rules within a given plan. For example, although many employers elect not to do this, a plan may provide that if a participant dies prior to reaching retirement, the accrued benefit derived from the employer's contribution may be completely forfeited; however, there can be no forfeiture of any survivor annuity payable in accordance with section 401(a)(11). There are other exceptions related to the suspension of benefits upon the rehiring of a retired participant, the retroactive effect of plan amendments, the withdrawal of mandatory employee contributions, and the limitations of benefits payable to the highest twenty-five employees in cases where a defined benefit plan terminates within ten years of its creation.

The determination of accrued benefits under defined benefit plans is not as simple as it is for defined contribution plans. Complex actuarial computations are necessary. Because there was potential here for discrimination by "backloading" *i.e.*, delaying benefit accruals until after an excessively long period of employment,[65]

62. I.R.C. § 411(b)(2)(A); Treas. Reg. § 1.411(c)-1(b)(1).
63. I.R.C. § 411(c)(2)(A)(ii); Treas. Reg. § 1.411(c)-1(b)(2).
64. I.R.C. § 411(c)(2)(A)(i); Treas. Reg. § 1.411(c)-1(b)(1).
65. Emering, *Accrual of Benefits* in INTRODUCTION TO QUALIFIED PENSION AND PROFIT

section 2004 of ERISA amended the Code by requiring that qualified defined benefit plans subscribe to one of the three methods for determining benefit accruals set out in section 411(b)(1): (1) the 3% Method, (2) the 133⅓% Method, or (3) the Fractional Rule. Under the 3% Method, the accrued benefit cannot be less than 3% of the normal retirement benefit (assuming plan entry at the earliest possible time and retirement at 65 or other normal retirement age under the plan) times the number of years of plan participation not in excess of 33 ⅓%.[66] The 133 ⅓% Rule states that the accrual rate for any given plan year cannot be more than 133 ⅓% of that for any other plan year.[67] With the Fractional Rule, which is the simplest of the three to compute, the accrued benefit must be the benefit the participant would have received had he reached normal retirement age, multiplied by a fraction, the numerator of which is actual years of participation in the plan, the denominator of which is the total years he would have had if he had participated until retirement.[68]

Although this is a simplified description of the computations required to determine accrued benefits, it should be clear that the bookkeeping chores for defined benefit plans can be time consuming and expensive as compared with those required for defined contribution plans.

F. *Minimum Funding Standards*

As part of its overall objectives to protect benefit rights and provide retirement security for the participants of employee benefit plans, ERISA added section 412 to the Code. Section 412 establishes minimum funding standards to assure that plans which are subject to these standards have accumulated sufficient funds to pay out the benefits they have promised to pay their participants upon retirement. The minimum funding standards apply to defined benefit plans and to money purchase pension plans as well as to other plans which have fixed or determinable future benefits

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SHARING PLANS, 129 (1979).

66. *Id.* at § 411(b)(1)(A); Treas. Reg. § 1.411(b)-1(b)(1).

67. I.R.C. § 411(b)(1)(B); Treas. Reg. § 1.411(b)-1(b)(2).

68. I.R.C. § 411(b)(1)(C); Treas. Reg. § 1.411(b)-1(b)(3). For a detailed discussion of benefit accrual, *see* BILDERSEE, *supra* note 24, at §§ 3A.1.1-3A.0.

whether or not they are qualified plans. Individual account plans such as profit-sharing and stock bonus plans are specifically excluded from meeting these requirements as are defined benefit plans whose benefits are covered entirely by individual insurance contracts for each participant.[69]

In essence, section 412 requires the employer's contribution to a plan to include not only the normal costs of the plan, but also an amount sufficient to amortize past service costs, liabilities, and experience losses. The complex calculations require the annual service of an actuary, an added expense to the plan sponsor. The plan must set up and maintain a "funding standard account"[70] which operates on a system of debits and credits. Each year the account is charged with the amounts necessary to meet the minimum funding standard; the account is credited with the contributions made to the plan plus any decreases in liabilities, any experience gains, and any waived funding deficiency obtained for that year.[71] If at the end of any plan year, the account balances or shows a plus, the minimum funding standards have been met. If, however, there is a deficit, the employer has an "accumulated funding deficiency"[72] and may be subject to a penalty excise tax of 5% of that amount.[73] If the deficiency is not corrected within ninety days after mailing of the deficiency notice, a further tax equal to 100% of the accumulated funding deficiency is assessed to the extent that the amount has not been corrected.[74] Such excise taxes are not deductible.[75]

An alternative minimum funding standard is available in cases where a plan's contributions are at least equal to those required under the "entry age normal funding method,"[76] *i.e.*, the method used primarily by self-insured plans. The alternative standard has

69. I.R.C. § 412(i). CANAN, *supra* note 23, at §§ 12.1-12.8 contains a helpful review of the minimum funding standards. *See also* Emering, *Actuarial Cost Factors and Description of Funding Methods*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT-SHARING PLANS, 245 (1977 & Supp. 1979).

70. I.R.C. § 412(b).

71. *Id.* § 412(b)(2)-(3).

72. *Id.* § 412(a)(2).

73. *Id.* § 4971(a).

74. *Id.* § 4971(b) and (c).

75. *Id.* § 4971(e).

76. *Id.* § 412(g)(1).

its own rules for debiting and crediting the alternative minimum funding standard account,[77] although the employer must still maintain a regular funding standard account in case the plan decides to return to the basic funding standard if the alternative standard proves more expensive.

Provisions under the Code allow an employer to apply to the Internal Revenue Service for a waiver of the funding requirements where he can demonstrate his inability to meet the minimum standards without incurring substantial business hardship and an adverse effect on the plan participants. Such waivers shall not be granted for more than five of any fifteen consecutive plan years for any given employer.[78]

G. *Plan Termination Insurance*

As a means of insuring benefit plan participants and their beneficiaries against loss of accrued benefits arising from complete or partial termination of a plan, ERISA created the non-profit Pension Benefit Guaranty Corporation (PBGC),[79] a federal agency established within the Department of Labor. The general purposes of the PBGC are:

> (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants;
> (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this title applies, and
> (3) 'to maintain premiums established by the corporation under section 4006 at the lowest level consistent with carrying out its obligations under this title.[80]

Not all employee benefit plans are covered under the PBGC although its authority extends beyond the qualified plans which are the focus of this discussion. Generally, all defined benefit pension

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77. *Id.* § 412(g)(2).
78. *Id.* § 412(d)(1).
79. ERISA § 4002(a). For a more detailed discussion of this area, see CANAN, *supra* note 23, at §§ 19.1-.11.
80. ERISA § 4002(a)(1)-(3).

plans are covered. Defined contribution plans,[81] such as profit-sharing, money purchase pension plans, and stock bonus plans are specifically excluded because their participants simply get what is in their individual accounts rather than a definite retirement benefit whose funding must be based upon acturial assumptions and computations, as is the case for defined benefit plans.

Plans for whom coverage is mandatory can not avoid a voluminous amount of paper work to comply with the PBGC's requirements.[82] In addition, the plan must pay the mandated insurance premiums to help fund the PBGCs guarantees to pay basic benefits in the event of a plan's failure. As of 1980, the premiums amounted to $2.60 per plan participant per year, with interest and penalties imposed for late payments.[83] The employer who sets up an employee benefit plan which is under the authority of the PBGC also has a contingent liability to the extent of the lesser of the excess of the present value of the insured benefits over the market value of the plan assets as of the date of the plan's termination, or 30% of the employer's net worth.[84] To cover this contingent liability, ERISA requires all employers to purchase insurance either from the PBGC or from an approved independent carrier or from both.[85] Under sections 404(g) and 6511(7) of the Code, the employer liability payments will be treated as contributions to a qualified plan.

Not all accrued benefits are covered by the PBGC. The guaranteed benefits are generally classified as those nonforfeitable pension benefits, payable directly or indirectly to a living person.[86] There are limitations on the amount of guaranteed benefits payable to any one participant or his beneficiary,[87] and allocation priorities have been established.[88] The basic benefit available to a participant of a terminated plan shall not exceed the actuarial equivalent of the lesser of 100% of his average wages during his

81. *Id.* § 4021(a) and (b).
82. *Id.* §§ 4008, 4043.
83. 29 C.F.R. § 2602.5(b).
84. ERISA § 4062(b).
85. *Id.* § 4023.
86. *Id.* § 4022(a); 29 C.F.R. §§ 2605.3-.4.
87. ERISA § 4022.
88. *Id.* §§ 4044(a) and (b); 29 C.F.R. §§ 2608.6-.11.

highest paid five years of plan participation or $750 monthly.[89] The $750 amount has been, and will continue to be, adjusted for cost of living increases; it equalled $1,159.09 in 1980.[90]

H. *Plan Administration*

Although a lengthy discussion of plan administration is beyond the focus of this article, some general observations must be made in order to point out additional evidence of the extensive burden that compliance with the Internal Revenue Code and the Department of Labor imposes upon plan sponsors.

As a means to protect employee benefit rights and assure that qualified plans are operated solely for the benefit of their participants, ERISA established specific guidelines for a fiduciary who serves under one of these plans. The fiduciary is judged by the more stringent federal prudent man rule rather than by the rule established by local law.[91] He has a duty to diversify investments and is held personally liable for any plan losses attributable to him.[92] There are restrictions on who may serve in a fiduciary capacity,[93] and there are strict bonding requirements for those who do serve.[94] There is a long list of prohibited transactions,[95] participation in which results in the imposition of a 5% excise tax[96] as well as potential civil[97] and/or criminal[98] actions against the fiduciary.[99]

Administering a qualified plan involves an incredible amount of expensive paper work due to the various filing and reporting re-

89. ERISA § 4022(b)(3).
90. CANAN, *supra* note 23, at § 19.6.
91. ERISA § 404(a)(1). For a fuller discussion of fiduciary responsibilities, liabilities, and prohibited transactions, *see* BILDERSEE, *supra* note 24, at §§ 16.1-17.5; Offer, *Fiduciary Responsibilities*, in INTRODUCTION TO QUALIFIED PENSION AND PROFIT-SHARING PLANS, 289 (1977 & Supp. 1979).
92. *Id.* § 409(a).
93. *Id.* § 411(a).
94. *Id.* § 412(a).
95. *Id.* §§ 406, 407(a); I.R.C. § 503.
96. I.R.C. § 4975.
97. ERISA § 502.
98. *Id.* § 501.
99. *Id.* § 3(21)(A).

quirements needed to satisfy the Internal Revenue Service,[100] the Labor Department,[101] and the PBGC.[102] In addition to the paper work needed to initiate the plan, there are numerous annual reports which require detailed disclosures to the various agencies, as well as written communications which are due the plan participants. The plan itself must also be under constant review to insure its continued compliance with the law. In addition, the administrative procedures relating to custodianship, investment of the assets and the payment of benefits, and trustee selection must all be considered by the sponsor before deciding which plan, if any, he will select.

V. Plan Selection Since ERISA

A. *Factors to Consider*

For the employer who is considering increasing his employee benefits, the obvious tax advantages of the qualified plan are undoubtedly enticing; but since ERISA imposed its sweeping changes, the cost of attaining this preferential tax treatment has caused many employers to have second thoughts. Each potential plan sponsor must approach the decision by asking himself: Who is the plan primarily designed to benefit? Will having to provide greater coverage under a qualified plan make the plan undesirable? Can he afford the financial commitment the company will have to make in both time and money? Is he willing to expose himself to additional liabilities under federal law? Can he afford the expense of hiring additional people to fulfill the extensive record keeping requirements? Should he hire a corporate trustee?

Assuming the employer has weighed the factors and has opted for the tax shelter of the qualified plan, he then must go through a similar questioning process to determine which type of qualified plan is most suitable for his particular company and its objectives. Because some plans are treated more favorably under ERISA than

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100. For a discussion of the federal filing and reporting requirements, *see* Canan, *supra* note 23, at §§ 18.1-.4. For samples of the many forms needed for compliance with the I.R.S., *see* Bildersee, *supra* note 24, at A-105-274.

101. For examples of forms satisfying Department of Labor reporting requirements, *see* Bildersee, *supra* note 24, at A-293-313.

102. For examples of forms required by the PBGC, *see id.* at A-293-313.

others,[103] his decision must frequently be dictated by the cost involved rather than by a motivation to provide the best benefit program available to his employees. In making a choice between a defined benefit plan and a defined contribution plan the following points are pertinent. In general, the defined contribution plan or individual account plan offers greater flexibility and more employer discretion regarding contributions and investments. Defined contribution plans are usually less expensive to operate and less burdensome administratively because, with some exceptions for the hybrid plans, they are exempt from some of ERISA's most stringent and therefore costly requirements such as the minimum funding standard, benefit accrual rules, and coverage by the PBGC. Ironically, some of these very features from which defined contribution plans are exempt would result in the most protection for the rank and file employees. It may be true that as a result of the complex actuarial tailoring and the mandatory contributions, the benefits payable upon retirement to the participants of a defined benefit plan will be more certain and perhaps more substantial than the account balances received by participants of defined contribution plans. However, the high cost of the additional paperwork and financial commitment required by such a program make its advantages less attractive to many small companies or to those with an uneven history of profits who are justifiably concerned over their ability to contribute a relatively fixed amount year after year regardless of economic conditions or business performance. By selecting a defined contribution plan, an employer will also have the discretion, within certain limits, to condition contributions upon the existence and extent of profits. With a profit-sharing plan, for example, an employer's contribution can fluctuate according to the business's profits, even to the extent of there being no contribution in a year with no profits. Costs can further be reduced for the employer who selects the defined contribution option by incorporating such features as the integration of the plan with social security.

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103. Wangard, *Selecting a Qualified Plan After ERISA: The Alternatives, Problems and Costs*, 43 J. TAX 145 (1975).

B. *Trends in Plan Selection Since ERISA*

A comparison of the statistics in the following chart shows a definite trend in plan selection since the enactment of ERISA in 1974. The figures are taken from informational releases issued each year by the I.R.S. to indicate how many Determination Letters were issued for that year. (Determination Letters are requests by plan sponsors for a ruling from the I.R.S. as to the plan's qualification for tax-exempt status.) Having such approval is not a prerequisite for setting up a plan nor will securing it prevent the I.R.S. from auditing the plan at some later date; however, approval is sought by knowledgeable plan drafters because it does keep the I.R.S. from retroactively denying tax benefits.[104] Since these figures reflect only requests for rulings on initial qualifications, no conclusions can be drawn from them as to the number of plans in existence in any of these years. For purposes of illustrating selection trends, the figures have not been broken down beyond the defined benefit and defined contribution plan classification.

EMPLOYEE BENEFIT PLANS:
DETERMINATION LETTERS ISSUED ON INITIAL QUALIFICATION
(1974—June 1980)[105]

	Defined Benefit Plans	Participants	Defined Contribution Plans	Participants
1974	32,579	1,104,772	26,806	402,437
1975	15,319	626,575	14,720	161,872
1976	2,595	134,462	18,891	780,708
1977	6,953	1,639,719	28,463	3,315,205
1978	9,728	1,125,498	55,956	2,754,635
1979	15,755	972,062	41,122	1,050,595
Jan.-June 1980	5,978	176,425	26,871	823,930

104. CANAN, *supra* note 23, at § 11.4.

105. This table is derived from Determination Letter statistics gathered from the following Internal Revenue Service News Releases: Public Affairs Division Release, 3-21-75, cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,022; IR-1557 (2-10-76), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,061; IR-1854 (7-1-77), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,139; IR-1973 (3-24-78), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,163; IR-2090 (2-8-79), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,179; IR-80-47 (4-7-80), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶ 125,203; IR-80-86 (8-8-80), cited in [1980] 4 PENSION AND PROFIT SHARING (PH) ¶

The figures above suggest that the more favorable treatment accorded the defined contribution plan by ERISA has led to its becoming, by a wide margin, the preferred plan over its more costly and administratively burdened counterpart, the defined benefit plan. The fact that there is not a more drastic discrepancy between the number of participating employees under each type of plan would probably indicate that it is the larger corporations who can better afford the higher costs of the defined benefit plans.

Defined contribution plans, although less popular prior to ERISA, are now definitely in the lead and will probably remain so unless further changes are made to simplify compliance and to reduce the voluminous paper work required by the three agencies involved. There have been steps in the right direction such as the amendments introduced in the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

VI. Conclusion

Certainly there were numerous and flagrant abuses in the area of employee benefits law which needed correction, and ERISA was indeed a giant step in the right direction. However, one sometimes wonders if the burdens imposed are not so restrictive that ERISA has instead frightened away many employers due to the high cost and increased employer liability. A large percentage of those who have adopted qualified plans have chosen the least restrictive type which is not always in the best interests of the lower paid employees. Hopefully steps toward lessening the burden, while retaining the obvious benefits, will become the established trend so that the employer will have a wider range of choices available without having cost be the overriding plan selection factor. If the right changes are made, more employers will establish qualified plans, and more may be willing to select the defined benefit plan with its specified-

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125,211. Although the chart uses the ERISA classification throughout, the 1974 and 1975 statistics had been actually broken down into (1) corporate type pension plans and annuity plans and (2) profit-sharing and stock bonus plans. Consequently, it is not known how many pension plans were of the money purchase type which after 1975 would be classified as defined contribution plans. However, before ERISA, only a small portion of pension plans were the money purchase type according to Isidore Goodman, former Chief of the Pension Branch of the I.R.S. *See* Goodman, *Defined Contribution Plans Under ERISA* in [1980] Pension Plan Guide (CCH), Issue #205, No. 197, Pt. II, ¶ 18 (Jan. 5, 1979).

in-advance retirement benefits and guarantees in the event of plan failure. The true beneficiaries of such actions will be the very individuals—the rank and file employees—for whose benefit ERISA was designed.

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