Introduction

The Employees Retirement Income Security Act of 1974 (ERISA) is the most extensive pension legislation ever enacted in the United States. The basic purpose of the Act is to protect the rights of employees to their expected benefits. The effect of the new Act will be to require changes, generally more liberal changes, in the provisions of almost every pension and profit sharing plan in the nation. The Act is to be administered jointly by the Departments of Labor and the Treasury.

Prior to the passage of this new legislation, regulation of the terms of a pension plan on such matters as benefit formula, entry ages and service for participation and vesting, were only those deemed necessary to prevent discrimination in favor of officers, stockholders, highly compensated and supervisory employees. The only regulation of funding was on the maximum which could be deducted.

The new Act sets minimum standards for (1) age and service requirements for participation (2) vesting (3) funding. The Act also imposes a mandatory joint and survivor provision and sets maximum limits on benefits and contributions for individuals. All reports to be made either to the Secretary of Labor or the Secretary of the Treasury require certification by an enrolled actuary where any actuarial values are involved, and the Act provides for the enrollment of qualified actuaries by the Federal Government.

Perhaps the most novel feature of the Act is the introduction of Plan Termination Insurance. This is set up to protect the employee from losing his pension benefits in the event that the employer's plan is terminated for any reason.

The Act liberalizes Keogh plan limits and deductible limits under pension plans but tightens deductions on profit sharing plans and the combination of pension and profit sharing plans. It expands the present reporting requirements and fiduciary standards of pension, profit sharing, stock bonus, health and welfare plans. It also introduces new Individual Retirement Accounts to allow employees and self-employed individuals not covered under any existing employment plans, either qualified or governmental, to establish retirement savings plans with tax deferral.

Excluded from most provisions of the Act are (1) Federal, State and other governmental (including Railroad Retirement Act) plans; (2) church plans unless coverage is elected and some miscellaneous plans. The new Act generally supersedes all State pension regulations except that it does not affect insurance, banking, and securities laws.

Administration and Enforcement

Administration of the Act is divided between the Secretaries of Labor and Treasury. The Secretary of Labor has primary responsibility for disclosure and fiduciary requirements and for plan termination insurance. The Secretary of the Treasury has primary responsibility for participation, vesting, and funding requirements, for tax provisions, and for individual retirement savings. The two Secretaries are directed to coordinate their activities. A Joint Board established by the two Secretaries will enroll actuaries.

Many duties of the Secretary of the Treasury will be delegated to the Internal Revenue Service. A new Office of Employee Plans and Exempt Organizations is established in the Internal Revenue Service, under a new Assistant Commissioner of Internal Revenue. A new procedure is established for taxpayers to seek declaratory judgments from the Tax Court regarding plan qualification.

The Secretary of Labor will establish and chair the Pension Benefit Guarantee Corporation to administer Plan Termination insurance.

Participation and Vesting

The participation and vesting standards are to be administered primarily by the Internal Revenue Service. For plans in existence on Jan. 1, 1974, the effective date is the beginning of the first plan year beginning after Dec. 31, 1975. For plans established after Jan. 1, 1974, the new provisions are effective for the first plan year beginning after Sept. 2, 1974.

Essentially all private pension, profit sharing, savings and thrift plans to which employers contribute are covered. Exemption is provided for unfunded plans of deferred compensation for "a select group of management or highly compensated employees," unfunded plans to provide benefits in excess of new limitations in the tax law, and plans for buy out of partner interest.

(Continued inside)
Participation

The maximum waiting period before eligibility for participation in a plan is one year of service. A plan may also exclude from participation any employee who has not attained age 25. An exception is made for plans providing for immediate vesting of accrued benefits upon participation. In this last case the waiting period may be set at three years. After meeting these minimum age and service requirements, an employee's participation must begin within the next six months, but not later than the next plan anniversary.

Defined benefit plans and target benefit plans, may exclude older employees hired at an age within five years of the normal retirement age specified in the plan. Normal retirement may not be later than age 65 and completion of 10 years service.

A year of service is defined as a twelve-month period (such as a plan year) during which the employee works 1,000 hours or more (no doubt future regulations will prescribe equivalents of 1,000 hours in work situations where "hour" is not a convenient measuring period).

The Act preserves the basic tax qualification rules on coverage—the current 70% or 80% coverage requirements, as well as the rule that coverage not discriminate in favor of stockholders, officers, and the highly compensated. There is specific provision for exclusion of members of a collective bargaining unit in applying the coverage and discrimination tests, provided that retirement benefits have been a subject of good faith bargaining.

Tests for coverage must include all employees of a controlled group of employers. The Conference Report states that this provision does not require every subsidiary to have the same plan as the parent, or that it necessarily must have a plan. The intent is to prohibit a plan solely for a management corporation; or a liberal plan for employees of a corporation in which the employees are highly paid, with a meager plan for a related corporation employing the lower paid.

Vesting

Benefits attributable to employee contributions must be vested immediately.

Accrued benefits attributable to employer contributions must become vested according to one of three given vesting schedules:

1. A graded schedule beginning at 25% after five years service, going to 50% after ten years service, and 100% after 15 years service.
2. 100% after ten years service.
3. The "Rule of 45", a graded schedule beginning at 50% at 10 years service, or at the later of 5 years service and the year when the sum of the employee's age and service equals 45; and increasing 10% per year to 100% vesting 5 years later.

In cases where there has been a pattern of abuse in dismissing employees prior to achievement of vesting or where there is clear potential for discrimination, the Internal Revenue Service may require a more rapid vesting schedule.

In a Class Year plan, benefits must be 100% vested in the fifth class year after allocation.

The Act provides specific definitions of service and benefit accrual thereby facilitating the administration of pension plans.

Accrued Benefit

On the premise that certain employers would subvert the vesting requirements by adopting a severly "backloaded" plan—such as one in which the benefit accrual is $1 per year of service for the first 20 years and $20 per year of service beyond 20 years, the Act provides rules concerning benefit accrual, "Frontloading" is allowed.

For a defined contribution plan the accrued benefit is the equivalent of the balance in the employee's account.

For a defined benefit plan the accrued benefit is determined in relation to the normal retirement benefit without regard to early retirement supplements, death payments or other ancillary benefits.

For a plan funded exclusively through individual retirement income and annuity contracts, the accrued benefit is the equivalent of the cash value of the policies.

Accrued benefits under the plan must meet one of three minimum tests.

The 133 1/3% rate is a regulation in the plan formula itself for a unit benefit type plan and the other two rules envision a smooth accrual of benefit over the employee's working career.

1. 3% method—The projected benefit at normal retirement must accrue at the rate of 3% per year (maximum 33 1/3 years).
2. 133 1/3% rate—The plan formula must be such that the accrual of benefits in any later year cannot exceed 133 1/3% of the accrual in an earlier year.
3. Fractional rate — The accrued benefit is the benefit projected to normal retirement multiplied by the ratio of service to date of determination to total possible service at normal retirement.

The 133 1/3% rule permits a limited amount of backloading. It should be noted that the rule does not preclude amendment of a plan increasing benefits for future service only. The rule applies to the plan formula at any point in time.

Thus a plan providing a benefit of $3 per year of service for service prior to Jan. 1, 1970 and $6 per year of service for service thereafter, could be amended to provide $10 per year of service for service after Jan. 1, 1974.

The other two rules effectively inhibit a plan amendment improving benefits for future service. An increase in only future service benefits increases the projected benefit at retirement, automatically increasing the proportion of the projected benefit accrued to date.

In determining the accrued benefit at any time all pertinent items, such as Social Security provisions, are assumed to remain constant into the future. For the projections called for in the 3% rule and fractional rule, a pay related plan may provide for a projection of past average pay, but the averaging period may not exceed 10 years. For a career pay plan, this could convert the accrued benefit into something larger than what we normally regarded as the accrued benefit.

Rules for accrued benefit are not retroactive. For service prior to the effective date the accrual as then stated in the plan can prevail, provided it yields an accrued benefit at the effective date equal to at least one-half that which would have been provided by the rules.

Vested benefits cannot become forfeitable for any reason other than death. The present practice of forfeitures for
Joint and Survivor Annuity

If benefits are provided in the form of an annuity the plan must make available to married participants a joint and survivor annuity (at least 50% to survivor). This is automatic unless the participant elects not to take the joint and survivor annuity.

If early retirement benefits are provided and if the married participant dies after reaching early retirement age, within 10 years of normal retirement, a survivor's annuity must be paid if the participant has elected to take this protection during the early retirement period. The cost of this early retirement protection may be recovered by actuarially reducing the annuity payable to the covered participant on his retirement.

These options need not be provided when the participant has been married less than one year.

Limits on Benefits and Contributions

The law places new maximum limits on the benefits and contributions which may be credited to individuals under qualified pension, profit sharing and stock bonus plans and under tax-deferred annuities.

Effective Jan. 1, 1976, the maximum annual benefit under a defined benefit plan is the lesser of $75,000 (to be cost-of-living adjusted) or 100% of the employee's highest three-year average pay, but not less than $10,000. The limits are adjusted if the retirements benefit is paid other than as a life annuity or joint and survivor annuity, if the employee contributes, if benefits begin prior to age 55, or if the employee has less than 10 years of service. There is a minimum adjusted limit for employees who were participants on Oct. 2, 1973. Cost of living adjustments after retirement or vested termination may increase the limits.

In a defined contribution plan, the maximum contribution which may be allocated for any participant in any year is the lesser of $25,000 (to be cost-of-living adjusted) or 25% of pay. This limitation includes (1) employer contributions, (2) employee contributions above 6% of pay (or ½ of the employee's contributions, if less) and (3) forfeitures.

If an employee is covered under more than one plan of the same employer, all such defined benefit plans are treated as one plan and all such defined contribution plans are treated as one plan. Employers with at least 50% common control are treated as one employer. An employee covered under both a defined benefit plan and a defined contribution plan can have 140% of the combined limits. For example, an employee earning $100,000 could receive an annual benefit of $75,000 under a defined benefit plan (100% of his limit) and also receive an annual contribution of $10,000 (40% of his limit) under a defined contribution plan.

A change in the maximum deductible contribution under corporate pension plans is discussed under Funding. The current year deductible contribution limits under a profit sharing plan, or under a combined pension plan and profit sharing plan, remain unchanged, except that the former 30% limitations including carryover are reduced to 25%. Limitations on tax-deferred annuities under section 403(b) are also changed.

Contributions for the self-employed (H.R. 10 or Keogh) and "shareholder-employees" (Subchapter S corporations) are increased from the lesser of $2,500 or 10% of earned income to the lesser of $7,500 or 15% of earned income; (but not less than $750 of income for H.R. 10 plans) but earned income over $100,000 may no longer be taken into account under such plans. Defined benefit plans for these two groups are specifically authorized for the first time, with stated limits. New taxes are imposed to punish excess contributions or premature distributions.

Funding

Minimum funding standards are established for most defined benefit pension plans. Plans fully insured under level premium individual insurance and annuity contracts, or similar group permanent contracts, are excluded from these funding requirements.

Each plan must maintain a funding standard account (FSA) which is a cumulative record of the excess of actual contributions over the minimum required. The major purpose of the funding standard account is to allow contributions greater than the required minimum, accumulated with interest, to reduce the minimum required in future years. The account also keeps track of accumulated funding deficiencies.

In general, employers must contribute enough to pay the normal cost and to amortize past service liabilities over a period of years adjusted by an amortization of gains and losses. Costs are charged to the funding standard account and contributions are credited. Any credit balance or any deficiency is accumulated with interest.

Each year the funding standard account is charged with the normal cost and the level annual amount needed to amortize the initial past service liability over 30 years (40 years for multi-employer plans). For plans in effect Jan. 1, 1974, the unfunded liability on the date the minimum funding standard first applies must be amortized over 40 years. Changes in liability due to amendment (plus or minus) or changes in actuarial assumptions are amortized over 30 years (40 years for amendments under multi-employer plans).

Actuarial experience gains or losses are amortized over 15 years (20 years for multi-employer plan). This 20-year amortization will give multi-employer plans more stable contributions, larger or smaller. Under integrated plans, changes in liabilities resulting from legislative or automatic changes in Social Security are amortized as gains or losses. Amounts to be amortized may be combined or offset. Some multi-employer plans may amortize amounts as a level percentage of pay instead of a level dollar amount, which may result in substantially lower required contributions.

Assets must be valued "on the basis of any reasonable actuarial method. . . which takes into account fair market value and which is permitted under regulations." For bonds and other evidence of indebtedness, amortized cost may be used.

Liabilities must be determined under "actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the ac-
A plan which uses a funding method that requires contributions in all years not less than those required under the entry age normal funding method may use an alternative funding standard account. Every other method requires contributions less than entry age normal for some years, so the above language apparently applies only to entry age normal. Under this alternative, the minimum contribution for any year is the normal cost (either entry age normal or unit credit) plus any additional amount needed to fully fund the value of accrued benefits.

The minimum contribution may be reduced under the full funding limitation. The full funding limitation is any excess of the accrued liability over the asset value (lesser of market value or value used for valuation purposes). The accrued liability is to be determined under the entry age normal cost method “if such accrued liability cannot be directly calculated under the funding method used for the plan.”

Amortization periods may be extended ten years by the Secretary of Labor. The minimum contribution may be waived by the Secretary of the Treasury if the employer cannot meet this without “substantial business hardship.”

A money purchase plan will automatically comply with the funding requirement via the full funding requirement if the employer pays the current cost less gains (surrender credits and dividends).

Any funding deficiency for a plan year results in a 5% excise tax on the accumulated deficiency. If the deficiency is not corrected within 90 days after notice, a second tax of 100% of the deficiency is charged. In such a case the government has the right to terminate the plan.

Maximum deductible employer contributions are changed in several respects. Of the three alternative former limits, (a) the 5% of compensation limit is deleted, (b) the level cost limit is unchanged, and (c) the normal cost plus 10% of initial past service liability (12- to 14-year funding with interest) is increased to normal cost plus 10-year funding of past service. In addition, the minimum funding requirement is allowed if larger than the regular maximum. Maximum deductible contributions must be determined under the same method and assumptions (best estimate) as used for the minimum funding standard.

Funding requirements generally become effective at the same time as participation and vesting requirements, except that the effective date for funding may be extended for multi-employer plans. A plan may elect an earlier effective date for participation, vesting, and funding. This, in some situations would effectively reduce the minimum funding requirement for later years. The effective date for the new deduction requirements is unclear if the tax year and plan year differ.

The minimum annual contribution required to satisfy the funding requirement may be more or less than the minimum charge to expense under Opinion 8 of the Accounting Principles Board of the AICPA.

### Actuarial Reports

Each defined benefit plan (except fully insured individual policy plans) must file actuarial reports prepared and signed by an enrolled actuary.

An actuarial report must be filed by the plan administrator with the Secretary of the Treasury for the first plan year subject to the funding requirements, and each third plan year thereafter. Treasury can require more frequent reports. The report must include (1) a description of the actuarial cost method and assumptions, (2) “a certification of the contribution necessary to reduce the accumulated funding deficiency . . . to zero”, (3) a statement that the requirements concerning reasonable actuarial assumptions have been met, (4) “such other information as may be necessary to fully and fairly disclose the actuarial position of the plan”, and (5) any other information Treasury requires.

The extensive annual report to be filed with the Secretary of Labor must include an actuarial report each year. An actuarial valuation must be made at least every three years. In addition to the information indicated for the actuarial report to Treasury, the report to Labor must include among other items, (1) date and amount of contributions, (2) justification for any change in methods or assumptions, (3) method of asset valuation and the amount of assets, and (4) value of vested benefits by priority categories. The last item above may be waived for certain plans. The annual report must also explain the reason for any change in appointment of the enrolled actuary. Requirements may be modified for plans with fewer than 100 participants.

The Secretaries of Labor and Treasury are required to coordinate their requirements for actuarial reports.

### Enrollment of Actuaries

The Secretaries of Labor and Treasury have established a Joint Board for the Enrollment of Actuaries. The Board will issue regulations for enrollment and dis-enrollment of actuaries, and will enroll and disenroll individuals. The required actuarial reports to Labor and Treasury must be prepared and signed by an enrolled actuary.

The Joint Board will “establish reasonable standards and qualifications for actuaries.” For persons applying before 1976, these must include “an appropriate period of responsible actuarial experience relating to pension plans.” For those applying later the standards must include, in addition, “education and training in actuarial mathematics and methodology”, evidenced by (1) a college degree in actuarial science, (2) completion of an exam given by the Joint Board, or (3) completion of other actuarial exams deemed adequate by the Joint Board.

The Joint Board may establish appropriate requirements in addition to those listed, there is a clear intent to have higher educational requirements for those enrolled after 1975.
For those applying both before and after 1975, enrollment is permanent. But in addition to the permanent enrollment, the Joint Board is authorized (but not required) to make an interim temporary enrollment ending Jan. 1, 1976. This would enable the Joint Board to make temporary enrollments before it has issued its final regulations for those applying before 1976.

Plan Termination Insurance
Plan Termination Insurance is established to protect employees from the loss of vested benefits upon plan termination. It has been compared to FDIC for banks, but there are substantial differences as well as some similarities.

A non-profit Pension Benefit Guaranty Corporation (PBGC) is established within the Department of Labor. PBGC has a Board of Directors consisting of the Secretaries of the Treasury, Labor, and Commerce. An Advisory Committee of seven members with labor, employer and public representatives is established for the purpose of advising the PBGC.

Plan Termination Insurance applies to all qualified defined benefit pension plans. It does not apply to profit sharing plans or defined contribution pension plans, non-qualified plans, and some others.

PBGC establishes four funds, each with a separate purpose: (1) Basic retirement benefits for single employer plans; (2) Basic retirement benefits for multi-employer plans; (3) Non-basic benefits (not clearly defined) for single employer plans; (4) Non-basic benefits for multi-employer plans. Initially only the basic retirement benefits are covered.

Annual premiums are initially $1 per employee for single employer plans and 50¢ for multi-employer plans, and may be changed in amount or in basis (related to value of guaranteed benefits, total or unfunded) in future years.

PBGC guarantees the vested accrued benefit (not minimum required vested) up to 100% of 5-year average pay, but not over $750 monthly (to be adjusted for changes in the taxable wage base). It fully covers plans and amendments in effect for at least five years, and to a lesser extent more recent plans and amendments under a 5-year phase-in rule.

A plan may be terminated by the plan administrator after notification to PBGC, or may be terminated by PBGC under certain circumstances. Upon termination PBGC will determine whether the plan’s assets are at least equal to the value of guaranteed benefits at the date of plan termination. If they are less, the employer must pay PBGC the difference, but not more than 30% of the employer’s net worth. In multi-employer plans this liability is allocated among the various employers; this may make some employers take more interest in how such plans are operated. Successor employers are liable for pension commitments of prior employers; this calls for careful consideration in acquisition and merger situations.

To avoid this potential liability on plan termination, employers can purchase contingent employer liability insurance from PBGC. PBGC will determine premiums. Later private insurance companies may provide part or all of this coverage under arrangements which are either voluntary or compulsory for employers. The contingent insurance cannot cover plan terminations until premiums have been paid for at least 60 months. Some employers have been concerned about whether or how the contingent liability would need to be shown in financial statements; the contingent employer liability coverage could relieve that problem after 60 months.

The plan administrator must notify PBGC in various situations, such as disqualification by IRS, plan amendments decreasing benefits, failure to meet minimum funding requirements, or other events which may affect possible plan termination.

Plan provisions must indicate a prescribed order of priority for allocation of assets on plan termination, with all guaranteed benefits receiving an allocation before any other benefits. On plan termination PBGC may ask the U.S. District Court to appoint a trustee for the plan.

The plan termination provisions generally became effective Sept. 2, 1974.

Disclosure and Fiduciary Requirements
Disclosure and fiduciary requirements are increased for both employee welfare plans (health, disability, death, unemployment, vacation, day care, scholarship or legal benefits, insured or uninsured) and pension plans.

The plan administrator must publish a comprehensive plan description, as well as a summary plan description. The summary must be written to be understood by the average plan participant. Both descriptions must be filed with the Secretary of Labor. The summary must be furnished each participant every fifth year. If there have been no changes in the plan the summary may be furnished every tenth year. A description of any plan modification must also be provided to the Secretary of Labor and to participants.

An extensive annual report including financial, actuarial and other information must be filed annually with the Department of Labor. A summary of this report must be furnished each participant annually.

Reports, descriptions and plan documents, except for personal information, will be publicly available.

Welfare plans, and pension plans with less than 100 participants, may be excused from part or all of the above requirements by the Secretary of Labor.

The Pension Benefit Guaranty Corporation requires its own reports for premium collection.

The Internal Revenue Service will require annual reports on minimum funding requirements, as well as deduction of contributions, and will receive triennial actuarial reports.

Any employee who requests must receive a statement of his accrued benefits and vested benefits. Each terminated vested participant under a pension plan must receive a statement regarding his vested rights. An annual report listing terminated vested participants must be filed with Treasury, which will send a copy to Social Security, which in turn can remind the participant of his vested benefits when he applies for Social Security benefits.

There are broad definitions of “fiduciary,” which suggest that actuaries may become fiduciaries under the Act. Fiduciary requirements are listed. Diversification of investments is required for some plans, and investments in employer securities or real estate are restricted. The law specifies “prohibited transac-
tions." A fiduciary is personally liable for losses resulting from a breach of fiduciary responsibility.

Individual Retirement Accounts

The Act allows individuals not covered under qualified and governmental retirement plans to establish individual retirement savings plans, with tax deferral. This new type of plan may be funded through an (1) individual retirement account (IRA), (2) individual retirement annuity (IRA) or (3) a special retirement bond issued by Treasury. Some insurers see this as having substantial business potential.

Annual contributions up to 15% of compensation, not to exceed $1,500, may be excluded from taxable income, regardless of whether deductions are itemized. Compensation refers to actual earnings, rather than earnings imputed under community property laws.

Individual retirement accounts must have a trustee or custodian which is a bank or another person (insurance company?) approved by the Secretary of the Treasury. Individual retirement accounts may invest in various assets, including annuities. There is a general restriction against purchase of life insurance contracts, but certain endowment contracts receive special treatment, as discussed below. The individual retirement account must have various provisions, including nonforfeitability, distributions to begin by age 70½, and restrictions on the form of payments at death.

Individual retirement annuities must include restrictions comparable to individual retirement accounts. Apparently an annuity contract could be issued either as an individual retirement annuity or as an investment of an individual retirement account.

Retirement bonds to be issued by the government will meet specified requirements.

"Rollover contributions" are allowed. An individual who receives a distribution from one IRA and reinvests it in another IRA within 60 days has no taxable income, but only one such rollover is allowed each three years. A lump sum distribution from a qualified pension plan may also be rolled over into an IRA, but it will thereby lose the capital gains or 10-year spread treatment. An IRA consisting solely of a rollover from a qualified trust may be rolled over into another employer's qualified plan if that plan so allows, but the rolled over account apparently will not regain its favorable tax treatment for a subsequent lump-sum distribution.

If an individual retirement account purchases an endowment contract maturing by age 70½, the portion of the premium "not attributable to the purchase of life insurance" is treated as a rollover contribution and the portion attributable to "life, health, accident or other insurance" is treated as a distribution to the individual. A cloud of questions on this bill will need to be dispelled by regulations.

Future Plans

ERISA is not going to be the last word in Pension legislation because the Act establishes a Joint Pension Task Force to study (1) the effect of vesting requirements on discrimination; (2) portability; (3) plan termination insurance for small employers; (4) preemption of State and local laws relating to pensions; (5) any other matters referred to the Task Force. The staff to carry out these assignments will be comprised of the staffs of five existing Congressional Committees. Further, four existing Congressional Committees are directed to study Pension plans for Government employees including States and political subdivisions thereof.

Conclusion

This summary presents only the highlights of a very complex act. The Act itself is the primary source of information. The report of the Conference Committee, which should be read, is particularly helpful in providing the intent of Congress regarding many sections.

The answers to many questions await the publication of regulations and other guidelines by the Departments of Labor and Treasury.

Many uncertainties remain about the Act, but one thing is sure. This Act (sometimes called the "actuaries relief act") will substantially increase the work of actuaries working for companies, consulting firms, and the government.