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NEW GAO REPORT RAISES QUESTIONS ABOUT HOUSE AND SENATE PENSION PROVISIONS THAT WOULD WEAKEN "TOP-HEAVY" PROTECTIONS

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Pension bills that the House of Representatives and the Senate Finance Committee have approved — and that may be enacted in some form before Congress adjourns — would substantially weaken the “top-heavy” protections of current pension law. These protections are designed to protect ordinary workers under company pension plans that provide 60 percent or more of their benefits to “key employees” such as owners and top executives.

Proponents of the House and Senate Finance Committee provisions that would weaken the top-heavy protections charge that the current rules impose large administrative burdens on pension plans, especially plans offered by small businesses. They argue that these administrative burdens lead fewer such businesses to offer pension coverage.

The findings of a new report the General Accounting Office (GAO) released on October 2, *Private Pensions: “Top-Heavy” Rules for Owner-Dominated Plans*, challenge these assertions.¹ The GAO report finds that the top-heavy rules generally do *not* involve substantial administrative costs. The GAO also finds that the top-heavy rules can be important in ensuring a more equitable division of pension tax benefits between ordinary workers and highly paid workers than would otherwise be the case. The GAO findings raise important questions about the rationale for seriously weakening the top-heavy rules, as the House and Senate pension bills would do.

Background

Under current law, tax-preferred pension plans must not discriminate in favor of highly compensated employees. The law’s “nondiscrimination rules” are intended to ensure that tax preferences for pension plans are shared among a wide array of workers, rather than just among highly compensated workers.

An additional set of rules apply to pension plans that, while meeting the nondiscrimination rules, still deliver the bulk of their benefits to company officers and owners. The “top-heavy” protections, as these safeguards are known, apply to plans in which 60 percent or more of the

¹ General Accounting Office, *Private Pensions: “Top-Heavy” Rules for Owner-Dominated Plans*, GAO/HEHS-00-141, August 2000, released on October 2, 2000.

pension benefits accrue to such key employees.² The top-heavy rules require firms with such “top heavy” plans to take additional steps to protect middle- and low-income workers through certain minimum employer contributions or benefits and accelerated vesting.

The GAO Findings

The GAO report finds that:

- ***The administrative costs resulting from the top-heavy rules are relatively low.*** The GAO found that “annual administrative costs to ensure compliance with the top-heavy rules generally appear to be a minor part of an employer’s total administrative costs to operate a tax-qualified plan....Indeed, pension consultants we interviewed estimated the costs to be low in most situations....Practitioners explained that computer software makes running top-heavy tests as routine as hitting a key on a computer.” In other words, for most firms, the administrative costs associated with implementing the top-heavy rules are small.³
- ***Top-heavy protections are often important in ensuring a more-even distribution of benefits.*** The GAO report found that the top-heavy rules appear important in ensuring that key employees in small firms do not receive a disproportionate share of the benefits from pension plans, with too small of a share provided to other employees. For example, in one pension plan the GAO examined, the key employees would have received 81.5 percent of the pension contributions in the absence of the top-heavy rules, even though the key employees earned only 41.3 percent of the total earnings in the firm. This plan satisfied the nondiscrimination rules despite its skewing of pension contributions toward the highly paid staff. This plan illustrates why the top-heavy protections serve an important function as a backstop to the nondiscrimination rules. The top-heavy rules increased the share of contributions accruing to non-key employees under this plan from 18.5 percent to 43.1 percent, which was still smaller than their 58.7 percent of total earnings but much larger than the contributions they would have received without the top-heavy protections.

² The top-heavy rules are evaluated on the basis of the *cumulative* value of pension contributions or accrued benefits. The nondiscrimination rules, on the other hand, are evaluated on the basis of *annual* contributions or benefit accruals. Many pension experts believe that basing the top-heavy rules on *cumulative* pension values makes them much more difficult to circumvent than the nondiscrimination rules.

³ The GAO also noted that administrative costs can become significant in certain “nonroutine” situations. The GAO did not specify what qualifies as “nonroutine,” but the report suggests that some such situations include when a firm is being audited by the Internal Revenue Service and needs to demonstrate that its pension plan is not top-heavy, and when a firm hires a new pension lawyer or consultant who may need to correct or create pension records. In addition, although not specifically mentioned in the GAO report, administrative costs may be high when a firm is undertaking complicated steps to circumvent the intent of the top-heavy rules.

In the absence of the top-heavy protections, the average contribution that would have been made on behalf of rank-and-file workers under the plan examined by the GAO would have been 1.3 percent of those workers' pay.⁴ Because of the top-heavy protections, however, the actual contributions for rank-and-file workers equaled 3 percent of their pay. The GAO concluded that "top-heavy minimums can require employers to raise contributions for nonkey employees. In such cases, nondiscrimination rules—absent the top-heavy rules—could leave some younger workers with about 1 percent of pay."

- ***Top-heavy plans are especially prominent among doctors, dentists, and law firms.*** The GAO report found that 67 percent of new pension plans for physician, dentist, and law firms in 1996 — or two of every three — were top-heavy.
- ***There is no empirical evidence of negative (or positive) effects from the top-heavy protections.*** The GAO could find "no studies that quantified overall effects — positive or negative — of the top-heavy rules on numbers of plans or participants, or on employers' contributions or administrative costs." In other words, there is no empirical evidence that the top-heavy rules have discouraged pension plans among small businesses as the proponents of weakening the rules have charged.

The House and Senate legislation

The House and Senate Finance Committee pension provisions would substantially weaken the top-heavy safeguards in several ways. The provisions would redefine who counts as a "key" employee so fewer individuals would be counted in this regard. They also would selectively count and not count certain pension contributions in evaluating whether a plan meets the top-heavy criteria and would exempt certain types of 401(k) plans from the rules. The result of these provisions would be to exempt from the top-heavy rules a number of pension plans that currently are subject to these rules. This would allow those plans to concentrate pension contributions more heavily on highly paid owners and executives and to provide smaller contributions for ordinary workers.

The GAO report raises serious questions about the wisdom of the proposed changes in this area. Policymakers evaluating potential modifications to the pension legislation should take the GAO report into consideration. The top-heavy rules are complicated and could be simplified. But the primary effect of the changes in the top-heavy protections that the House and Senate Finance Committee bills would make would be to undermine the top-heavy protections rather than to improve them.

⁴ This "average" is the weighted average of the individual contribution rates.