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HOUSE "ENRON" PENSION LEGISLATION INCLUDES TROUBLING PROVISIONS THAT COULD HARM RANK-AND-FILE WORKERS

by Peter R. Orszag[1]

On April 11, the House of Representatives passed H.R. 3762 ("The Pension Security Act of 2002") by a vote of 255-163. The legislation is intended to address some of the pension problems highlighted by the collapse of Enron. President Bush emphasized when the House passed the legislation, "Importantly, the reforms adhere to the principle that what is right for executives is also right for workers."[2] The legislation includes, however, several relatively obscure provisions that contradict this principle. As a front-page *New York Times* article noted, "Some of the bill's provisions would lead companies to seek to reduce the number of employees covered by pensions and give proportionately larger pension benefits to the most highly paid executives, [according to pension experts]."[3]

One of the most troubling provisions of the House legislation (found in Section 204 of the legislation) involves a potentially significant loosening of the non-discrimination rules governing pension plans.

Under current law, tax-preferred pension plans must not discriminate in favor of highly compensated employees. The non-discrimination standards are designed to ensure that the generous tax benefits granted to qualified pension plans serve a fundamental public purpose: providing additional retirement security to those who most need it, by directing proportionate benefits to moderate- and lower-income workers. For example, pension plans are not generally allowed to use a more liberal formula in figuring employer pension contributions for high-income executives than for other employees.

In practice, the non-discrimination rules allow significant disparities between the pension benefits flowing to higher-income executives and those flowing to lower-income workers. In effect, the non-discrimination rules allow higher-income executives to receive more tax-favored

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[2] Statement by the President , April 11, 2002, available at http://www.whitehouse.gov/news/releases/2002/04/20020411-10.html

[3] Richard A. Oppel, "Critics Charge Pension Bill Favors Highly Paid Workers," *New York Times*, April 10, 2002, page A1.

pension benefits than lower-income workers.[4] Not only can the benefits for higher-income employees be greater in terms of absolute dollar amounts, but they also can represent a higher percentage of compensation so long as the differential does not exceed certain limits.[5] Many pension consultants have grown adept at circumventing the intent of the non-discrimination rules by exploiting various loopholes that exist within them. They are able to design plans that direct 80 percent to 90 percent, and sometimes even larger percentages, of a firm's tax-preferred contributions to top executives rather than to rank-and-file workers.[6]

The House legislation would result in substantial further weakening of the non-discrimination protections. Under current law, the permitted degree of disparity between contributions for higher-income executives and rank-and-file workers is defined by two mathematical tests: the "ratio percentage" test and the "average benefit" test. A pension plan must generally conform to one of these tests to meet the non-discrimination rules and thereby qualify for pension tax preferences:

- Under the ratio percentage test, the firm calculates the percentage of highly compensated employees (defined essentially as those earning more than $90,000) covered by the pension plan. To pass the ratio percentage test, the plan's coverage rate for *non*-highly compensated employees must be at least 70 percent as high as the percentage for the highly compensated workers. In other words, if 80 percent of the highly compensated workers are covered, at least 56 percent (70 percent of 80 percent) of rank-and-file workers also must be covered.

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[4] The disparities allowed by the tax code are even more severe on an after-tax basis. Tax benefits to individual taxpayers, such as exclusions from income and tax deductions, are worth far more to workers in higher marginal tax brackets than to less affluent workers. As a result, the after-tax disparities associated with pension benefits are even larger than the pre-tax disparities.

[5] For example, the "permitted disparity" rules allow integration of the employer's pension plan with Social Security. By integrating the plan with Social Security, the firm is allowed to provide higher contributions to high-income workers without triggering the non-discrimination rules that normally apply. In effect, the pension component of the integrated plan discriminates in favor of high-earners, but that regressivity is considered to be compensated for by the progressivity of the Social Security system. Approximately 50 percent of workers covered by defined benefit plans in medium and large firms are in an integrated plan. In defined contribution plans, Social Security integration is much less common. But 401(k) plans allow a different kind of disparity: In such plans, the contribution rates of, and employer matching rates for, higher-income executives are allowed to exceed those of rank-and-file workers, as long as the differential does not exceed certain generous bounds.

[6] For a discussion of how some firms are able to satisfy the non-discrimination rules while still directing 90 percent or more of their contributions to executives, see Peter Orszag and Norman Stein, "Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky," *Buffalo Law Review*, Volume 49, 2001, and Peter Orszag, "How the 'Cross-Testing' Pension Loophole Harms Low- and Moderate-Income Workers," Center on Budget and Policy Priorities, March 2000.

- If a plan fails the ratio percentage test, it still qualifies if it passes the average benefit test. The average benefit test requires that the plan include and exclude employees under a reasonable business classification system, that the classification be nondiscriminatory (which is determined by a much weaker version of the ratio percentage test), and that the average benefit of the rank-and-file workers (measured as a percentage of pay) be at least 70 percent of the average benefit (as a percentage of pay) of the highly compensated employees.

Current law thus already allows a pension plan to cover a higher percentage of – and provide significantly more generous benefits to – higher earners than lower earners.

The House legislation would significantly weaken the existing rules in several ways. For example, the legislation would allow plans to satisfy the non-discrimination coverage requirements even if they fail to meet both of the above tests (as long as they are consistent with regulations to be issued by the Secretary of the Treasury).[7] All that would be required is that the Internal Revenue Service agree that the plan's "facts and circumstances" are sufficient to satisfy non-discrimination concerns.[8] Under the approach proposed in the House legislation, assuming that the Treasury regulations call for IRS examinations of individual plans, an IRS official would examine a plan and determine if the "facts and circumstances" of the plan warranted the favorable tax treatment accorded to qualified pension plans.

The approach proposed in the House legislation was used before Congress replaced it with the current mathematical tests; it was replaced because it was found to produce disparities and inconsistencies across firms. Unlike under the current tests, the criteria applied under the "facts and circumstances" approach are subjective and unclear and can vary with the IRS officials undertaking the reviews.[9] Furthermore, as one of the leading textbooks on pensions notes, the facts and circumstances approach is generally less stringent than the current mathematical tests.[10]

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[7] In particular, the House legislation amends both the general non-discrimination statute (Section 401(a)(4)) and the specific coverage statute (Section 410(b)) to allow for "facts and circumstances" testing. The Secretary of the Treasury is directed to issue regulations allowing for a facts and circumstances approach to Section 401(a)(4), whereas the change to Section 410(b) is promulgated directly in the House legislation.

[8] The House legislation would also allow a "facts and circumstances" test in determining compliance with the "separate lines of business" rules. These rules allow a diversified employer to provide benefits to its average- and lower-paid employees that are significantly smaller than the benefits it provides to its higher-paid employees, provided that the groups of employees work in lines of business of the employer that are so different and separate that they should fairly be treated as if they worked for two distinct employers.

[9] It may also be difficult for IRS officials to evaluate the impact of complex pension provisions without resorting to the type of objective, mathematical tests required under current law.

[10] Dan M. McGill, Kyle N. Brown, John J. Haley, and Sylvester J. Schieber, *Fundamentals of Private Pensions*, Seventh Edition (University of Pennsylvania Press: Philadelphia, 1996), page 68.

The proposed changes, moreover, would result in an even weaker system than existed when the facts and circumstances test previously was in place, since firms would have the *choice* of seeking approval for their plans based on *either* the mathematical tests or the facts and circumstances test. When the fact and circumstances existed previously, the mathematical tests did not exist. Some plans could pass the mathematical tests but not the facts and circumstances one, so the proposal to offer a choice of the mathematical tests or the facts and circumstances test would impose even weaker constraints than testing all plans based on their facts and circumstances alone. In sum, since the only plans that would need to resort to the proposed options are ones that fail the existing tests, the change represents a loosening of the rules – and potentially a major loosening of them.

Pension experts have underscored the dangers of this proposed package of changes. Professor Daniel Halperin of Harvard Law School, one of the nation's leading pension experts, has stated: "This provision is an outrage." He argues that these provisions would "basically gut" the non-discrimination rules.[11] In particular, the subjective standards applied under a "facts and circumstances" test may be insufficient protection against complicated pension plans that skew benefits toward higher earners.

Proponents of the proposed package have suggested that it is not intended to weaken the existing regulations substantially and that they do not anticipate the new provisions would be widely used. Such assumptions are not credible, however, since they are not clearly reflected in the statutory language. The language does not reflect an intent to limit the exceptions to a handful of unusual cases. Nothing in the legislation would preclude hundreds of plan sponsors from seeking approval of practices that fail to meet the non-discrimination standards of current law.

The weakening of the non-discrimination rules could potentially result in a significant reduction of pension contributions for average and lower earners because they could more easily be excluded from qualified pension plans or relegated to inferior benefit formulas. Yet they are the very workers who are supposed to be protected by the House legislation. It is difficult to see how such a provision could be justified, particularly in legislation ostensibly addressing the problems highlighted by the Enron collapse.

Several other provisions in the House legislation also are problematic. One would reduce reporting requirements for small pension plans. Such plans already enjoy simplified reporting requirements under current law. There is danger that the reduced reporting requirements in the House bill would make it harder for federal regulators to monitor compliance with basic

[11] Quoted in Richard A. Oppel, "Critics Charge Pension Bill Favors Highly Paid Workers," *New York Times*, April 10, 2002, page A1.

requirements related to pension plans and would result in more abuses going undetected.[12] Another provision would extend a temporary and unwarranted subsidy for defined benefit pension plans contained in the recent stimulus legislation. The extension would reduce revenue by more than $1 billion over the coming decade.[13]

Conclusion

These provisions of the House-passed Pension Security Act are inconsistent with the ostensible purpose of that legislation: to prevent problems similar to the ones experienced during the collapse of Enron. The provisions could harm the very workers the legislation is supposed to be protecting; their inclusion in an "Enron" pension bill is inappropriate. The Senate, in designing its own pension legislation, should exclude these problematic provisions so its legislation at least would do no harm to rank-and-file workers.

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[12] As J. Mark Iwry, the former benefits tax counsel at the Department of Treasury, has argued, "Small plans already have substantial relief when it comes to pension plan reporting...Relaxing the reporting requirements still further would make it harder for regulators to monitor compliance with the rules." Quoted in Richard A. Oppel, "Critics Charge Pension Bill Favors Highly Paid Workers," *New York Times*, April 10, 2002, page A1.

[13] The stimulus legislation raised the maximum interest rate that could be used to value defined benefit pension liabilities; the increase in the maximum rate reduces the present value of a plan's future liabilities and therefore reduces the firm's current financial obligations to contribute to the plan. The House pension legislation would extend the unwarranted interest rate adjustment. Although the extension is relatively modest, it would reduce federal revenue (including Pension Benefit Guaranty Corporation premiums) by more than $1 billion over the coming decade. (The premiums would be reduced because fewer plans would be classified as underfunded under the proposed change. Underfunded plans have to pay a special premium to the Pension Benefit Guaranty Corporation.) For more details on the interest rate adjustment, see Peter Orszag and David Gunter, "Note on Proposed Change in Assumed Interest Rate for Defined Benefit Pension Plans," The Brookings Institution, February 2002.