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GAO

Report to the Honorable Charles B. Rangel, House of Representatives

October 1987

PENSION PLANS

Vesting Status of Participants in Selected Small Plans

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

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October 30, 1987

The Honorable Charles B. Rangel
House of Representatives

Dear Mr. Rangel:

On August 31, 1987, you requested information regarding the extent to which men and women in "top-heavy" pension plans had vested benefits and how their vesting status would have changed if the Tax Reform Act of 1986 (TRA 1986) rules had been used instead of the top-heavy rules. Pension plans are considered top-heavy if more than 60 percent of (1) the present value of the total accrued benefits or (2) the aggregate account balances go to company owners and others who are defined as key employees. Vesting refers to pension plan participants earning nonforfeitable rights to benefits.

Because of your concern that legislation introduced in the 100th Congress might result in repeal of the top-heavy rules without a review of current data, we agreed to provide information on the vesting status of individuals in top-heavy plans from our ongoing review of pension plans of small employers (fewer than 100 employees). Top-heavy plans are also subject to other standards; however, this report focuses only on vesting provisions. Discussions with your office indicated that this information would be useful, even though it should not be considered as representative of all participants in top-heavy pension plans. Our results show employees' actual vesting status at a point in time (1985) and not necessarily what their vesting status will be when they leave their job.

Results in Brief

Shorter-tenured workers in the 128 plans included in our review would have been adversely affected if top-heavy vesting had been replaced by TRA 1986 vesting rules. They would have had to work longer under the TRA 1986 rules to achieve the same vesting status. The proportion of nonvested women in the plans would have increased, at a minimum, from 16 to 29 percent if the TRA 1986 rules had been used. Similarly, the proportion of nonvested men would have increased from 8 to 15 percent. Details of our analyses begin on page 6.

Background

The minimum vesting standards for private pension plans were first established by the Employee Retirement Income Security Act of 1974 (ERISA). These standards, including 10-year cliff and 5- to 15-year graded vesting, required employers that sponsored pension plans to give participants a right to their pension benefits before their retirement. Using a cliff schedule, participants move from nonvested to fully vested status after a specified length of service. Using a graded schedule, vesting begins after a specified length of service and increases by a fixed percentage each year until full vesting is achieved.

As part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Congress added top-heavy rules to the requirements pension plans must meet to qualify for tax benefits under the Internal Revenue Code. The top-heavy rules were intended to curb perceived inequities in pension plans when an employer's key employees were primary beneficiaries. (A key employee is an officer, an employee owning more than a 5-percent interest in the firm, an employee owning more than a 1-percent interest in the firm and earning over $150,000, or one of the 10 employees owning the largest interests in the firm.) Among other things, TEFRA reduced the time required for vesting in top-heavy plans, increasing the likelihood of shorter-tenured workers receiving pension benefits. Top-heavy rules prescribe the following minimum vesting schedules: (1) 2- to 6-year graded vesting or (2) 3-year cliff vesting. Internal Revenue Service regulations prescribe procedures a plan must follow to determine its top-heavy status with respect to any plan year.

Under TRA 1986, the Congress changed the rules for pension plans (other than collectively bargained multiemployer plans or top-heavy plans) to require quicker vesting. The TEFRA rules, which still apply to top-heavy plans, provided for shorter vesting periods than the TRA 1986 rules. The new minimum vesting schedules under TRA 1986 provide: (1) 3- to 7-year graded vesting or (2) 5-year cliff vesting.

A comparison of top-heavy and TRA 1986 vesting schedules is provided in table 1. For example, after 3 years of service a participant in a top-heavy plan would be 40-percent vested under a graded schedule or 100-percent vested under a cliff schedule. The same participant, subject to TRA 1986 vesting, would be 20-percent vested under the graded provision or not vested at all under the cliff provision.

Table 1: Comparison of Top-Heavy and TRA 1986 Vesting Schedules

Figures are percentages

	Years of service						
	1	2	3	4	5	6	7 or more
Top-heavy:							
2- to 6-year graded	0	20	40	60	80	100	100
3-year cliff	0	0	100	100	100	100	100
TRA 1986:							
3- to 7-year graded	0	0	20	40	60	80	100
5-year cliff	0	0	0	0	100	100	100

Need for Top-Heavy Rules Under Debate

The passage of TRA 1986 has led to a debate about whether to repeal the top-heavy rules. Although the top-heavy rules under TEFRA did not specifically target small businesses, these firms' plans are more likely to be top-heavy because of the limits on the number of key employees. Some representatives of small businesses contend that the top-heavy vesting rules should be dropped because they are similar to the TRA 1986 vesting schedules. Furthermore, because the top-heavy rules require special determination procedures which TRA 1986 does not, these representatives believe that TRA 1986 rules present less of an administrative burden than the top-heavy rules.

Groups concerned with protecting workers' and retirees' pensions argue that retaining the top-heavy vesting schedules is necessary because of the high mobility of workers employed in small businesses. These groups assert that faster vesting helps shorter-tenured workers. They also disagree with small business representatives that the top-heavy rules are burdensome to administer. Further, they believe that employers may voluntarily meet the top-heavy requirements and, thereby, avoid the burden of the special determination process.

Proposed legislation, the Small Business Retirement and Benefit Extension Act (S. 1426 and H.R. 2793), introduced in the 100th Congress provides for repeal of the top-heavy rules. In addition, the Congress may consider repeal of the top-heavy rules during the fiscal year 1988 budget reconciliation process.

Objectives, Scope, and Methodology

Our objective was to determine how the vesting status of men and women in top-heavy plans would have changed if their plans had adopted the TRA 1986 rules.

Data on top-heavy pension plans were drawn from initial returns of our survey of 1,025 pension plans of small employers (fewer than 100 employees) to satisfy the requirement in the Retirement Equity Act of 1984 that GAO examine the effect of pension rules on women. At the time of the request, we had received usable responses from 306 plans, including 202 top-heavy plans.

For our analysis, we used 1985 data on 859 employees (437 men and 422 women) participating in the 128 top-heavy plans with a 2- to 6-year graded schedule. We selected this vesting schedule because it was one of the two top-heavy minimum schedules and was used by the largest number of plans in our initial returns. In addition, most of the participants were in plans using this vesting schedule.

We did not include 20 plans, which used 3-year cliff vesting because of their small number. We also did not include 54 plans that used vesting schedules which required less time to vest than the minimum top-heavy vesting schedules.

Of the 128 plans included in our review, 72 were sponsored by legal, medical, or health services firms. The 128 plans had an average of seven participants each. The median job tenure for men in the plans was 7 years, for women 4 years. (See app. I for additional information on the 128 plans as well as the 74 plans with other vesting schedules.)

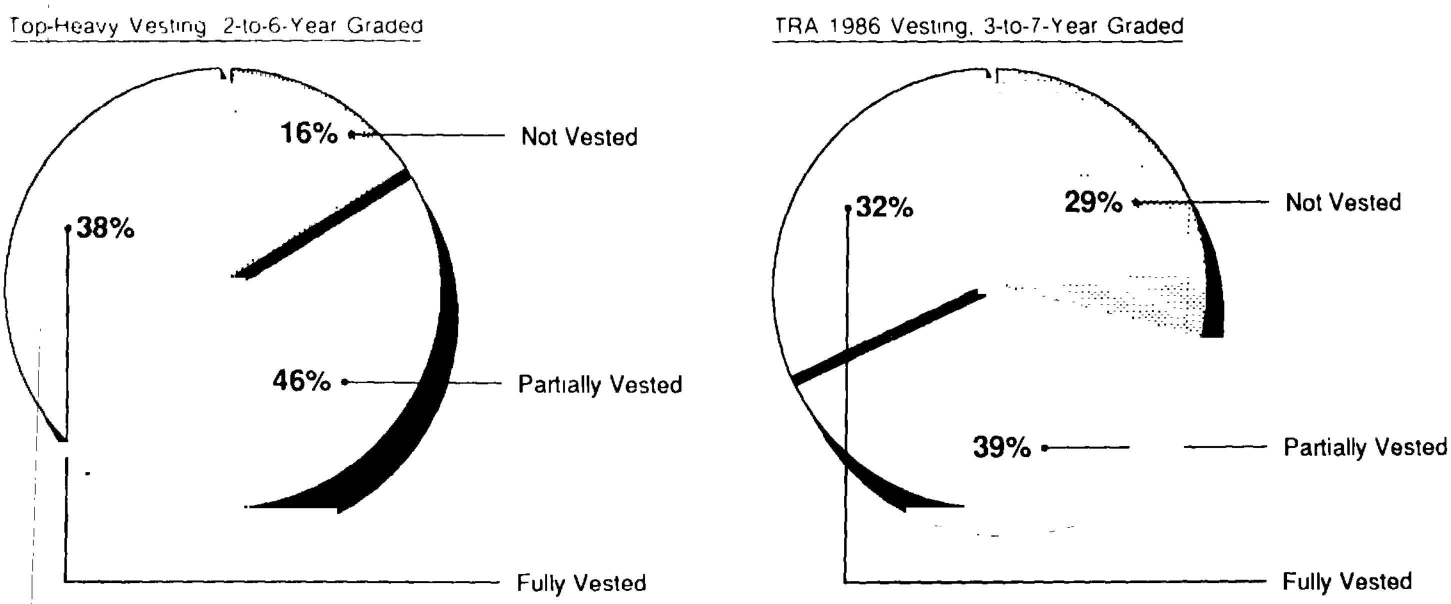
We determined the percentages of men and women who were fully vested, partially vested, and not vested under their top-heavy plan and compared their vesting status with what it would have been under the two TRA 1986 minimum vesting schedules. Because we could not exclude the key employees from our analysis, we could not isolate the effect of the TRA 1986 schedules for only non-key employees. Further, our results do not show what the participants' actual vesting status will be when they leave their job.

Our results are descriptive and are not projectable to the universe of top-heavy plan members because the study was designed to examine plans, not participants. Consequently, we did not perform tests of statistical significance.

Our review was done in accordance with generally accepted government auditing standards. As requested by your office we did not obtain formal written comments on this report. However, we discussed the contents of this report with an official from the Office of the Tax

Legislative Counsel, Department of the Treasury, and made changes where appropriate.

Figure 1: Comparison of Women's Top-Heavy Vesting Status With What Their Status Would Have Been Under TRA 1986 Graded Schedule



Note Based on 1985 data from 128 top-heavy plans using a 2- to 6-year graded vesting schedule, with 859 active participants 422 of whom were women, in 97 companies with fewer than 100 employees

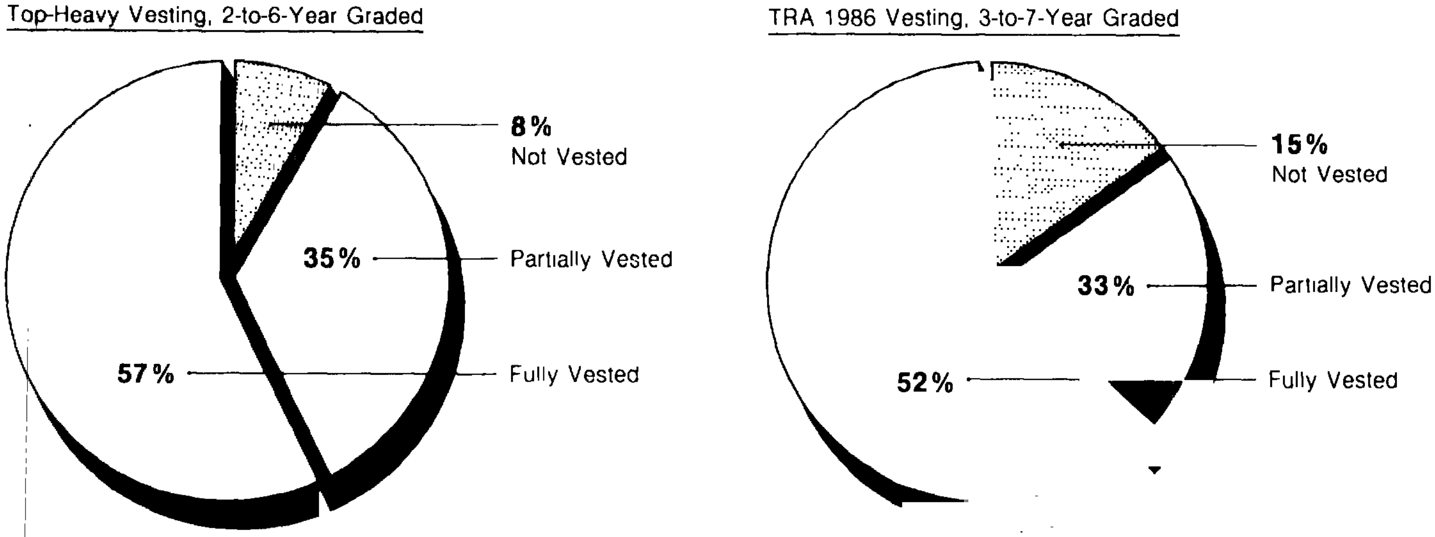
TRA 1986 Would Adversely Affect Top-Heavy Plan Participants

Based on our analysis of the 859 participants in the 128 top-heavy plans using 2- to 6-year graded vesting, we estimated that if plans had used TRA 1986 instead of the top-heavy rules, more employees would have no vested benefits.

Under the TRA 1986 graded vesting schedule, the proportion of nonvested women would have increased from 16 to 29 percent, as shown in figure 1. Similarly, the proportion of nonvested men would have increased from 8 to 15 percent, as shown in figure 2.

Smaller percentages of participants would be vested under the TRA 1986 graded schedule than under the top-heavy schedule. For example, 38 percent of women were fully vested under their top-heavy plans, while 32 percent would have been fully vested under TRA 1986. Under top-heavy rules, 57 percent of men were fully vested, while 52 percent would have been fully vested under the TRA 1986 graded schedule. (See figs. 1 and 2.)

Figure 2: Comparison of Men's Top-Heavy Vesting Status With What Their Status Would Have Been Under TRA 1986 Graded Schedule



Note Based on 1985 data from 128 top-heavy plans using a 2- to 6-year graded vesting schedule, with 859 active participants, 437 of whom were men, in 97 companies with fewer than 100 employees

We also analyzed the difference between the top-heavy and the TRA 1986 graded vesting schedules, using the average vesting percentages for men and women under each set of rules. The average vesting percentage equals the sum of the participants' vesting percentages—that is, 0, 20, 40, 60, 80, or 100 percent—divided by the number of individuals. For women, the average vesting percentage would have decreased from 60 percent under top-heavy to 49 percent under the TRA 1986 graded schedule. The average percentage for men would have decreased from 74 to 66 percent.

If the plans had changed their 2- to 6-year graded vesting schedule to TRA 1986's 5-year cliff schedule, most of the partially vested participants would not have been vested. Under the top-heavy schedule, 46 percent of women and 35 percent of men were partially vested. If these plans had used a 5-year cliff schedule, the proportion of women with no vested benefits would have increased from 16 to 53 percent, while the proportion of women fully vested would have increased from 38 to 47 percent. Similarly, the proportion of men with no vested benefits would have increased from 8 to 36 percent, while the proportion of men fully vested would have increased from 57 to 64 percent.

Copies of this report are being sent to interested Senate and House Committees; we will make copies available to others on request. As agreed with your office, we provided the Senate Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, with a statement summarizing our results for use in its October 23, 1987, hearings on the Small Business Retirement and Benefit Extension Act (S. 1426).

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Senior Associate Director

Background Information on 202 Top-Heavy Pension Plans

Table I.1: Top-Heavy Plan Participants by Vesting Schedule, Industry, and Sex[a]

Vesting schedule	Legal, medical, health services		Wholesale trade		Retail trade		Financial, real estate		Other services		Row totals
	Men	Women	Men	Women	Men	Women	Men	Women	Men	Women	Men[b] and Women[c]
2- to 6-year graded	116	255	173	62	72	54	17	21	59	30	859
3-year cliff	34	31	3	0	0	0	2	4	17	16	107
1- to 5-year graded	80	202	2	0	0	0	0	0	2	0	286
Immediate	43	43	11	4	0	0	2	8	13	8	132
Total	**273**	**531**	**189**	**66**	**72**	**54**	**21**	**33**	**91**	**54**	**1,384**

[a]Based on 1985 data from 202 top-heavy plans

[b]646 men with median age 45 years and median tenure 7 years (For the 437 men in plans using the 2-to 6-year graded schedule the median age was 43 years and median tenure 7 years.)

[c]738 women with median age 37 years and median tenure 5 years (For the 422 women in plans using the 2- to 6-year graded schedule the median age was 37 years and median tenure 4 years.)

Table I.2: Top-Heavy Pension Plans by Vesting Schedule and Industry[a]

Vesting schedule	Legal, medical, health services	Wholesale trade	Retail trade	Financial, real estate	Other services	Row total
2- to 6-year graded	72	16	17	7	16	128
3-year cliff	15	1	0	1	3	20
1- to 5-year graded	19	1	0	0	1	21
Immediate	21	4	0	2	6	33
Total	**127**	**22**	**17**	**10**	**26**	**202**

[a]Based on 1985 data on top-heavy plans covering 1,384 participants (738 women and 646 men)

Table I.3: Top-Heavy Plan Participants, Plans, and Average Number of Participants Per Plan by Vesting Schedule[a]

Vesting schedule	Number of participants	Number of plans	Average number of participants per plan
2- to 6-year graded	859	128	7
3-year cliff	107	20	5
1- to 5-year graded	286	21	14
Immediate	132	33	4
Total	**1,384**	**202**	**7**

[a]Based on 1985 data from 202 top-heavy plans covering 1 384 participants (738 women and 646 men)

Table I.4: Vesting Status of Participants in Top-Heavy Plans by Vesting Schedule (Percent of Men and Women)[a]

	2- to 6-year graded		3-year cliff		1- to 5-year graded		Immediate	
Vesting status	Men	Women	Men	Women	Men	Women	Men	Women
Nonvested	8	16	13	39	5	7	c	c
Partially vested	35	46	c	c	23	36	c	c
Fully vested	58	38	88	61	73	57	100	100
Total[b]	100	100	100	100	100	100	100	100

[a]Based on 1985 data from 202 top-heavy plans covering 1,384 participants (738 women and 646 men)

[b]Totals may not add to 100 due to rounding

[c]Not applicable

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