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ERISA@40: A History Lesson

This is the first in a multi-part series of articles to be published over the next several months celebrating the 40th birthday of the Employee Retirement Income Security Act. ERISA was signed into law by President Gerald Ford on September 2, 1974 — Labor Day. This landmark law regulates many aspects of employer-sponsored retirement and welfare benefit plans. The series looks back to explore how the employer-sponsored employee benefits industry has evolved, highlights lessons learned, and looks forward to what employers may expect in the future. This first article looks at the evolution of private sector retirement plans in the US and emerging federal regulation of those plans up to the date that ERISA was inked.

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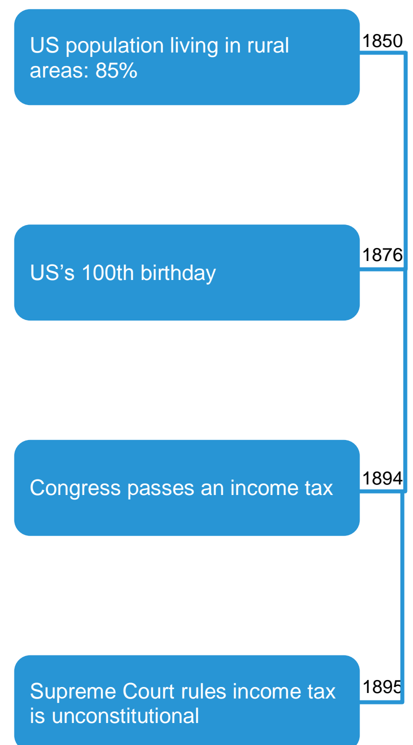
Introduction

Employer-provided retirement plans today cover 50 to 70% of the US workforce. The exact percentage varies depending on who is counted in the workforce and whether an offer to participate — without actual participation — counts. This is considerable progress, as just 85 years ago employer-provided plans covered only an estimated10% of the private workforce.



Nineteenth Century Innovation

At the beginning of the twentieth century, employer-provided retirement plans in the private sector were a relatively new compensation innovation intended to attract skilled workers. Some British factories began offering workplace pensions beginning in the second half of the nineteenth century, and it was a British-owned railroad company that introduced North America's first industrial pension plan in 1874 — in Canada. One year later, in 1875, American Express established the first private pension plan in the US. By 1929, there were almost 400 retirement plans in the US and Canada, including plans established by employers such as U.S. Steel Corporation, General Electric Company, AT&T, Goodyear Tire and Rubber Company, and Eastman Kodak Company.

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Retirement pay as a compensation tool also coincided with technological and economic innovations in the late nineteenth century that would transform American society — from a primarily agriculture based economy and society to a fully industrialized urban society. In 1850, 15% of Americans lived in cities; by 1900 that figure was almost 40%. Not only did the retirement plan serve as a means to attract skilled workers, but the advent of employer-provided plans also served an important social policy function as America industrialized. Nineteenth and early twentieth century work in factories was labor intensive; many factory owners restricted the hiring of older workers and had mandatory retirement ages. Workers who did not have the foresight or discipline — or luck — to save enough on their own could find themselves on the street without sufficient resources. Employer-provided plans were a means of preventing destitution among the elderly.

Regulation through the Tax Code

Federal regulation of private-sector pensions first took place through the tax code. Similar to today's tax-qualification rules, the early tax codes in the twentieth century spurred employers' adoption of plans by providing favorable tax treatment, as long as certain conditions were met. Thus, for example, the Revenue Acts of 1921 and 1926 provided tax exemption for trusts and other plan funding vehicles, and provided tax deferral for participants until distribution of plan benefits. The Revenue Act of 1928 allowed employers to deduct pension contributions. All of these are key tax benefits that we still see today.

In 1939, Congress passed a compilation of income tax laws — the Internal Revenue Code of 1939. This law was a restatement and codification of piecemeal income tax legislation that had been passed over the prior two decades. It did not include any substantive changes to tax law. Section 23(p) of the 1939 tax code allowed employer deductions for reasonable contributions to retirement plans. Section 165 allowed the tax exemption for a trust funding the plan — provided that the trust was organized for the exclusive benefit of employees, and it was impossible prior to the payment of all plan liabilities to divert trust funds for any purpose other than plan benefits — still features of today's tax-qualification rules.

Three years later, the Revenue Act of 1942 provided stricter tax-qualification rules by adding coverage and nondiscrimination requirements and also placed limits on the amount of an employer's deduction for plan contributions. For example, minimum participation rules required that the plan benefit at least 70% of all employees — or 80% of those eligible to benefit if at least 70% of all employees were eligible to benefit. Excluded employees were those not employed long enough (as specified by the plan — but not more than 5 years), employees customarily working 20 or fewer hours per week, and seasonal

1913 — 16th Amendment to the US Constitution ratified — permitting Congress to enact an income tax

1930 — US population living in rural areas: 44%

1935 — Social Security Act enacted. Punch-card technology used to process records for millions of workers

1936 — A car costs $600, gasoline 19 cents per gallon, milk 48 cents per gallon, postage 3 cents, an average house $6,200, and average annual pay is $1,600

1937 — Shopping carts are first introduced by Piggly Wiggly supermarkets

1938 — Popular radio shows include Little Orphan Annie, Dick Tracy, The Guiding Light, and Kraft Music Hall with Bing Crosby

1939 — Congress passes Internal Revenue Code of 1939

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employees (5 or fewer months out of the year). As an alternative to the percentage test, the plan could instead satisfy a classification test. Under that test, the plan needed to cover a classification found by the IRS commissioner not to be discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees. In addition to the coverage test, the plan had to satisfy a nondiscrimination requirement and the seed of exceptions for social security integration was introduced into the Code — including the ability to leave out employees entirely if remuneration did not exceed the FICA wage base.

The new nondiscrimination rules led to the 1945 publication of Mimeograph 5717 — the original "high 25" benefit restrictions that applied to terminating plans. These were later moved to a regulation under Code section 401 — the new home for Code section 165 in the 1954 Internal Revenue Code.

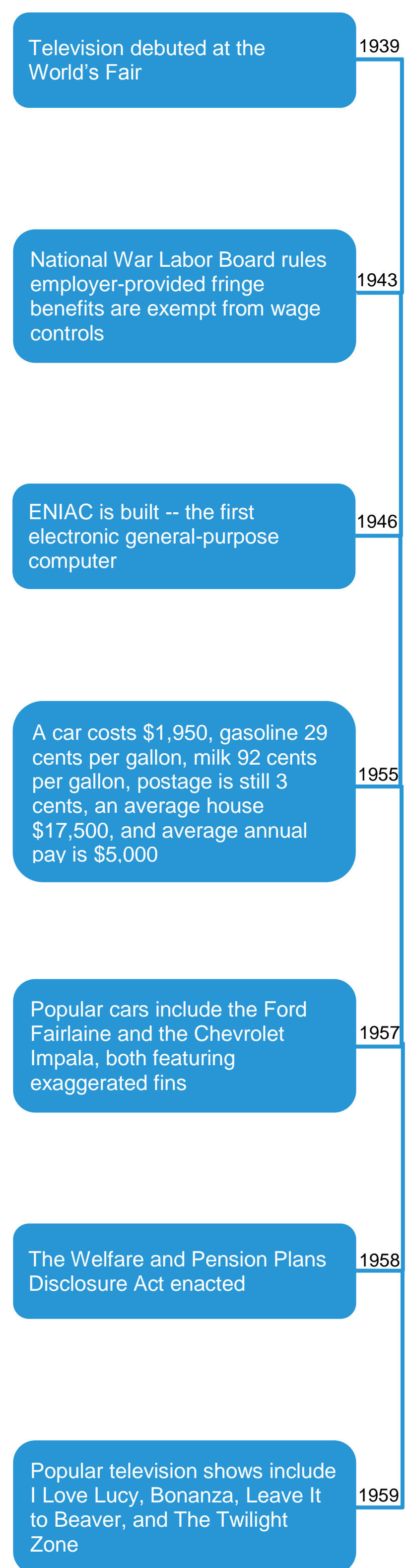
Increased Popularity of Retirement Plans

Pensions — and other employer fringe benefits — got a big boost in 1942 with the enactment of price and wage control laws. The laws were intended to stabilize prices and labor supply during America's involvement in World War II. In 1943, the War Labor Board — charged with enforcing the wage control laws — ruled that the wage limits did not apply to employer-provided fringe benefits, such as retirement plans and health insurance. To attract workers who were in short supply, employers began offering retirement and health plans — with the result that the number of private sector workers covered by pension plans accelerated.

After the war, unions identified pensions as a key benefit that could be negotiated in bargaining agreements. The United Automobile Workers (UAW) included pension payments in employment contracts with Detroit automakers. The first UAW pension plans were included in contract talks with Ford, Chrysler and General Motors. In 1950, a fixed pension of $100 a month, including social security, was added to GM compensation packages.

Arresting Financial Abuses

In the two decades after World War II, employer-provided pensions had surged in popularity and workforce coverage — by 1940, approximately 15% of private sector workers were covered by a pension plan, by 1950 it was 25%, and by 1960, 41%. As pension funds grew, financial abuses followed, and in 1958 the Welfare and Pension Plans Disclosure Act (WPPDA) was enacted to shed light on, and stop perceived abuses by, plan fiduciaries. This law required plan administrators to disclose information on plan terms and finances to participants and the Department of Labor. To prevent mismanagement and



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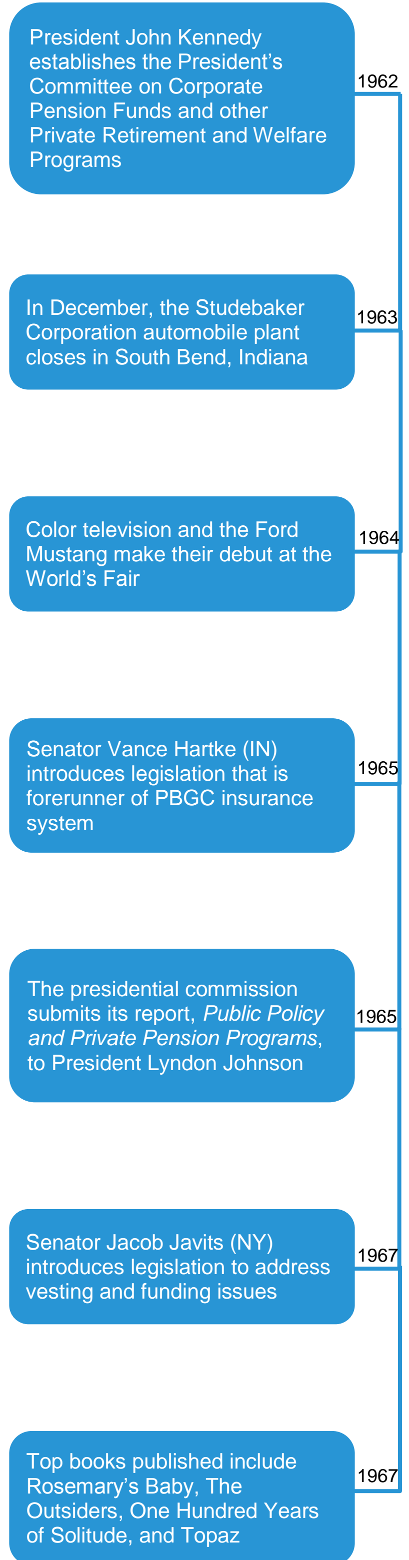
abuse of plans funds, the WPPDA was amended in 1962 to give the secretary of labor enforcement, interpretative, and investigatory powers over employee benefit plans.



Studebaker's Demise and the Dawn of ERISA

In December 1963, the Studebaker-Packard Corporation closed its South Bend, Indiana automobile plant. Shortly afterward, the pension plan for hourly workers was terminated. The plan was seriously underfunded and left thousands of workers with little or no benefits. This drew national media attention to the need for pension reform. While the Studebaker plan failure intensified attention on pension reform, policy experts in Washington had already been studying the underlying problems. In 1962, President John F. Kennedy created a special committee charged with investigating the shortcomings in private pension plans, "The Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs."

A Decade Passes

Congressional action in the 1960s and 1970s moved at a glacial pace. It took more than a decade from Studebaker's demise until the enactment of ERISA. In 1965, Senator Vance Hartke — whose home state of Indiana was the location of the Studebaker plant — introduced legislation that would establish a federally run insurance program for failed pension plans — a forerunner to the PBGC's insurance system that is a cornerstone of ERISA today.

Also in 1965, the presidential commission submitted its report, Public Policy and Private Pension Programs, to President Lyndon B. Johnson. Among the recommendations were that reasonable vesting schedules should be required as well as minimum funding of pension plan liabilities — with the goal that employees would actually receive promised pensions. In 1967 Senator Jacob Javits (NY) introduced legislation to address vesting and funding issues identified by the presidential commission — two additional cornerstones of ERISA. The legislation stalled.

Several years later, in 1971, Senators Javits and Harrison Williams (NJ) released an influential two-year survey of pension plans that received widespread media attention — because it concluded that only a relative handful of employees would ever receive benefits. The next year, NBC aired a widely-viewed news program — Pensions: The Broken Promise — that highlighted many of the concerns raised in the report.

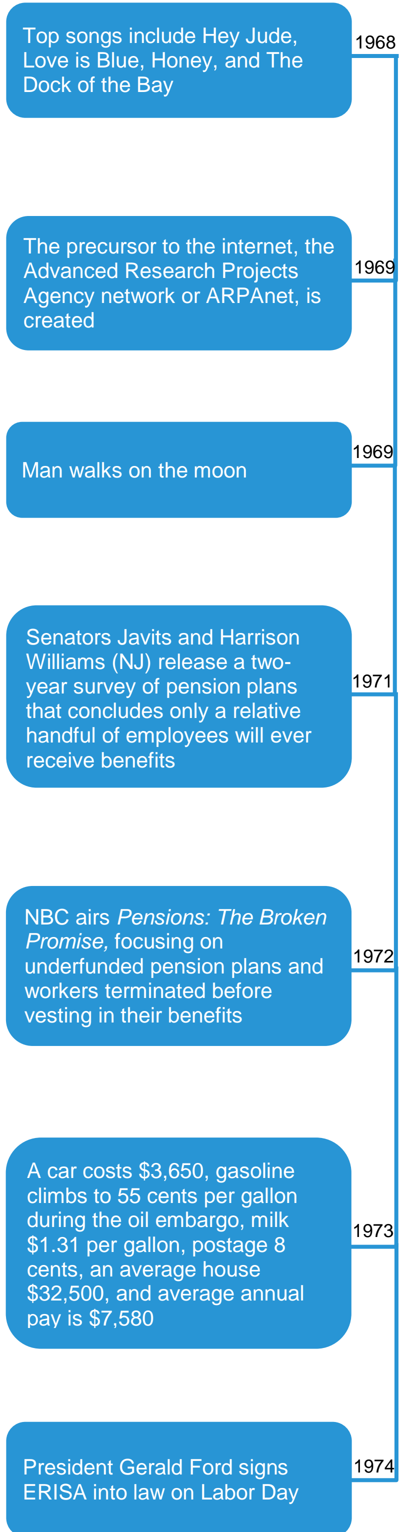
Like many pieces of major legislation, ERISA died a thousand deaths on its way to enactment. Business groups in particular had significant reservations about the legislation and only embraced it when the lack of federal action

began prompting some states to consider enacting their own retirement protection rules. The prospect of inconsistent state rules disrupting the benefit programs of national employers — and ERISA's bedrock principle of pre-emption — helped marshal support for the legislation, which helped push it across the finish line.

In Closing

ERISA's birth came just after the US ended direct military involvement in the Vietnam War and the resignation of President Nixon amidst the Watergate scandal. It was the end of an era when employers could disclaim liability for defined benefit plans; it was the beginning of an era that provided a pension bill of rights for US workers. It was the beginning of the Pension Benefit Guaranty Corporation — an agency dedicated to saving pensions and those covered by them.

Many new obligations were imposed on employers with the passage of ERISA — vesting, funding, PBGC premiums, and controlled group liabilities. Some certainty was added around the ability to exclude employees from coverage and nondiscrimination tests where benefits were bargained even if the bargain was for no benefits at all. Changes in the controlled group rules were a two edged sword — broader coverage tests, but clearer ability to maintain a common plan. PBGC coverage came at a cost, but in sum, the insured promise would be more credible in addressing the goals of attracting and retaining employees with a defensible promise. Now retirement would be more than a roll of the dice, and retirees would not be left with empty pockets, ill prepared for the future.



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