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December 10, 1975

Lt. General W. L. Creech, USAF
Commander, Electronics Systems Division
Hanscom Air Force Base
Bedford, Massachusetts 01730

Dear General Creech:

The General Accounting Office recently completed a survey of pension costs at MITRE Corporation, Bedford, Massachusetts. The survey was made to determine the reasonableness of pension plan costs charged to Government contracts.

Previously, we briefed your Contract Management Office and MITRE officials on the tentative results of our work. We are now reporting our findings and conclusions for your consideration.

BACKGROUND

Contracts with MITRE are awarded and administered by the Electronic Systems Division of the Air Force Systems Command. The Administrative Contracting Officer (ACO) in the Contract Management Office is responsible for evaluating pension costs to determine compliance with the Armed Services Procurement Regulation. The ACO relies upon the Defense Contract Audit Agency (DCAA) for assistance in evaluating pension costs.

MITRE has two pension plans--a Trusteed Plan for its weekly salaried employees and the Teachers Insurance and Annuity Association and College Retirement Equities Fund (TIAA-CREF) for its monthly salaried employees.

FINDINGS

In summary, we noted that:

--the benefits and related cost under the TIAA-CREF plan are high when compared to other plans,

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--the TIAA-CREF plan favors officers and higher paid employees,

--the Trusteed Plan is overfunded, and

--an expensive method was chosen in transferring employees to TIAA-CREF.

Reasonableness of Benefits and Related Cost

ASPR 15-309.23 established the requirements for allowability of pension costs to be charged against Government research and development grants and contracts by educational institutions. Costs of an institution's pension plan incurred in accordance with established policies of the institution are allowable provided such policies meet the test of reasonableness.

Pension benefits at MITRE (TIAA-CREF plan) are high when compared to either commercial organizations or the Government (Civil Service) pension plan. In fact, DCAA in its overhead audit of 1973 concluded that charges were unreasonable in comparison with the U.S. Government Civil Service Retirement Program. DCAA considered this to be a fair comparison since MITRE is a Government-sponsored non-profit institution.

Set forth below is our comparison of the pension benefits of several DOD contractors and the Government with MITRE. The comparison is for a person who retires at age 65 with 37 years of service. The starting salary was $8,500 and the ending salary $25,000.

	Retirement annuity[a]	Percent of final salary[b]
MITRE (TIAA-CREF) (OPTION 1)	$22,290	89.2
U.S. Government	$16,743	66.9
Contractors		
A	$14,095	56.4
B	$11,009	44.0
C	$10,867	43.5
D	$7,566	30.3

[a]Single-life annuity - males.

[b]Does not include Social Security benefits for MITRE and contractors' employees.

As can be seen, a MITRE employee with the same years of service and salary experience will retire with a retirement annuity over 50 percent greater than that of four large New England based DOD contractors and over 30 percent greater than the Government.

In another comparison the level of pension benefits of the Government and MITRE at various retirement ages was computed.

	Retire-ment age	Year of salary	Starting salary	Annual rate of interest	Final salary	Retirement annuity[a]	Percent of final salary[b]
MITRE Corporation	55	30	$10,000	3%	$23,575	$16,199	68.7
	62	37	$10,000		$28,993	$29,806	102.8
	65	40	$10,000		$31,682	$38,557	121.7
Government	55	30	$10,000	3%	$23,575	$11,860	50.3
	62	37	$10,000		$28,993	$18,072	62.3
	65	40	$10,000		$31,682	$21,385	67.5

[a]Life annuity 10 years guaranteed - males

[b]Does not include Social Security benefits for MITRE employees.

Again, this comparison shows that the MITRE pension benefits are much higher than the Federal Government's for all three ages. These very generous pension benefits are having a significant impact on the pension cost being charged to the Government and appear to be excessive when compared to commercial organizations doing Government business.

In our opinion, as a part of its review of pension costs, the Contract Management Office should consider the reasonableness of the benefits in light of the benefits offered by other contractors doing business with the Government, other laboratories in the same geographic area, and the U.S. Government Civil Service Retirement Plan.

TIAA-CREF Plan Favors Officers and the Higher Paid Employees

MITRE's pension plan favors officers and highly compensated employees and MITRE maintains that current regulations concerning nondiscrimination do not apply to them. The issue is two-tiered at MITRE.

First, the pensions for the higher paid staff, in general, and second, the additional pension for three key officers.

High paid staff

Prior to June 1974, weekly salaried employees could only join the Trusteed Plan and monthly salaried employees joined TIAA-CREF. Employees contributed 2.5 percent of base salary up to the social security base and 4.0 percent thereafter under the Trusteed Plan. Employees contributed a straight 6.0 percent of base salary under the TIAA-CREF.

For comparable salary and years of service, the MITRE Trusteed Plan provided less than one-half the normal retirement benefits of the then TIAA-CREF plan.

Since June 1974, all new hires could only join TIAA-CREF and on-board weekly salaried employees were encouraged to transfer to the TIAA-CREF plan with its better benefits. Employees at MITRE have the following immediate alternatives under TIAA-CREF:

--contribute 6% (or more) of salary with MITRE giving 9.3% (OPTION 1)

--contribute 2.5% of salary up to Social Security base and 6.0% thereafter with MITRE giving 5.0% up to Social Security base and 9.3% thereafter (OPTION 2)

--contribute 0% of salary with MITRE giving 0% (Non-member)

Enrollment in either OPTION 1 or 2 is mandatory after five years of credited service or age 30, whichever is later and eligible employees may elect from OPTION 1 or 2 on an annual basis.

As indicated below, approximately 30 percent of MITRE employees earn more than $25,000 annually (755 out of 2,502). Of these people, about 96 percent have elected OPTION 1 which requires a 6 percent contribution by them with a 9.3 percent contribution from MITRE.

An additional 30 percent of MITRE employees earn between $15,000 and $25,000 annually (750 out of 2,502). Of these people, about 83 percent have elected OPTION 1.

However, the remaining 40 percent earn less than $15,000 per year (997 out of 2,502) and only 41 percent of them joined OPTION 1.

STATUS OF MITRE EMPLOYEES
January 1975

Salary	Number of people	TIAA-CREF OPTION I	TIAA-CREF OPTION 2	Trusteed plan	Non-members
Under $15,000	997	408	123	31	435
$15,000 - $25,000	750	626	32	-	92
Over $25,000	755	722	16	-	17
Totals	2,502	1,756	171	31	544

In our opinion, these low salaried employees (less than $15,000), with the present Social Security requirement to contribute 5.85 percent of the Social Security base of $14,100 are inclined to avoid OPTION 1 with its 6 percent contribution. Rather, they elect to contribute 2.5 percent up to the Social Security base under OPTION 2, or the Trusteed Plan, or not contribute for at least 5 years when enrollment is mandatory.

Under these conditions, it appears that the employer contributions --based on the level of employee contributions--is inequitably in favor of highly compensated employees.

DCAA views

ASPR XV, Part 2, deals with commercial organizations and cites that for pension expense to be an allowable charge against Government contracts, it must be deductible for Federal income tax purposes under Section 404 of the Internal Revenue Code of 1954, as amended, and the regulations of the Internal Revenue Service. One of the provisions of the Code is that a pension plan must be qualified as defined in Section 401. One requirement to be qualified is that a pension plan must not discriminate either in contributions or benefits in favor of officers, supervisors, or highly compensated employees.

DCAA, in reviewing non-profit or tax-exempt contractors' pension cost for allowability as a charge to Government contracts, has adopted the IRS criteria in these sections as applied to commercial organizations.

The Defense Contract Audit Manual (DCAM) 11-016.5 provides that:

"***the first requisite for acceptance of the costs of any pension plan is that it must be eligible for approval by the Internal Revenue Service. The best evidence of compliance with this requirement is the actual approval issued by IRS for contractors subject to Federal income tax and for non-profit or tax-exempt contractors who have submitted their plan for approval. In the case of all other plans, compliance with IRS requirements will be determined by applying, insofar as applicable, the regulations, criteria, and standards of IRS***."

The manual is specific in stating that in the case of nonprofit or tax exempt organizations, pension cost accepted by the auditor should not exceed the approximate amount which could have been deducted for income tax purposes in the current taxable period had the organization been subject to payment of income tax.

In our opinion, the Defense Contract Audit Manual 11-016.5 with its reliance on IRS criteria for qualified plans, including the nondiscrimination provision, is a good guide to follow in determining the reasonableness of pension cost. In its overhead audit of 1973, DCAA concluded that the TIAA-CREF plan appeared discriminatory in that it favored higher-rated personnel and low-rated personnel were excluded. Apparently this was not reported to your office and DCAA has not yet analyzed employee enrollment and affected employer contributions since the TIAA-CREF plan was made available to all employees.

Contractor's views

MITRE contends that their pension costs are governed by the principles of Part 3 of the ASPR XV dealing with educational institutions, which contains no reference to IRS Code Sections 401(a) and 404(a) criteria. As an organization exempt from Federal income tax under Section 501(c)(3) of the Code, MITRE may offer a nonqualified annuity per Section 403(b) of the Code. Under such plans (e.g., TIAA-CREF), the employer may offer an employee the opportunity to have contributions made toward purchase of the annuity on a before-tax basis through execution of a salary reduction agreement. The term nonqualified annuity indicates that it is not part of a plan which was qualified or approved by the Internal Revenue Service per Section 401.

MITRE has received a legal opinion from its attorney stating that unlike qualified plans, these nonqualified plans can be limited to specifically selected employees irrespective of the degree of discrimination.

We believe that the matter should be reviewed to determine whether (1) MITRE is correct in its interpretation, and (2) the employer contributions based on the level of employee contribution is inequitably in favor of highly-compensated employees.

Special contributions for key officers

Effective January 1, 1972, MITRE increased pension contributions for its three senior officers. MITRE agrees the supplemental contribution is discriminatory but believes it is allowed under the Code, Section 403(b). In providing the supplemental contribution, MITRE reasoned that since the three officers ranged in age from 48-50, their retirement at age 65 would drain the corporation of its top leadership during a 2-year period. MITRE, therefore, decided to improve early retirement benefits to encourage one or more of the officers to exercise this option.

The annual contributions for each of the officers through age 55 follows:

		MITRE Contribution			Percent of
Officer	Salary	Annual	Supplemental	Total	salary
A	$60,000	$5,580	$7,500	$13,080	21.8
B	$45,000	$4,185	$4,000	$8,185	18.2
C	$45,000	$4,185	$4,000	$8,185	18.2

The total dollar impact of the increase in pension contributions for the three officers is:

Officer	Age	Additional contribution	Years thru age 55	Total
A	50	$7,500	5	$37,500
B	49	$4,000	7	28,000
C	48	$4,000	8	32,000
				$97,500

DCAA in a 1972 special study for the Contract Management Office noted that the additional contributions for key executives were unallowable based on the guidance contained in their audit manual. However, in June 1973, the Contract Management Office allowed the cost. One official of that office advised us during our review that such additional compensation was not only legal, but similar to additional benefits given to top executives in private industry in the form of such items as stock purchase plans.

We find no support—other than a desire to encourage early retirement—to justify the increase in benefits for MITRE's top executives. The contribution of 18.2 and 21.8 percent of gross salary being charged to Government contracts appears unreasonable and favors only the three key officers.

We believe that the matter should be reviewed to determine whether this special contribution for the top three executives totaling $97,500 is an unreasonable charge, is discriminatory, and can be considered an allowable cost in view of the requirements of the DCAA audit manual.

Trusteed Plan Is Overfunded

A realistic appraisal of assets and liabilities in the Trusteed Plan indicated that the plan is overfunded by about one-half million dollars.

In 1974, when weekly salaried employees transferred from the Trusteed Plan to TIAA-CREF, they were informed that the transfer offered many advantages including immediate vesting, improved death benefits, deferred taxation and greater flexibility in type of investments and level of contributions. As of December 1, 1974, 344 of the 439 members of the Trusteed Plan transferred. MITRE purchased TIAA-CREF benefits for the transferees equal to the value of benefits earned under the Trusteed Plan. The purchase was funded by liquidating trust assets.

As of May 1, 1975, the market value of the remaining assets totaled $1,001,509; whereas, the liability for earned and future pension benefits of the employees remaining in the Trusteed Plan was $461,698. The difference of $539,811 represents the overfunding at that date.

Because of the difficulty in freeing monies transferred to an irrevocable pension trust, the Government may not be able to recover the overfunding even though it was accumulated through charges against Government contracts. We believe that the overfunding should be reviewed to determine what is involved in obtaining an equitable adjustment for the Government. One course of action may be to direct MITRE to purchase annuities for the remaining members, terminate the trust and refund the excess to the Government. Another might be to negotiate a fee reduction to offset the overfunding of pension cost.

Expensive Method Chosen in
Transferring Employees to TIAA-CREF

For weekly salaried employees who chose to transfer from the Trusteed Plan to TIAA-CREF, MITRE purchased TIAA-CREF annuities comparable to benefits earned under the Trusteed Plan. This proved costly to the Government for several reasons.

1. Assets of the Trusteed Plan had to be liquidated. These sales incurred an estimated $9,300 in commission expenses.

2. Younger aged employees received a greater credit under TIAA-CREF than benefits earned under the Trusteed Plan. This was because under the Trusteed Plan their contributions with compounded interest exceeded the earned benefits.

3. On the other hand, older aged employees closer to retirement were to receive a smaller credit for future benefits under TIAA-CREF. MITRE assured these employees that this situation as relates to their future earned benefits under TIAA-CREF would not happen. MITRE estimated this assurance would cost approximately $100,000.

4. In arriving at the amount necessary to make the above transfer (October 1974), MITRE did not consider a TIAA dividend increase of 1 3/4% (5 3/4% to 7 1/2%), which was applicable to investments made through February 1975. Such consideration would have reduced the amount of assets transferred to buy into TIAA by approximately $7,500.

5. The benefits under the Trusteed Plan were guaranteed by MITRE. To equate this guaranteed benefit under TIAA-CREF, MITRE took a conservative position for future occurrences by:

a. assuming the assets as transferred would earn interest at the rate of 5 3/4% per year in TIAA when the interest experience has been 7 1/2% in recent years, and

b. assuming the assets as transferred would be fully invested in TIAA when in reality one-third of the assets are invested in CREF. CREF over the years is expected to have a much higher return on investment.

As an alternative, MITRE could have allowed its weekly salaried employees to join TIAA-CREF prospectively. Under this arrangement, assets related to benefits earned to date would remain in the Trust for future retirement payments.

MITRE officials stated that a prospective approach was considered. However, the decision to go to a retroactive approach was made after considering many aspects of the goals of MITRE. Specifically, MITRE wanted to eliminate the Trusteed Plan and wanted to provide uniform benefits to all employees. We believe, however, these goals could have been achieved with a prospective approach and are reporting this to you for your information.

CONCLUSION

In summary, the matters discussed in this report indicate a need for closer surveillance of MITRE's pension costs by your office. We are recommending that your office look into the findings discussed in this report and advise us of your views and any action taken or contemplated within 60 days. We would be glad to discuss this report with you further if you so desire.

A copy of this report is being sent to the Regional Manager of the DCAA Regional Office for his information.

Sincerely,

Joseph Eder

Joseph Eder
Regional Manager

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