RECORD OF SOCIETY OF ACTUARIES
1975 VOL. 1 NO. 3

Vol. 1, No. 3 May, 1975

RECORD

AN OVERVIEW OF ERISA

An Address by
ALVIN D. LURIE*

Among the more unbelievable aspects of the now quite unbelievable job which I occupy is the fact that I am the boss of an entire Actuarial Division of the Internal Revenue Service. My office controls three divisions of the Internal Revenue Service, the Exempt Organizations Division, the Employee Plans Division, and the Actuarial Division. That includes every actuary working for the Internal Revenue Service, all twenty of them. I like working with actuaries. In fact, some of my best people in IRS are actuaries. My Technical Adviser, Ira Cohen, is an actuary, and I do not know what I would do without him. The top actuary in the IRS is Donald Grubbs, who is the Director of our Actuarial Division. I believe I have the best actuary in America working for me in Don Grubbs.

It is, of course, the pension-connected activities of actuaries that I want to dwell on today. The most respected government name in pensions, Isidore Goodman--who, to my great delight, is a member of my staff--wrote over fifteen years ago:

> The actuary is the architect in the pension planning field. He designs the plan, he determines its cost, and he sees to it that it is put into operation effectively. In many cases, he does even more--he supervises its basic activities so that it will be a smoothly-running program in accordance with the purposes for which it was established.

That strikes me as still a pretty good statement. In fact, with all the complexity that ERISA (the Employee Retirement Income Security Act of 1974) has added to pension planning, the statement is, if anything, truer now than when it was written.

Pension funding is the job of actuaries, and much beyond the actual comprehension of most other professionals in the field. I can still remember my great bewilderment when, just a lawyer, I was exposed for the first time a number of years ago to the 5% rule for deduction of pension costs. It was not the 5% that puzzled me, but rather its relation to the level funding method with which it was coupled in the Revenue Code. I must confess that it has continued to puzzle me ever since. ERISA has solved this particular complication for me, by eliminating the 5% rule; so ERISA is sort of a tax simplification law for me.

This talk is billed as "An Overview of ERISA." I think I am better qualified to give you the inside view.

Let me begin by describing the room at the top. That is the Commissioner's room (room 3000 in the IRS Building in Washington). The Commissioner is Donald Alexander, a native Cincinnatian and our No. 1 pension man in IRS. Professionally, Don Alexander has got to be, in everyone's book, the top pension expert in the country at the present time. It never ceases to amaze me how, with all of the unbelievably back-breaking tasks that that man shoulders, he stays completely on top of all the intricacies of the new ERISA legisla-

*Mr. Lurie, not a member of the Society, is Assistant Commissioner, Employee Plans and Exempt Organizations, Internal Revenue Service, Washington, D.C.

tion, and of my office's various activities in implementation of it. That should be very reassuring to you who work in this field, because it tells you of the personal commitment and dedication that the Commissioner himself brings to this newly-exploded area.

Down a long hall from Don Alexander's office is the office of the Assistant Commissioner (Employee Plans and Exempt Organizations). It is room 3410 and, as noted in the very generous introduction, is my office. The principal decoration in that room is a large dart board that sits on the wall behind me. It is not actually a dart board, so much as a photographic blow-up of the Table of Contents of ERISA. If I ever find myself with a moment to reflect on what problem under the new law I should address, it is a simple thing for me to throw a dart at that board. Wherever that dart hits is a problem I could profitably spend my time on.

Fortunately, I have excellent people helping me with these problems, including my fine deputy, Ted Rademaker, excellent assistants and technical advisers, and three superb division directors who run each of the three divisions that make up my office, the Exempt Organizations Division, the Employee Plans Division, and, last and smallest but by no means least, Don Grubbs' Actuarial Division. That is our top management team in the National Office.

The place where you will normally enter the system is in our District Offices.

Requests for determination of initial qualification of plans will be handled in fifty-two district offices around the country, as they are now, to give those concerned with plans someone close at hand to talk to. Nineteen of these districts are designated key districts, each of which has an Employee Plans and Exempt Organizations Division and is headed by a Division Chief. Employees of these divisions are stationed both in the key districts and in the remaining associate districts, in accordance with workload requirements. The Division is responsible for issuance of advance determination letters in both the employee plans and exempt organizations areas, examination of related returns, and review of actions to insure uniformity of application of the statute and regulations.

For administrative purposes, IRS has divided the nation into seven regions. In each of the regions there is a new Assistant Regional Commissioner (Employee Plans and Exempt Organizations). The Assistant Regional Commissioner will be responsible for implementing, monitoring, and evaluating the employee plans and exempt organizations programs in his region. His office will also conduct formal conferences as the first level of the appeals process in the Employee Plans and Exempt Organizations areas. Another responsibility of the Assistant Regional Commissioner will be to conduct programs to insure uniformity of application of the statute, regulations, and Internal Revenue Service policy within the region. He will also conduct case management reviews as part of the effort to insure uniformity in technical areas and the effective utilization of resources.

By far our biggest problem is the amount of work to be done. With every pension plan in the country being amended, the number of requests for determination during the next two or three years could run to ten times our usual annual number, and most of those will be more complicated and will require more time to review. There will be several times as many requests for technical advice from the National Office. We estimate the number of appeals will go up at least proportionately with the increased number of cases because that will be the only ladder to get into the Tax Court under the new declaratory judgment procedure. Individual retirement accounts will provide their own increase in our workload. We are adding staff to help meet the increased demands, and will do our best to provide prompt service.

The budget we are working with is considerably less than we felt we needed to provide a high level of service around the country. This inevitably means that we have fewer people and cannot provide service as fast as we would like; but we are adjusting to do the best possible job with what we have.

As a result of the new law, the actuarial staff has increased by 13 people, including 7 who are members of one or more of the American Academy of Actuaries, the Conference of Actuaries in Public Practice, or the Society of Actuaries, and some others who have passed one or more of the Society exams. In the last twelve months, a new emphasis has been placed on the professional development of our actuarial staff. An on-the-job study-time program has been established similar to that of major insurance and consulting firms, and we are pleased that two of our young men became Associates of the Society of Actuaries by passing November exams. New recognition has been given to the value to the Service of having our actuaries attend professional meetings, and a much higher proportion of our actuaries is attending professional meetings this year than in any prior year.

IRS will not station qualified actuaries in the regional offices initially. We want to see, first, whether it is really feasible to do this in the terms of the most efficient use of the professional talent our budgets will allow. After we have coped with the wave--perhaps "flood" would be a better word, or even "deluge"--of requalification requests and worked out all of the various forms of reporting (on the funding standard account, to mention just one of them), we should have a better idea of exactly where actuaries would fit into our field operations. We would be glad to hear your thoughts on this point.

Coordination with Department of Labor

We have been working closely with the Department of Labor in areas of common concern. For example, in the area of prohibited transactions, a number of publications have been released to solve immediate problems, and more are coming soon. Perhaps of more immediate interest to you, we are working with Labor to develop a common form for annual reports, to combine the proposed EBS-2 and Form 4848, with a single reporting date. We expect to have a single actuarial report acceptable to both agencies. We are also working with Labor to enable each of us to develop our respective regulations in areas of common concern, for example, the "years of service" regulations.

Regulations and Other Publications

In IRS, we already have put out quite a substantial bulk of regulations under ERISA, either as temporary or proposed regulations. Our most recent regulation was a 100-pager on lump-sum distributions, just three weeks ago.

Publication Program

Our primary emphasis has been on regulations that will be first needed by taxpayers during the remainder of 1975 and in 1976. In this connection, proposed or temporary regulations have been published in the Federal Register covering a multiplicity of subjects, including: exception for insurance contract plans from minimum funding standards; "Keogh" or H.R. 10 plans; individual retirement accounts; vesting schedule amendments affecting 5-year-service employees; disclosure by IRS of plan information to the Department of Labor and the Pension Benefit Guaranty Corporation; employees of foreign subsidiaries; lump-sum distributions; the election to accelerate the effective date of the new participation, vesting, funding, and benefit provisions of ERISA; and other elections relating to retroactive amendments of accrued benefit provisions of a plan and to alternative methods of valuing funds and other debt instruments owned by a plan.

The drafting of regulations on all tax matters involves the Office of Chief Counsel, my office, including both the Employee Plans and the Actuarial Divisions, the Commissioner's office, and, finally, the Assistant Secretary of the Treasury for Tax Policy and his Tax Legislative Counsel. Naturally, such a large group of thinking people, all with their separate responsibilities and perspectives, are going to come up with differing ideas. There is a fair amount of bouncing back and forth which takes a good bit of time, but we hope its saving grace may be that it helps prevent our overlooking many possible problems.

Because regulations are time-consuming, we are proceeding to issue guidelines and information in a variety of other forms that lend themselves to providing quicker answers. This includes revenue procedures, revenue rulings, technical information releases, sets of questions and answers, and other publications. These explain the rule we will apply before final regulations are issued.

For example, just eight days after ERISA was passed, IRS announced that an H.R. 10 plan could be amended to reflect the new higher limits, with no need for getting a new determination letter. If the plan qualified before, any amendment which merely reflected the new higher limits would not affect the qualification. Recently, we have published extensive new regulations on H.R. 10 plans.

The development of new forms is more complex than you might imagine. It is far easier to look at a proposed form and see difficulties than it is to develop from scratch forms that are suitable for the tremendous variety that exists in plan design, funding media, size of employer, and a range of other factors. The task is made even harder by some of the time constraints under which we must operate. Take lump-sum distributions, for instance. ERISA changed the rules for taxing all lump-sum distributions made after January 1, 1974, eight months before the law was enacted. Many employers had already distributed Form 1099 to employees who terminated early in 1974, and they needed instructions on how to revise them as well as how to prepare Form 1099 for the balance of the year. A new form was needed to apply the new ten-year spread rule for tax years ending on or after December 31, 1974. Regulations were needed. All these needs have been met.

In March, IRS published Publication 861, Annuity Factors for Lump-Sum Distributions, prepared by the Actuarial Division. This book contains factors needed to determine the tax on a lump-sum distribution when the lump-sum distribution is made concurrent with the distribution of an annuity contract. The publication provides annuity values for a variety of forms of single life annuities and for joint and survivor annuities, based on the 1959-1961 U.S.Life Tables and 6% interest.

ERISA may become principally remembered for initiating the era of the IRA. Individual Retirement Accounts can be established beginning January 1, 1975. IRS has published a form which any individual can use to establish his own IRA, without the need for submission to IRS to establish qualification. We have also published forms for insurance companies, banks, and others to use to submit IRA prototype plans to IRS for approval, and we are already reviewing many requests for approval of IRA prototype plans. Detailed regulations on IRA's have been published.

In the corporate pension plan amendments area, we decided to try to define certain kinds of plans with few problems for which it would be possible to issue determination letters now, and to gradually expand the area where we could make determinations as regulations and other guidelines are published. In January, we published Revenue Procedure 75-5 which listed certain deferred contribution plans for which we believe we can now make determinations. A series of Questions and Answers was published, designed to provide guidelines in the several areas where we can make determinations. But it was then necessary to exclude all defined benefit plans until guidelines could be developed on the definition of accrued benefit. It was also necessary to exclude many categories of defined contribution plans. We are now working on guidelines which will enable us to widen the area in which we can make rulings. Forms 5301 and 5302 have been published, to request determinations regarding qualification of defined contribution plans. Work is continuing on our plan to open up the defined benefit determination letter program.

We are also developing acceptable specimen plan language for the joint and survivor benefit, and for other items. We expect that this and other techniques we are exploring will vastly simplify the tasks of thousands of practitioners who feel unable to cope with the formidable drafting burdens which the new law has imposed.

Minimum Funding Standard

Prior to ERISA, the principal concern of IRS was overfunding, or at least excessive deductions. IRS had minimum funding requirements in only two specific situations. First, if contributions were suspended, the plan would be treated as discontinued, requiring full and immediate vesting, if the unfunded liability exceeded the initial unfunded liability or if the benefits to be paid were affected. Second, in a collectively bargained plan for which contributions were agreed to only for the duration of the collective bargaining agreement, IRS ruled that the permanence requirement would be considered to be met if the contributions during the period were sufficient to fund the normal cost plus interest on the unfunded liability, and if the contributions were sufficient to fund the benefits for participants expected to retire during the period. In other situations, there were no minimum funding requirements.

The new funding requirements are to be administered both by the Department of Labor and by the Internal Revenue Service. IRS may enforce compliance for qualified plans through the imposition of excise taxes on employers. The Department of Labor may enforce compliance for both qualified and nonqualified plans through civil suits, but it is likely that Labor will rely on IRS to enforce compliance for qualified plans.

The employer's minimum annual contribution to a defined benefit pension plan generally consists of the normal costs of the plan, plus amortization of past service liabilities, experience losses, and similar charges. With certain exceptions, minimum amortization payments are calculated on a level payment basis, consisting of interest and principal, over stated periods of time and are based on all accrued liabilities.

The general rule is that initial past service liabilities, and past service liabilities arising under plan amendments, are to be amortized over no more than thirty years, except that in case of existing plans with past service liabilities on September 2, 1974, the period of amortization can be forty years. In the case of pre-ERISA plans, the initial unfunded past service liability is the unfunded liability existing as of the first day of the plan year for which the new participation, vesting and funding standards become effective. (For plans in existence on January 1, 1974, it is the plan year which begins on or after January 1, 1976.) Thus, the increase in liability as a result of amendments made to comply with the Act can be amortized over a forty-year period in the case of existing plans.

Experience gains and losses, however, are to be amortized over fifteen years. Such gains and losses need not be calculated more often than every three years.

The amortization periods are longer for multiemployer plans: past service liabilities may generally be amortized over a period up to forty years, and experience losses over twenty years.

Unlike Opinion 8 of the Accounting Principles Board which established a minimum charge for each plan year, the requirements of ERISA are cumulative. If the employer contributes more than the minimum required by ERISA during a year, the excess is available to reduce the minimum ERISA contribution in future years. Thus, the minimum ERISA contribution may be zero, although Opinion 8 would still require its usual charge to expense (unless it happens to be revised in light of the ERISA funding rules).

To keep track of the carryover of any excess or deficit of actual contributions vis-a-vis required contributions, ERISA establishes a new creature called the funding standing account, which, perhaps not without danger, is abbreviated FSA. I will describe some of the problems which we face in developing regulations on minimum funding.

The Act allows the combining and offsetting of amounts to be amortized. Without this combining and offsetting, the administration of the funding requirement would be quite burdensome. But, specifically, how should combining and offsetting be accomplished? Should IRS prescribe a single method, or several specific ones, or should we allow any method and rely on our audit to determine its reasonableness?

The funding standard account is to be charged or credited with interest at the rate used for valuation of plan liabilities. But what if the plan uses one rate for active participants and a different one for retired participants? What if the interest rate is graded down from the high rates available today to lower rates estimated for the future?

The value of plan assets is to be "determined on the basis of any reasonable actuarial method which takes into account fair market value and which is permitted under regulations." What are reasonable actuarial methods for valuation of assets? Which methods should be permitted under regulations? If, for example, average market value over a period of years is determined to be reasonable, should IRS set any maximum on the number of years used? Our Actuarial Division is studying the wide variety of asset valuation methods currently in use.

An election may be made to value bonds and other evidences of indebtedness on an amortized cost basis. Under state insurance laws, bonds must be amortized to maturity date or earlier call date, whichever produces the lower asset value. Should this lower value basis be either required or allowed under ERISA? What, if any, is the call date of a mortgage under the variety of redemption features existing in practice? Should all convertible debentures be considered evidences of indebtedness, and if not, which ones should?

Now I come to the tough question. The actuarial assumptions and methods must be reasonable in the aggregate. Actuarial assumptions may be used to estimate experience during forty-five years of active employment and perhaps fifteen years of retirement, a total of sixty years into the future. These actuarial assumptions are estimates of the unknown. Any view of history persuades one that the best thinking of one year will be proved far wrong in some later year. In addition, some serious thinkers say that the world is undergoing social, economic, and environmental changes which will make the past an inadequate guide for the future. Some feel the rate of change is escalating, making the future even less predictable. In light of all this, what are reasonable actuarial assumptions?

Some actuaries have suggested that, in this situation, IRS should accept the opinion of the actuary without question, especially now that the government will enroll actuaries upon finding that they meet suitable qualification standards. Others have suggested that to place no restriction at all on assumptions would allow the unscrupulous actuary, or, at least, the actuary with poor judgment, to defeat the basic purpose of the Act, which is to require sound funding of benefits. Some want IRS to issue no regulations, but to review reasonableness upon audit on a case-by-case basis. Others want regulations or other published guidelines to guide the actuary and provide advance assurance that the basis chosen will not later be determined to be unreasonable.

The Pension Benefit Guaranty Corporation, and ultimately those who pay its premiums, may have to pick up the tab if a plan terminates with unfunded guaranteed benefits, which introduces another consideration. Any answers we come up with must be appropriate for small plans--my information is that over 90% of plans have less than 10 participants--as well as for large ones.

Some have suggested that the requirement to amortize gains and losses solves the problem of inappropriate assumptions. While it solves part of the problem, it does not solve all of it. An inadequate salary scale or too high turnover may be reflected in losses at the end of the first year, and we are studying the extent to which such loss amortization overcomes inadequate assumptions in the early years. But if a small plan with no participant over age 45 were to assume an average retirement age of 70 instead of 65, it might substantially underfund benefits for at least 20 years before experiencing a loss.

It is not generally appreciated that requiring multiemployer plans to amortize gains and losses over 20 years rather than 15 years may actually result in higher required contributions for such plans, depending on whether gains or losses predominate.

For purposes of the minimum funding requirement, an actuarial valuation is required at least every 3 years, unless regulations require more frequent valuations. Under what circumstances should regulations require more frequent valuations? And how should the minimum and maximum contribution requirements be determined in interim years?

IRS may waive the funding requirement if satisfying the standard would create substantial business hardship and if application of the standard would be adverse to plan participants. If you want to know what it is like to be in IRS these days, try developing regulations on this and then administering them.

The new alternative minimum funding standard is a puzzlement to some--though surely not to this body. But you may have some questions regarding the alternative minimum funding standard. A plan may use the alternative minimum funding standard only if, under its regular funding standard account, the plan "uses a funding method that requires contributions in <u>all years</u> not less than those required under the entry age normal funding method." Clearly the entry age normal method meets this criterion, but does any other method? Our actuaries tell me that any method requiring larger contributions than entry age normal in one year inevitably requires smaller contributions in some other year, so that, arguably, no other method meets the criterion.

Even if the alternative minimum funding standard is being used, records must be maintained on the regular funding standard account, allowing one to switch back in some later year. For any particular year, one or the other basis may produce a lower minimum required contribution.

Under the alternative minimum funding standard, different actuarial assumptions may be used than those under the basic actuarial valuation which is used for the <u>regular</u> funding standard account. Obviously, if you used a salary scale for the basic entry age normal valuation, you would not use a salary scale to value accrued benefits under the alternative minimum funding standard. Other assumptions which may, in the aggregate, have been reasonable under the basic valuation would be inappropriate in the alternative minimum funding standard.

Under the alternative minimum funding standard, the limits on guaranteed benefits in Title IV are not recognized. The alternative standard is based on accrued benefits, not guaranteed benefits.

<u>Maximum Deductible Contributions</u>

In addition to regulating the minimum funding requirements, IRS has continuing responsibility for regulating <u>maximum</u> deductible contributions. Some have suggested that we are working at cross purposes. They fear that the revenue agent who has for many years been preventing excessive deductions will not be vigilant to require higher contributions and thus higher deductions. We are attacking this problem head-on with training programs and with plans to assure that management objectives of the National Office are carried out in every district. We expect to provide fair and effective enforcement of both minimum and maximum requirements.

Three changes were made under ERISA in maximum deductible contributions for pension plans. First, the old 5% rule was abolished, as I have already noted. Second, the old deductible limits allowed deduction of the normal cost plus, if past service benefits are provided, 10% of past service cost "which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan." The new law changes the 10% to 10-year funding, but eliminates the words "as of the date when they are included in the plan." We have been asked whether all past service bases will be restarted as of the plan anniversary when this new section first applies, or whether the original base will remain. The original base will remain. Of course, if you change actuarial assumptions, the past service base will need to be recalculated or adjusted. Third, a new maximum was added equal to the new minimum, so that the minimum required will always be deductible.

Generally, the same actuarial method and assumptions used in the determination of a plan's minimum funding standard must also be used in determining its maximum limit for current tax deduction purposes. Of course, the difference between the 10-year amortization allowed in the maximum limit and the 30-year or 40-year amortizations now allowed in the minimum standard will permit the employer some flexibility to vary his contributions from year to year to meet his cash flow needs.

A feature that may seem whimsical at first, but which obviously rests on sound ground, is that minimum contributions are based on plan years while maximum deductible contributions are based on tax years. Regulations will be needed to clarify how the maximum deductible contribution is determined related to the minimum contribution requirement when the two years differ.

Since the minimum funding requirement provides for amortization of gains and losses, some have questioned whether a similar treatment would be allowed with respect to maximum deductible contributions. This question will be considered.

Role of Actuaries

Actuaries have a new and very indispensable role in the regulatory scheme, in view of the express requirement in ERISA for actuarial reports for almost all defined benefit plans, which reports must be signed by "enrolled actuaries." For the first time, the Federal Government is directed to determine the qualification of actuaries. A Joint Board for the Enrollment of Actuaries has been appointed by the Secretary of Labor and the Secretary of the Treasury. Three of the five members of the Joint Board are actuaries. It was my pleasure to serve as chairman of the joint IRS-DOL task force that worked in the early weeks of ERISA to define the form of that Board, and to suggest enrollment guidelines. The Joint Board recently published regulations on qualifications for enrolled actuaries, which will be discussed at one of your sessions tomorrow. These proposed regulations, once approved, will serve as the standards for enrollment this year.

ERISA requires the enrollment status only for the certification of valuation results, and the proposed regulations are directed specifically to measure competence in just that one area of actuarial expertise. We all recognize that there are many other parts of the actuarial function that do not directly relate to the valuation process, but can be at least as crucial to the effective operation of a pension program. Enrollment is not required for those other functions.

Conclusion

I have been talking about your contributions to the plans you serve. Selfishly, I hope we can persuade you also to serve us in Government. In this room, are some of the most knowledgeable experts in pensions in the country, and we need the benefit of your thinking. If you have ideas on what kind of regulations are needed, or how IRS can serve the public better in the area of employee plans, put your ideas in writing and send them to me. I will see that they are read, most often by me, but also by our analyst or specialist who has responsibility for the problem.

We welcome your input and, although our facilities and staff are not really set up to give you ready response to all your suggestions, I can assure you that every idea you send in will be carefully considered.

What about the future for more pension legislation? In large measure, the future depends on you. You are the people who work up the plans and best understand what makes the plans work. You understand the problems of the private pension system, because you work with its nuts and bolts on a continuing basis. You have worked out the formulas that made it possible to bring more and more workers under the coverage of pension plans, and have the creativity to develop new solutions in this area. I challenge you to think seriously about these responsibilities now and in the months ahead.