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NON-TRADITIONAL PENSION PLAN TERMINATIONS

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Some plan sponsors appear to be terminating pension plans for new reasons--to obtain cash or to force the PBGC to fund underfunded plans. Such terminations are discussed from the viewpoint of:

- IRS
- PBGC
- Plan participants
- Plan sponsor

MR. BOB RYAN: The topic for this panel discussion is Non-Traditional Pension Plan Terminations. Because of the current debate regarding recapture of surplus funding, the panel has decided to limit its discussion to those issues involved with the reversion of assets.

Our panel is comprised of individuals representing a diverse experience on this subject. Elaine Church is an attorney with Wolper Ross & Company She recently joined this firm, having served the prior two years in Washington, D.C. with the Joint Committee on Taxation. Prior to that time, Elaine spent seven years with the Internal Revenue Service.

Bob Chmely is Vice President and Actuary for the Group Pension Department of Prudential. Bob has served in a variety of positions during his twenty-seven years with this company.

Trevor Lukes has been with Occidental Petroleum for the last eleven years and has had assignments in several exotic locations including Libya, Europe and California.

Vince Amorosa, Actuary for the PBGC, was originally scheduled to appear on this panel. However, because of the sensitivity of our subject matter, he is unable to be here.

From January 1, 1980 through August 1, 1983, 114 plans have been terminated, each of which had at least a $1 million reversion of assets to the plan sponsor. These 114 plans represent an aggregate recapture of $443 million. In addition, twelve plan sponsors have or will soon file notices to terminate which represent $890 million of asset reversions. This will bring the total to $1.3 billion in less than four years.

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Why all this activity? Some of the reasons I have heard to explain this would include:

- a more mobile society in which individuals favor a plan that pays today rather than rewards a thirty or forty year career.
- recent unfavorable business conditions which would include poor cash flows, depressed earnings and significant merger and acquisition activity.
- certain advantages for defined contribution plans which have been created by Congress through the Internal Revenue Code. These would include special ten-year averaging for lump sum distributions, capital gains treatment on portions of stock bonus distributions and larger 415 limits on employee stock ownership plans.
- perhaps most importantly, high interest rates. These have (1) increased the cost to employers of new sources of capital and (2) decreased the cost of annuities which can be purchased to fully fund accrued benefits.

The types of terminations that we have seen to date generally fall into one of three categories.

1. Termination of a defined benefit plan without any replacement plan.
2. Termination of a defined benefit plan which is subsequently replaced with a noncomparable plan such as a profit sharing or stock bonus plan.
3. Termination of a defined benefit plan with a comparable plan being used as its replacement.

A fourth possible classification might be the spinoff of liabilities for active participants along with a minimal amount of assets, leaving behind all inactive liabilities and significant overfunding. Annuities would then be purchased to fully fund these inactive liabilities and that plan terminated in order to recapture the surplus. This approach may be a subset of the third type of termination.

Currently the IRS, DOL and PBGC are trying to determine what if anything should be done about the recent level of activity. Elaine is going to review the historical developments that have led to the current environment and the position of the IRS on these issues.

MS. ELAINE K. CHURCH: The topic that we are discussing today of terminations is one that, as everyone knows, has become extremely volatile in the past several years. Nevertheless, insofar as the Internal Revenue Code is concerned, the issues that we presently face have been with us since as early as 1962 because a plan's qualified status and obviously the resulting tax benefits attributable to an employer and it's employees were contingent on the plan's maintaining its qualified status upon plan termination. Prior to ERISA, in fact, the Internal Revenue Service was the only agency with immediate jurisdiction over the area of plan termination.

It is true you had to file some reports with DOL but they did not get actively involved nor was there the PBGC. When the IRS got involved they issued Regs which attempted to make a very simplistic determination of what was or was not a complete termination. If in fact you changed from one type of plan, i.e., from a profit sharing to a pension or visa versa, that was a complete termination--end of the story. Whenever you had a partial termination, of course, the issue was a lot more complicated both pre-and post-ERISA. There are a series of Revenue Rulings which essentially say everything will be tested on a facts and circumstances basis. One fact which the service deems very important is the number of participants actually terminated. The courts have considered cases ranging from a 6% reduction in plan participation to as much as an 80% reduction in plan participation. The Service's pre- and post-ERISA rule of thumb, with respect to a partial termination, was, when there was a reduction of 20% or more of plan participants. That is the amount currently required to be reported enabling the Service to monitor those partial terminations.

The tax consequences, whether you have a partial or a complete termination, affect both the employer, the employees and the plan...most importantly, the plan for a number of reasons. Since the focus of our talk will be on the plan issues, let me just briefly mention how it is important or why it is important to the participants and the employer.

For the participants, there are a number of tax advantages incident to qualified plan status. The 10-year forward averaging and the capital gains treatment that Bob referred to apply only if the plan is qualified upon the ultimate distribution. For that purpose, upon termination most employers will request a letter from the Service that the plan is qualified at that time. Absent subsequent discriminatory operation of the wasting trust, the participants are entitled to rely upon that interpretation insuring that if they leave their monies in the plan long enough they will be entitled to the favorable tax benefits. Or, alternatively, if they chose immediate cash-out they will be able to roll those monies over to an individual retirement account or annuity.

For the employer, the primary issue that concerns us today is what to do with the amounts that may or may not revert to the employer. The tax consequences, should a reversion occur, are that the amount reverted to the employer is fully includable in the employer's gross income. Now, the only pre-ERISA Revenue Ruling on that point is 73-528 which actually deals with the diversion of assets from two on-going plans, rather than a termination. But the Service's official position, articulated in General Information Letters and in the Continuing Education Program at the Service is that that Ruling is equally applicable to a reversion scenario.

The Ruling holds that the total amount reverted is includable in gross income under Section 61 of the Code--the overall inclusion of income from whatever source derived. Thereafter, to the extent that the employer has not previously claimed a deduction equal to the amount reverted and that amount which was nondeductible is not attributable to investment yields, there may be a reduction in the amounts included in the employer's income.

Obviously in the current planning environment, with the magnitude of the reversions that we are discussing, the employer for tax planning purposes wants to ensure that the reversion occurs at a moment when his tax liability would otherwise be minimal, due to operating losses, carrybacks, investment changes, etc. For that reason, when you are advising a client on the timing of the reversion, you need to know that upon and only upon complete termination of the plan will the Service deem a reversion to occur.

The one way that you can affect the timing of a reversion, of course, is to terminate the plan and maintain a wasting trust and ensure that the last participant cashes out of the wasting trust during the year in which it is most advantageous to receive the reversion in the employer's income. In that way you will ensure that you have the most favorable tax treatment for the employer of the amounts reverted. A lot of times, in the scenarios that we see, the companies who are looking for very, very large reversions have negative tax postures anyway and they want the money with some immediacy. So that planning technique is not required although it is more flexible in the small employer situation.

When a plan terminates a couple of things must occur automatically and the plan must so provide. First is that the plan must provide that all benefits become fully vested upon termination and the rule says that the benefits of all affected employees must become fully vested. So in a situation where you have a partial termination, only those employees affected are statutorially required to vest in their account balances.

Second, the plan must provide that any amount remaining unallocated under the plan be allocated as of the moment of plan termination. Thereafter, if the plan so permits, if it is a complete termination and unless it contravenes local law, the surplus may revert to the employer.

Now let's go over a couple of issues that the Service can raise upon plan termination. Because, for the reasons I have previously cited, you want to preserve that plan's qualified status, you have to look at some administrative positions the Service has taken over the years. First, the Service interprets the term "plan", included in Section 401(a) of the Code, to imply a permanent rather than a temporary arrangement. As a result, their regulatory position is that the termination of a plan within a short period after its inception, for reasons other than business necessity which was unforeseeable at the time of inception, will create a rebutable presumption that the plan was never intended to be permanent and therefore never intended to be tax qualified. Should they succeed in enforcing that allegation, of course, the plan would be retroactively disqualified. Participants would be currently taxed to the extent of their vested interest. The employer, in most instances, would permanently lose a deduction for amounts contributed to a defined benefit plan. Not defer that deduction--permanently lose that deduction. The reason for that disparity is that under Section 404(a)(5) of the Code a deduction for contributions made to a non-qualified plan of deferred comp is available only when the participants have a corresponding income inclusion and then only if the plan actually maintains individual accounts for each participant. As we all know, the DB plan does not maintain such individual accounts. So for that employer, disqualification would mean total denial

of those deductions. The courts have upheld that concept indirectly leading to the enactment of Code Section 404A dealing with the foreign plan scenario, where qualified plans were unable to satisfy, for example, both the German Book Reserve requirements and ERISA. And the Congress said, "Well, you know the statute says clearly that if you have a defined benefit plan you never get a deduction. We feel it is unfair because of the conflict between the two statutes, so we will create another series of rules. If those rules aren't applicable and you are only under the general rules of 404(a)(5), you permanently lose your deduction."

The reasons suggested by the Service as acceptable are outlined in two Revenue Rulings that predate ERISA--Revenue Rulings 69-24 and 69-25 which include bankrupcy, insolvency, termination of the business, arms length sale of the business, and financial inability. Again, those Revenue Rulings state that those reasons in and of themselves are not sufficient. But, in addition, they must have been unforseeable, at the time the plan was adopted. Now, obviously, if you look at that series of reasons, the employer's need to revert the surplus assets is not a reason which will suffice to overcome this rebutable presumption that the plan was never intended to be permanent.

The Service has never defined how many years a plan must exist before the permanency requirement becomes a problem. For other reasons in the Code, namely the early termination restrictions applicable to the high 25 individuals in a plan, the applicable period of years is 10 years. The Service's informal opinion is that if a plan has been in existence for at least 10 years the permanency requirement should not be a problem. Interestingly enough, the tax court in the case of Harold S. Davis took a position that six years was sufficient, although the Service has not yet agreed with that position.

While we are on the concept of permanency let me just close that issue by noting that the concept itself is not contained in the Code or in the legislative history either pre- or post-ERISA. The Service derives the concept and has historically asserted this concept since the '39 Code. As a result of the statutory use of the word "plan" the courts have not considered the issue since 1954. But at that time they concluded that the concept of permanency was not a concept independent of exclusive benefit. In the case of Lincoln Electric, they concluded that a profit sharing plan which was established for only one year, funded for only one year and totally distributed within 10 years was nevertheless a qualified plan despite the Service's allegations about permanency, because, in that situation the plan was truly maintained for the exclusive benefit of the employees and did not permit a reversion to the employer. Obviously, the courts' hinging the nonapplicability of the permanency rule on the lack of reversion possibility does not give us any comfort when what we are trying to deal with, with our employers, is reverting the excess assets. So you have to assume that the Service will, in fact, attempt to assert and may win in a reversion case the concept of permanency.

Related to the concept of permanency in the 10 year period, as I mentioned, are the early termination restrictions. If a plan is terminated within 10 years of its adoption or material modification and before the benefits are funded then benefits actually payable to those group of

employees who are among the highest paid 25 employees at inception are severely restricted. Again, in a small plan market this means that probably your client will not receive the full benefit that he intended out of that plan.

Leaving permanency the Service can also assert that the plan is not being maintained for the exclusive benefit of the participants. That is a concept that has been with us for years. In Pub. 778, a pre-ERISA publication, the Service took the position that aggresive overfunding would imply or infer that the plan was being maintained as a tax-free savings device for the employer rather than a retirement plan so that when ever you had aggressive overfunding coupled with a chance of employer reversion there is a possibility of violation of exclusive benefit. Where, however, the overfunding was minimal or reversion was precluded the only issue in the Service's eyes is one of deductibility. You are all familiar with the concept of full funding. So assuming you have reached the full funding limit there is no further deductions committed.

One of the last issues that the Service can assert is whether or not the distributions under the Plan are in fact discriminatory. Now here, of course, there is a great disparity between pre- and post-ERISA law. Under pre-ERISA law the only rule was that you had to cash out the participants and that to avoid an argument against exclusive benefit you had to use actuarial assumptions at least equivalent to those previously used during the life of the trust in computing those lump sum distributions.

Well ERISA came along, added Title IV, a new agency, PBGC, and gave us a specific ordering of distributions from affected defined benefit plans. Obviously, you have to distribute in accordance with ERISA 4044 categories. First, amounts attributable to voluntary employee contributions. Second, those attributable to manadatory employee contributions. Third, with respect to annuities and pay status for at least three years or those which would have been in pay status had the employee retired. Fourth, to PBGC insured benefits under Title IV of ERISA. Fifth, to any non-insured but non-forfeitable benefits and for purposes of category five, any benefits which become non-forfeitable as a result of a termination are not included. Then lastly, to all other benefits under the plan. Unfortunately, however, PBGC is not the be-all and end-all in the termination scenario. Both PBGC and IRS agree, and their regs so provide, that not withstanding the required 4044 allocation, you can have an adjustment to those allocations to the extent needed to satisfy the IRS that your ultimate distribution does not discriminate in favor of those employees who are officers, shareholders, or highly compensated. In particular, in calculating your 4044 benefits, benefits in excess of the early termination restrictions may clearly be reallocated to preclude discrimination.

Now, the Service has provided some guidance with what to do with excess assets upon termination. If a plan is either underfunded or if no reversion is desired and the employer wishes to actually distribute the surplus assets to the employees there is a Revenue Ruling which provides specific guidance. That Revenue Ruling is 80-229. It provides for two scenarios. First, if the value of the assets exceeds the present value

of all accrued benefits then you go through your 4044 categories and allocate the surplus to the participants in a nondiscriminatory manner. The important thing to note if you are going through that calculation is that the nondiscriminatory manner that you chose must be nondiscriminatory both on a termination and on an ongoing basis. In pertinent part, that Revenue Ruling goes through an example where you had an integrated offset plan and the employer amended the plan to provide that the surplus would go to the employees but provided that what he would do is gross-up the net benefit as reduced by the Social Security offset. That gross-up of the net benefit skewed the integration in excess of that permitted under 71-446. So that amendment was discriminatory and not permissible.

Alternatively, if the value of the assets is less than the present value of all accrued benefits you follow strictly the PBGC 4044 allocations and you must satisfy discrimination by insuring that the rank and file participants receive a percentage of the present value of their accrued benefits which is at least equal to the present value of accrued benefits paid to those who are members of the prohibited group--those who are officers, shareholders or highly compensated.

If however, you do not want to use 80-229 because you are overfunded and you do wish to revert, both Title IV of ERISA and the Service have developed some rules on how to allocate the residual assets. Now remember you can allocate the surplus to the employer only if the plan permits such a reversion, only if that reversion doesn't otherwise contravene applicable law and only if the plan is truly terminated. When I say the plan must permit, there is at least one court case where the employer tried to revert the monies even though the plan specifically precluded reversion--Krazinsky vs. Richards Brothers Punch Company. Obviously, the courts had no problem in saying that that reversion was impermissible. Not only must the plan permit it however, but you must be very careful as to the timing of any plan amendment to change the disposition of the surplus assets. Most importantly, we have all seen PBGC vs. Audio Visual, where the employer terminated the plan and after the termination noticed that the reversion under the terms of the plan went to the participants rather than the employer. The employer attempted to adopt and make retroactively effective an amendment which would permit the reversion to go to the employer. The PBGC, of course, felt that such monies belonged to the participants. And the PBGC won.

If you have a true termination the remainder may revert. Now, what is a true termination? I think this is applicable particularly in the last two scenarios that Bob suggested where you have either a spin-off or a DB replaced by a comparable DB. The Service draws a major distinction between a reversion and a diversion. Well, IRC 401 of the Code says that the plan must be maintained for the exclusive benefit of all employees and arguably that term historically has been interpreted to mean all of the employer's employees. IRC 401(A)(2) also says, that no amounts may be diverted from the plan prior to the satisfaction of plan liabilities with respect to those employees participating in that plan or you violate the nondiversion rule. So for example, in the pre-ERISA scenario, Revenue Ruling 73-534 took the position that in a situation where an employer maintained two pension plans, one union, one non-union, one underfunded

the other overfunded, and the employer actually transferred assets from the overfunded non-union plan to the underfunded union plan, that what you had was not a permissible reversion, not a permissible plan to plan transfer but a diminution of the rights of the participants in the non-union plan and therefore an impermissible diversion of funds disqualifying the non-union plan. That is the same fact pattern that gave rise to the discussion of the taxability of those amounts which the employer contributed to the second plan. As I mentioned earlier, all those amounts went back into the employers income. Now in this case, since they were actually recontributed to the second underfunded plan, he was eligible for a deduction to the extent otherwise permitted by the Code.

So there is a tension, between a partial termination and a full termination, between a spin-off and a full termination. If you can go over that hurdle and actually get to the point where you are, in everyone's mind, clearly terminating the plan, the next hurdle that you have to face is that the reversion is only permitted with respect to: First, any balance remaining after satisfying all fixed and contingent obligation to the employees covered under the plan. This means not only with respect to those who are presently vested or vested on termination but any other contingent obligations under the plan. Second, the amount of the surplus that may be revertable in a defined benefit plan is defined in the regs and it is quite a mouthful so let me read it: "Amounts attributable to erroneous actuarial computations during the previous life of the trust arising because actual requirements differ from expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of cost of providing pension benefits under the plan made by a person competent to make such determinations, in accordance with reasonable assumptions and correct procedures relating to the method of funding."

Under that scenario any reversions created by a change in benefit structure or change in eligibility pool are not caused by erroneous actuarial assumptions or calculations and therefore not amounts which are revertable to the employer. So again, we have a problem. So it seems to me before we get into a the discussion of the four types of reversions, the Service has a number of ways under the tax code that they can threaten the tax qualified status of your plan as you undergo this termination reversion procedure. They can argue permanency, they can argue exclusive benefit, they can argue discriminatory actual distribution of plan assets and when they finish all of the above they can say that what you have left is not an actuarial surplus resulting from erroneous actuarial calculations and therefore you can't revert it in any case.

That scenario is a problem most often in the last two categories that Bob mentioned. If I terminate one defined benefit plan and create a second defined benefit plan, an issue arises as to whether that second defined benefit plan is a continuation of the first. If so, and if it is comparable to the first then the Service rules under 411, for purposes of termination vesting, that you have never terminated the first plan. If you have never terminated the first plan, obviously you may not revert the surplus assets from the first plan. Now the Service's current position with respect to what is or is not a comparable plan, for purposes of 411 and this test I am just articulating, is contained in a GCM. And a comparable plan under the GCM is one which first preserves the existing

rights and benefits of all participants in the first plan, and secondly, which provides the benefit structure in the second plan which is comparable, not 81-22 comparable, but just generally comparable to the benefit structure in the first plan. So anytime your employer is terminating a defined benefit plan there is some pressure to follow that termination with a new defined contribution plan rather than a new defined benefit plan to ensure that, in fact, a termination has occurred and the reversion is applicable.

Similarly, in the most popular scenario, where you take your work force and split it into active employees and those who are retirees, allocating, of course, all of the surplus to the retirees, whom you will subsequently annuitize, allowing the reversion back to the employer, an issue arises as to whether or not the Service and/or the PBGC can collapse that transaction and say that that reversion that you attempted to the employer is really an impermissible diversion of plan assets because you have not yet satisfied all fixed and contingent liabilities with respect to the active employees. The PBGC feels fairly strongly that that is the position that is within the jurisdiction of the Service to assert although the Service has as yet not taken that position.

Where are we going now with respect to the number of terminations that we have seen. Two things have recently occurred, in addition to the fairly interesting hearings that Mr. Roybal had in the House Aging Committee. The first is the Service issued a TWX. It's not a disclosable document but I am sure it is one that the services will soon be picking up the day after those hearings. According to the terms of the internal TWX that the Service issued, any plan termination involving a reversion of assets in excess of a million dollars, will, from this day forth be forwarded to the national office of the Internal Revenue Service for review and study. That is sort of following up on the Service's promise to the Roybal Hearing Group that they would, in fact, devote more attention to studying the issue. Interestingly enough, both the Service and the Department of Labor concluded at the Roybal Hearings that not only did present law permit reversions but that there was some negative consequences incident to precluding such reversions, i.e., no one is going to fund their plan, probably even fully, let alone to allow reversion and that the negative impact that that would have on funding was inconsistent with the spirit of ERISA which encourages advanced funding.

The last thing that may occur on the legislative horizon is talk about imposing an excise tax on amounts reverted to the employer. Now remember, the employer is already going to pay income tax assuming he is in an income tax posture on the actual dollar amounts reverted. But the feeling is that in a lot of the situations that we have seen, the A&P situation, and the Occidental situation, the Philadelphia Bulletin situation, the employer is in a negative tax posture, so the threat of income taxation did not discourage the employer from going forth with the reversion.

Excise taxes, however, are imposed without regard to your otherwise applicable tax position. It is felt that an excise tax ranging from 20 to 50 percent of the amounts actually reverted to the employer would, if not terminate the concept of reversions, at least take a lot of the fun out of it. That position was mentioned by some of the members of Roybal's

Committee. The Service indicated that they were thinking about it. Obviously, that would involve a legislative initiative, and no legislative initiatives are currently contemplated although, as we all know, the Service, the PBGC, the Department of Labor and the Congress are deeply concerned about the reversions that are going on. In the phrase of the Aging Committee, "the raiding on pension assets and the destruction of the retirement income security of plan participants". They are, however, and I think this works in our favor, aware that over-aggressive action will have a long term negative affect on retirement income security because it will diminish funding or diminish the number of plans that are, in fact, adopted. In that regard, several PBGC proposals which would preclude the employer from terminating a plan have consistently been opposed by both the Treasury and IRS and the Department of Labor. Because it is felt that should you actually forbid an employer to terminate a plan, essentially you are not going to have any new plans ever adopted, and therefore, a lot of prospective participants will never receive any plan benefits.

MR. RYAN: I didn't realize I had to worry about all those things. I just thought I terminated, and then I called my friendly insurance broker and said, "Go buy some annuities" and they said, "Well, that's going to take some time." And then quotes came back that vary all over the map. I never have figured that out. So one of the reasons Bob Chmely is here today is to explain to us why we see such a variety of answers to what would appear to be a rather straight forward question. It is "how much do these things cost?"

MR. BOB CHMELY: Non-traditional pension plan terminations have received a lot of attention recently. The Society's preliminary program says: Some plan sponsors appear to be terminating pension plans for new reasons--to obtain cash and to force the PBGC to fund underfunded plans.

In my view, these are not new reasons, but merely new variations of the basic objective which still is: to manage the corporation on the most profitable basis.

I am going to discuss the benefits usually provided on plan termination, and the use of single sum annuity contracts. I will also mention the recent controversy regarding so-called "spin-off and termination" of pension plans.

In Revenue Ruling 83-52 the Internal Revenue Service restated its long standing rule that:

> "...when fixed and contingent liabilities are discharged through the purchase of a contract ... from an insurance company which provides the benefits with respect to individuals for whom the liabilities are determined, the remaining assets may be considered surplus arising from actuarial error and revert to the employer."

The insurance company product most often used in the context of Revenue Ruling 83-52 is a non-participating single sum annuity contract.

In order to receive any "surplus arising from actuarial error" on the termination of a corporate plan, the PBGC requires the plan sponsor to demonstrate that the plan is a "sufficient plan." This PBGC requirement is easier to meet than the IRS requirement because PBGC does not require the plan to provide benefits that become nonforfeitable solely as a result of plan termination. So let's focus on the benefits that the IRS requires to be provided on plan termination, as a condition for the return of any surplus to the plan sponsor.

Under IRS Regulation 1.411(D)(3), the rights of all affected employees to benefits accrued to the date of termination ... to the extent funded as of such date, must be nonforfeitable. So, the question for an over-funded plan is: "What benefits accrued to the date of termination must be provided?" I'd like to comment on several types of benefits.

- Accrued benefits payable at normal retirement date must be provided.

- The qualified joint & survivor benefit must be provided. A pre-retirement survivor benefit need not be provided, per Revenue Ruling 81-9. Also, lump sum death benefits need not be provided.

- The experts disagree whether the plan must provide subsidized early retirement benefits. At least four general approaches have been taken. From "most generous" to "least generous," they are as follows:

    1. The plan's liberal early retirement provisions are continued.

    2. Participants who satisfied the service requirement as of the termination date will be eligible for subsidized early benefits when they meet the age requirement.

    3. Only those who are eligible to retire early on the termination date may subsequently retire with subsidized early benefits.

    4. After termination no one receives a subsidized early retirement benefit.

The most liberal approach should not result in a challenge by the IRS or the employees. The less liberal approaches may be challenged. Those who believe the less liberal approaches are acceptable argue that the subsidized early retirement benefit does not have to be preserved.

A recently decided case in a U.S. District Court for West Virginia (Suggon vs. Weirton Steel) considered this issue. The court quoted ERISA's legislative history to the effect that accrued benefits under ERISA do not include conditional benefits such as the value of the right to receive

early retirement benefits. The court concluded that these are ancillary benefits which may be amended or deleted without violating ERISA.

However, another court might reach a different conclusion by emphasizing the requirement that fiduciaries must act solely in the interests of plan participants.

The IRS position on this issue is not clear to me. Perhaps someone in the audience can shed some light on this.

In addition to IRS and PBGC requirements, the plan fiduciaries must follow the terms of the plan; and a terminated plan must not violate any collective bargaining agreement.

As I mentioned earlier, the insurance product most often used at plan termination is a non-participating single sum annuity contract. Under it, a single sum payment is made to the insurance company. The insurance company guarantees to pay specified benefits to participants and, generally, issues certificates to them describing the guarantees.

Through 1979, single sum annuities were a relatively minor business for the insurance industry. However, the volume of business has increased substantially in the last few years. Volume by the major companies exceeded $1.1 billion of considerations during 1982.

The main reasons for this increase in volume are:

- the recent recession
- high interest rates, and
- corporate takeovers

First, let's review the effects of the recent recession. Since 1980, business conditions have caused severe cash flow problems for many plan sponsors and forced some to close their doors. Many companies with cash flow problems have reduced contributions to their pension plans. Some have terminated their plans. The number of plans requesting termination rulings gradually declined to about 3,300 in 1979, but steadily increased through the recent recession and may reach a peak of 5,700 plans in 1983.

The second major reason is the favorable rates available from insurance companies. Many employers found that their pension plans were over-funded. They learned that the excess funding could be recaptured by terminating the plan. They also found that insurance companies were offering very favorable annuity rates based upon current high interest rates. As a result, substantial funds could be recovered by using a single sum annuity contract.

The third major reason is related to corporate takeovers. One factor in takeover bids is the degree of funding of the pension plan. After a takeover, some companies have terminated the plan and recaptured excess assets. These may be used to reduce debt incurred in making the acquisition.

There are other reasons for the increase in single sum activity. For example, some defined benefit plans have been terminated in favor of defined contribution plans. The purpose is to add some degree of control on employer costs in an inflationary environment.

In addition, the Financial Accounting Standards Board wants unfunded pension liabilities to be disclosed on company balance sheets. Many executives are concerned that this disclosure will make their companies less attractive to investors.

Finally, PBGC currently charges $2.60 per year per participant for its guarantees. This charge is likely to increase soon to at least $6.00 per person for most plans. A single sum annuity allows the sponsor to avoid these premiums.

We have noted a decrease in single sum activity during 1983. Except for one large sale during the second quarter, industry sales are down by about thirty percent from a year ago.

One reason for the decline may be the questions about the legality of recovering pension plan assets.

In addition, sponsors may be waiting for an increase in interest rates, after the significant downturn from the rates available a year ago.

Finally, the combination of today's higher annuity costs and adjusted actuarial assumptions may have reduced the incentive for a plan to purchase annuities.

One phenomenon that has created some confusion in the market place is the big difference in cost quotations on single sum contracts. While I do not know the secret pricing formulas of other companies and surely do not intend to give away any of my own, I would like to discuss some of the considerations that may affect cost quotations.

As Chairman of the Society's Committee on Group Pension Mortality, I know that survivorship has improved much more rapidy than predicted by the 1971 group annuity mortality table. Recently, after examination of insurance company experience, population data, and studies from consulting companies, my committee determined that the 1971 GAM Table has already become obsolete even with the most conservative projections. In fact, the 1971 table was probably obsolete even before its adoption by all the states. As a result, significant differences in cost quotations can arise solely from differences in mortality projections.

Where active lives are included in the single sum contract and early retirement benefits are subsidized, the retirement age assumed by the insurance company can have a dramatic impact on the price. There is no scientific method that sets appropriate early retirement assumptions; there are a number of factors which should enter into the actuary's considerations:

- For example, the historical retirement pattern of the plan obviously should be noted. However, when a plan is being

terminated, conditions are created which can easily affect the incidence of retirement. A final average salary plan, by its nature, contains an incentive to remain in service. It may be replaced with a pension plan lacking such an incentive.

- Plant shut-downs or lay-offs may leave little incentive for participants to wait until normal retirement age to begin collecting benfits.

- U.S. News And World Report recently reported that the percentage of males aged 55 to 64 still working or looking for work had dropped from 90 percent in 1948 to 72 percent in 1980. By 1983, despite the fear of inflation, it had dropped further to 69 percent.

- Nonetheless, retirement decisions may also be affected by the increase in retirement age for social security benefits.

Add all this to the employer's right to offer early retirement incentive programs at any time and any projection of retirement rate may be hazardous.

Pricing of deferred annuities may also be affected by the Norris decision. If a participant can elect an option on terms that are more liberal than provided by sex-distinct actuarial equivalent factors, the pricing must recognize this.

Another consideration which is now a subject of increasing concern both to the Society of Actuaries and to an increasing number of state regulators is the sensitivity of assets and liabilities to changes in interest rates, the so called "C-3" risk. Any guarantees made or risks assumed by the insurer ultimately depend on the ability to achieve expected investment earnings. In an environment of fluctuating interest rates, matters such as call protection, stability of cash flow and liquidity are overlooked only at the insurer's peril. Even if all current investments achieve their expected yield, consideration must be given to the fact that the run-off of liabilities will often extend beyond the maturity of the longest fixed-income investments which can be found in today's market. The degree of conservatism taken with regard to long duration liabilities will have some effect on the price of the contract.

Finally, shifting tax bases have enabled companies to pursue a variety of tax strategies that may have had an impact on the pricing of single sum annuities.

We are just beginning to consider the pricing implications of the tax bill sponsored by Congressmen Stark and Moore.

In the broad view, this bill imposes a tax on gain from operations of all companies, stocks and mutuals alike. It imposes an additional tax on mutual companies' "imputed surplus" that is intended to achieve an objective called "segment balance."

We believe that the new bill will produce a better playing field--that is, a more level playing field--for the pension business than we had under the 1959 Act. However, it is too early to tell whether the Stark/Moore Bill will have any impact on single sum annuity pricing.

Before I discuss "spin-off and termination," I want to make a personal observation. During the past five years, I have discussed plan termination with a large number of sponsors. I am pleased to tell you that most sponsors are very concerned about the welfare of their employees. They want a positive response to their employee benefit programs. In most cases, their objective has been to provide more benefits than the minimum required by law.

Recently, some companies have announced their intention to split a pension plan into several plans. Excess assets would be allocated to one plan. That plan would be terminated, and the excess assets would be recovered by the company.

The House Select Committee on Aging has heard testimony that severely criticizes plan sponsors for such arrangements. The PBGC opposes these arrangements because they weaken the funding status of the continuing plan. The PBGC argues that a real termination has not occurred and the company cannot recover excess assets. The Internal Revenue Service, which at first did not raise legal objections, is reconsidering its position.

The problem is complicated by the economic distress of companies coming out of the recession. In addition, the PBGC guarantee structure seems to be unworkable.

As you know, the PBGC premium is the same $2.60 per participant for a well-funded plan as it is for an under-funded plan. Successful insurance programs usually charge a premium that varies with the risk of the insured event. This suggests that poorly-funded plans should pay a relatively greater premium than well-funded plans.

In addition, successful insurance programs insure against events that create losses for the insured party. The PBGC is trying to insure benefits on conditions that may benefit the plan sponsor. That is, the plan sponsor may be better off if the PBGC takes over its pension obligation. A partial remedy may be found by requiring that the sponsoring company must be bankrupt before PBGC will guarantee benefits.

MR. RYAN: Occidental Petroleum's termination of pension plan's represents the largest reversion of assets in the history of the free world, approximately $400 million. Hardly a day has gone by that we haven't been able to pick up some type of publication and find another horror story about what would appear to be some type of corporate rip off. Trevor has had to live in that environment and I thought it would be interesting to hear his side of the perspective and how they have been able to communicate this effectively to their employee group.

MR. TREVOR LUKES: I guess at this technical meeting I represent the consumer. Occidental is a large corporation. We have 41,000 employees worldwide, $15 billion in sales and I guess we are in the Fortune Top 20. The corporation developed through acquisitions. That is the history of Oxy. We had four salaried pension plans in the same petro-chemical business as a result of those acquisitions. To give you some idea of the employee population concerned with those four plans we had in total 21,700: 13,700 were active employees, terminated-vested were 5,200, and we had 2,800 retirees.

We looked at what we were going to do with having four pension plans serving the same petro-chemical business when we took an opportunity to consolidate and develop an entirely new approach. If you look at traditional pension plans, they are aimed at the career employee. The ten-year service professional receives a very modest pension. We really don't have very much portability. If an employee leaves a corporation in mid-career, he has a frozen benefit which by the time he reaches retirement age isn't worth a lot. And there is concern with Social Security what is going to happen down the road when the employment bulge in the 30 to 44 age bracket starts working its way out to people retiring at 55 and after.

I would like to spend 10 minutes for you to look at a video that we have prepared that explains our new program. There has been a lot of concern in relation to plan terminations and I think Occidental has a message that we have done it. We have done it on a very professional basis. We have offered our employees a very good benefit package in replacing these terminated plans. So, if you bear with me we have a 10 minute video to explain what we are offering the employees.

(video tape)

As you can see we have developed what we believe is an entirely new approach. The formulas are attractive, we make the most out of Section 415 limitations. We are going to encourage employees into the 401(k) provisions. We have in addition to that certain fixes that we have introduced into the new personal retirement account which has an age and service combination with extra additional percentages over and above what was explained on the video.

I see, and I think the employees see, a lot of advantages to this new program. We have created portability indirectly. The short service employee is going to be much better off. In terms of the interface between the old plan and the new plan we also went out to the insurance industry with a relatively new option. That was to have the present value of that annuity calculated in a cash basis and then rolled over into the new account. It is very interesting that 93% of our employees, the active population, have chosen roll-over. The residue have chosen an annuity. Now the roll-over provisions allow for a ten year contract, a GIC contract with a 5-year pay-out period. And one of the attractive features that we offered the employees was the fact that there was 12% net compound interest. So there is perhaps the major reason why our employees have chosen to go that way.

I think as you have seen from the video there has been a lot of planning and concern on our part that we were providing a very viable alternative program. We have worked very hard at a good communications strategy. And we believe that was of paramount importance. We had a letter from our chief executive officer and our president to the employees. We followed this up with brochures explaining it. We have training meetings with manuals with all the employee-relations people--some 70 employee-relations people--across the United States. We followed, of course, with all the videos which were distributed to all the locations. We followed that up with a newsletter telling the employees exactly where we are in developing the new programs. So I feel that we have had a very unique approach. I think two things that come out of it are: the employee now will see his personal account and he will see it grow rather than this undefined benefit which he gets out of a very complicated formula.

The employee's estate will benefit as well. Because, with death in service, what is in that account will go to the beneficiary. Under the pension plan a surviving spouse benefit is usually half of what his pension would have been. And of course there is advantageous tax treatment because there is 10-year forward averaging.

I think we had a very good message. It is working well right now. As you probably realize the PBGC and the IRS are still considering the matter but we feel we have a very clear case and that we have done it in a very positive manner.

MR. RYAN: There has been one significant development in the last couple of weeks and that is the House Select Committee on Aging had hearings on this whole question of plan reversions. They were seeking objective input into this problem, trying to figure out what was in the best interest of plan sponsors, plan participants and that probably explains why they entitled their hearings "Raiding America's Retirement Future - Corporate Misuse of Pension Assets."

Some of the ideas proposed, in addition to the excise tax that Elaine mentioned, would include:

1. The current environment is satisfactory and does not need to be changed.

2. Assets are the property of plan participants and their beneficiaries and therefore should never be allowed to revert to the employer.

3. Perhaps it should be permissible to allow assets to revert to the employer but only if the projected benefit is fully funded.

4. Reversions should be permitted under certain circumstances and therefore we need different rules depending upon the type of successor plan.

5. There should be a universal retirement system oriented toward the individual rather than the plan sponsor.

During the question and answer session, Tom Woodruff, formally Chairman of the President's Commission on Pension Policy, is reported to have stated that one of the reasons that there is so much variation in the selection of an interest rate for determining lump sum distributions is that, unlike the accounting profession which has the FASB to promulgate guidelines, the actuarial profession has not been able to develop a uniform approach. Therefore he suggested that Congress fill this void by enacting a uniform interest rate to be used for these calculations.

On that happy note, I would like to open the session for questions and comments.

MR. DICK HESTER: I would just like to make a couple of comments on the Occidental situation. First of all, I agree entirely that making a change in the laws that would prevent reversion to employers of excess funding would be bad for employees over the long run. I think that Occidental has every right in the world to recapture excess assets by terminating a defined benefit plan. Secondly, I think the presentation was a very well done thing. But finally, if anybody really believes that the employees are better off under the new system they don't understand the problem for the very simple reason that the company is going to be putting less of the corporate money into the new system and therefore the employees as a group have to be getting less out of it.

MR. LUKES: I'll comment on that because the new plan is costing in total more than the old pension plan and the old thrift plan. We have done a lot of work, one of the things that you didn't see up in the video is what we are providing these employees in terms of 15 year fixes. I left my notes here, but just to give you some idea, I am sure you have probably done your arithmetic. For example, in the OPC plan there is a further 2-1/2 percent going to be put in for a rule of 51--a combined age and service. The rule of 64 will put a further 5% in. If you look at the chemical division's plans we have a rule of 51 with 5% going in. And then in the City's plan, which was the company recently acquired by Occidental, we have a rule of 56--an extra 1%, a rule of 61--3.5%, and a rule of 74--7%. You add all that to the former plan and I can assure you we are putting more money in than we did under the old arrangement.

I would like to make one other comment. Your profession enables a plan sponsor to stop funding or to slow down funding. In Occidental we could have adopted that same approach but we chose to go this way. I think it is a question of timing rather than anything else.

MR. RYAN: Before I acknowledge the next question, can I ask a follow-up question and that is: What was the rationalization for putting in a more expensive plan. Was it the value of that money, a financial decision, that drove that?

MR. LUKES: It was basically employee relations. The selling of this program was important to Oxy--that our employees perceived it as being positive.

MR. LEAR WOOD: Mr. Lukes, when you terminated the present plans I assume that the present plans were of final average earnings.

MR. LUKES: Correct.

MR. WOOD: The benefit that was retained for the prior service, was it related to termination, the average earnings at change, or the prospective future average earnings. That seems to me to be significant to individuals who may be changing over and who have say 20 years service with 10 years to go. Their salary increase may be quite substantial in the next 10 years and I don't know whether those monies that you are putting in, even for those over 35 at 12 and 13 percent, will compensate. I would believe that if you maintained the future salary as part of the prior service that it would be significant.

MR. LUKES: We ran a lot of models, projections. As you know in any pension funding you have to have certain assumptions. We used a lot of computer time to try and project out the earned benefits accrued and earned benefits to date, the lump sum equivalent of those benefits invested in a known 10 year deal with a five year payout. Then some other assumptions, interest assumptions down the road. We tried to see where these employees would be on a future basis. Those models were tested. We had to use some assumptions of what the cash would be at the time the employee reached ages 55, 60 and 65 and what would be the annuity that that money would buy at that point in time. So, precision, is not, it cannot be there because we are predicting into the future. But we have tried to tailor this plan to be able to produce a meaningful benefit, and in a lot of instances, a better benefit to our employees.

MR. WOOD: I'd like to ask one more question of Ms. Church. On a termination you indicated that you had to provide the accrued benefits and some contingent benefits. For a plan that provided a cost-of-living adjustment after retirement, would that benefit be considered as a contingent benefit?

MS. CHURCH: I think that is another one of those ancillaries for which we don't have any clear answer. Certainly, under 411 of the Code, there is a requirement that you vest only in your accrued benefits, and arguably, any post-retirement COLA's or ad-hoc COLA's would not be an accrued benefit. But those rules do not well interrelate with the pre-ERISA concept under 401(a)(2) saying you cannot revert to the employer until you satisfy all potential contingent and fixed liabilities under the plan and is an issue that the Service just has not resolved. So it may well be that you don't have to vest the employees in them at the time of plan termination but that you are precluded from a reversion unless you somehow allocate a pot of money to pay those contingent obligations.

MR. JOHN MASSEY: I happen to be a shareholder of Oxy, so I am not going to pass this opportunity up. I am delighted to hear that $400 and some million will revert to the company. I am naturally interested in knowing how and when the money will revert, what effect it will have on earnings per share and what effect, if any, on dividends? The second question is as a participant, not as a shareholder of Oxy. In the video presentation which was very well done, the young lady made the comment that most

employees will be better off. Obviously, some are not better off, who are they and of what concern is this to Oxy and what are you doing about it?

MR. LUKES: In answer to your first question I am just a simple man, so I can't answer the return to shareholders. But I can say the reversion of assets right now is with the PBGC and the IRS. We are hopeful that this situation will be resolved as quickly as possible.

MR. MASSEY: So I should hang onto my stock.

MR. LUKES: The real problem that we face in coming up with the plan design was to try and find the long service employee who was very close to retirement. That is the one area lacking continuity but the benefit is very close. We have got within 4 or 5 percent at that bracket. The most they have lost is about 4 or 5 percent. And that is the long service employee with a short time fuse on the new roll-over account or the Personal Retirement Account before retirement.

MR. GARY PINES: If the employer wants to keep its plan--this is to everyone on the panel--but wants to use the surplus, and of course, not terminate the plan, are there other ways to use a surplus, such as paying for post-retirement medical or life? Are there any other ways? What is going on with this?

MS. CHURCH: Certainly, as long as you use it to provide benefits under the plan there is no issue as to the nondiversion under 401(a)(2) and that has been clear both pre- and post-ERISA because there you have the same pool of employees under the plan. The how you do that on an actuarial basis I'll leave to you all. You have an experience game there that you can test or determine through your valuation procedures and then essentially use that gain or that surplus to reduce future contributions or to provide additional benefits without incurring additional employer costs.

MR. CHMELY: I believe that suggestion, though, involves a plan where you would have both these health insurance benefits and retirement benefits under the one plan. It would be impossible I think to divert from one plan structure to another plan structure. How you might use the excess was brought out earlier. You might avoid paying contributions to the plan for some period of time.

MR. DON GRUBBS: First, it has been pointed out that one of the aspects of this is use of the excess funds in a takeover situation. A corporation may want to take over another one because there is this tempting target of reversion. To try and prevent that one major corporation made amendments to its pension plan to say that any excess assets would be used to increase benefits. They just wanted to remove temptation from anyone out there. My question is for Elaine Church regarding the IRS TWX. Is there any indication which said that the local offices are to refer these things to the national office? Do we have any indication yet what the national office is going to do? Are they really going to review and act on these or are they going to delay until they develop policy, or what?

MS. CHURCH: Well I know there are a number of studies, Don, that probably started when you were there. But, leaving that aside, the Service's intentions at this point are merely to study the issues as they promised Roybal's Committee they would and to find out why and under what circumstances the reversions are occurring. The procedure is intended to be purely procedural not substantive. They don't envision a change in administrative or interpretative regulatory authority insofar as the reversions are concerned. They feel in fact that depending on the results of their study they may or may not need a legislative initiative. But this study is, I think, in part to give them the data so they could make, if they deem it appropriate, a legislative recommendation and also, I think, to satisfy the members of Congress that they are on top of the situation.

MR. GRUBBS: Will they continue ruling on these cases?

MS. CHURCH: The TWX does not indicate that there will be any cessation of rulings--merely that it will be akin to a technical advice procedure where the national office is going to have its input.

MR. NORM CROWDER: If I can screw on my professional hat for a minute, let me raise two issues. The first one involves something I heard about in the back of the room this morning and I have heard it on a couple of other occasions since before I came to the meeting. That is, that there may be, in fact, some of our brethern actuaries wearing different stripes, who are going around offering to prospective clients the opportunity to gain reversions. Not only unprofessional, but grossly unprofessional. I would like to caution all of you to think about this. Don't raise your client's expectations, or somebody else's client's expectations about this because it is clearly in violation of professional conduct. If you hear about such a thing I would suggest that you contact the Discipline Committee of the Society or any of the other actuarial groups. Having said that delightful comment let me go on to the next one.

Under ERISA, as EA's we all have a responsiblity to the plan participants and beneficiaries. So between those two things let us all, as operating consultants who are trying to serve our client's needs, temper this thing. I mean I can make a very clear case in my own mind about the strategic use of funds, and most plan sponsors have been, perhaps, overly conservative in today's light, because of the advice that we as actuaries have given. So, keep your opinions and your views balanced both in your own mind and as you talk to clients and other companies.

MR. HESTER: Technical question for Trevor. You mentioned the large amount of comparisons that you did between the old plan and the new plan and at one point you also mentioned a 12% guaranteed interest rate. When those comparisons were made, was a comparable salary scale built into the benefits to be expected from the defined benefit plan comparable to what one would expect if 12% interest, in fact, is going to be earned over the life of the participant? Technically, it is very easy to take a defined benefit plan and put in a 3% or 4% salary scale and demonstrate how, if you can earn 12% you are so much better off in a money purchase plan,

when in fact with comparable assumptions it is rarely, if ever, the case unless starting at the age of 15.

MR. LUKES: I understand your point. What we did, as I recall, was use a 7% salary escalation assumption in most of our models. That's a reality. We have 12% locked in for 10 years with a five year payout. Then there has to be some projections after that. We projected out at 8%. A salary assumption of 7% and an interest assumption of 8%.

MR. RYAN: If I could expand on that for one minute, not necessarily directed to Oxy, but to a more general question. I think, Dick, in a well funded plan, where the employer's contribution is currently at a rather modest level, using projected unit credit method and a fairly realistic interest rate, it is not too difficult to say that you are willing to increase the cost of the plan and therefore able to provide comparable benefits. So I understand the concern you are expressing but I think for the mere fact that they were extremely well funded their current cost level was extremely low. Therefore it wasn't that unreasonable to increase costs and thereby increase benefits or provide comparable benefits.