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## CURRENT DEVELOPMENTS IN RETIREMENT PLANS

*Moderator: JACK SCHECHTER. Panelists: DANIEL C. RUDIN, YALE D. TAUBER\*. Recorder: RICK WATSON*

1. Coping with the Federal Deficit
2. Unisex and Pension Equity
3. Surplus Plan Termination

MR. JACK SCHECHTER: This afternoon we will discuss current developments in retirement plans. My name is Jack Schechter; I'm a consultant and actuary with William M. Mercer-Meidinger in Stamford, Connecticut. I will be discussing the effects of the Federal Deficit on Pension Plans today. The next panelist is Yale Tauber, an attorney with the firm LeBoeuf, Lamb, Leiby & MacRae, who will discuss Unisex and Pension Equity legislation. Finally, panelist Dan Rudin, an Associate in Mercer-Meidinger's New York office, will address the issue of Surplus Plan Terminations.

I will kick-off our session with a review of recent deficit-related benefits legislation. On February 1 President Reagan released his 1985 Budget. On top of an estimated deficit of \$180 billion for 1984, the new budget projects total deficits of \$813 Billion in the years 1985 through 1989. Compared to Congressional Budget Office projections, the Administration's estimate of future deficits is an optimistic one.

How do Federal budget deficits affect the financing of employee benefits? There is one obvious effect. In the six trading days after publication of the 1985 budget, the Dow Jones Industrial average dropped sixty four points, and has continued its decline ever since. Equity holders -- including many corporate pension plans -- have taken a beating. If Treasury financing needs continue to keep interest rates high, the value of pension holdings can be expected to decline even further.

However looming Federal Deficits will have a more pervasive effect on employee benefits financing, in the form of a massive cost shifting from the public to the private sector. Indeed, this type of cost shifting is already well under way, and it predominates most recent benefits legislation.

### Recent Deficit Growth

Let's take a closer look at how the budget deficit has grown in recent years. Both outlays and receipts have increased each year since 1978. During the period from 1978 through 1984, the deficit gap has grown from under \$50 billion a year, to over \$180 billion for 1984. Projected future deficits are even higher.

\*Mr. Tauber, not a member of the Society, is an attorney with Leboeuf, Lamb, Leiby & Macrae, New York, New York.

Recent deficit growth is even more dramatic when viewed as a percentage of Gross National Product. From 1978 through 1981, the annual deficit stood at roughly 2% of GNP. By 1983, with the country in the grip of recession, the deficit rose to over 5% of GNP.

#### How Benefit Expenditures Affect the Deficit

How do Benefit Expenditures figure into these deficits? Medical care, income replacement, and other employee benefits impact the Federal budget in two distinct ways.

First, there are the Direct Expenditures. Social Security and Medicare represent the direct transfer of government funds to beneficiaries and to medical providers. The amount of these expenditures is significant. For fiscal 1985, Social Security and Medicare are projected to account for \$260 billion of a total \$925 billion of direct expenditures, or roughly twenty eight percent of the total budget.

Tax Expenditures make up the second major form of government spending for employee benefits. Such expenditures fall into three major categories:

- First, the government forgoes current revenue because taxes on contributions to qualified pension funds are deferred until benefits are paid. Investment earnings on qualified plan assets are similarly tax deferred.
- The second major tax expenditure is for employer-paid medical premiums. Such premiums are deductible by employers as business expenses, but do not constitute taxable income to employees.
- Finally, cafeteria plans -- which allow employees to choose between taxable and non-taxable compensation -- are viewed by IRS as another form of tax expenditure.

Measuring the magnitude of these tax expenditures is a matter of some controversy. However, Treasury clearly believes the revenue loss is significant. For example, the government estimates that tax expenditures for employer sponsored pension plans approximated \$47 billion for 1983, making this the highest of all tax expenditures made on behalf of individuals.

#### Legislative Response

What has been the Legislative Response to growing expenditures in these areas? The major legislated changes we will discuss are

- First, the 1983 Social Security amendments; and then
- TEFRA's rules regarding qualified Pension and Profit Sharing Plans.

The primary focus of these changes is to decrease benefits while increasing employee and employer taxes. This represents an erosion of the government's role in financing benefits, with a resulting shift in costs to the private sector.

We will take a closer look at the background of recent benefits legislation, review the key provisions of these laws, and indicate what should be done in response to these changes.

### Social Security

Lets first turn to Social Security. The problems of the Social Security System are well known. The major areas of concern are as follows:

- First, an automatic increase in benefits geared to inflation and wage levels, which outstrips the revenue needed to finance the system.
- Second, the increased longevity of beneficiaries.
- And finally, a demographic mismatch of Social Security recipients and tax-payers, due to aging of the population.

Before the enactment of the 1983 Amendments, the prognosis for the system was a gloomy one: A progressive depletion of the Social Security Trust Funds, and ultimate insolvency of the system.

### Legislated Changes

The April '83 legislation seems to have saved the system, at least temporarily. Let's see how this was accomplished. Legislated changes were in three major areas:

- Higher taxes,
- Lower benefits, and
- Broader coverage.

Payroll tax increases for OASDI will come on stream sooner than would have been the case under prior law. Social Security tax increases previously scheduled for 1985 will be advanced to 1984; and part of the increase scheduled for 1990 will be advanced to 1988. In addition, a portion of Social Security benefits will be subject to Federal Income Tax for the first time starting in 1984, and FICA taxes will be extended to elective 401(k) salary reductions and other deferred compensation.

In the benefits area, the 1983 law made three major changes:

- First, cost of living increases for 1983 were deferred six months, and will now be granted on a calendar year basis.
- Next, cost of living increases will be subject to a benefit stabilizer, which takes effect if trust fund reserves dip below a designated level. Under the stabilizer, cost of living adjustments will be limited to the increase in the Consumer Price Index, or to the increase in an average wage indicator if this produces a lower result. Under prior law, only consumer price changes were taken into account.

- Lastly, the retirement age at which unreduced Social Security benefits are received was increased from the current age of sixty five to age sixty seven in the year 2027. This increase will be phased in during the intervening years.

In addition to the tax and benefit changes, Social Security coverage of non-profit and federal and local employees will be extended.

It is expected that these changes will substantially increase the financial viability of the Social Security System. But how will they affect employers, and what should be done in response?

#### Employer Response

There are of course a number of issues which will have to be addressed immediately.

- Employees who sponsor 401(k) plans must make administrative changes to withhold FICA taxes on employees' elective salary reductions. It will be important to communicate these changes to employees to clarify the complicated tax aspects of these plans.
- Employers should review the retirement plans of more highly compensated employees due to the changed FICA tax treatment of deferred compensation and the imposition of income tax on Social Security benefits.
- Finally, employers who sponsor integrated pension plans should be sure their Actuary calculates the cost effect of the recent Social Security changes.

More important, though, are the long term issues that will have to be faced. Overall the cumulative effect of recent Social Security legislation will be to diminish the role which Social Security plays in meeting future retirement income needs. Private pensions and employee savings, the other two legs of the proverbial three legged stool, will have to pick up the slack to insure retirement income adequacy.

The basic question that will have to be addressed is whether employees will continue to absorb the increased cost of maintaining expected levels of retirement income. Answering this question will require Corporations to re-examine their basic retirement income philosophy.

For current retirees, companies will have to decide what provisions should be made to counter the erosion in retirement income adequacy. The imposition of income tax on Social Security benefits, and the changes which apply to cost of living adjustments will aggravate this serious situation. Most likely, ad hoc benefit increases for retirees will have to be made more frequently, and some companies may build automatic retiree benefit increases into their plans.

For active employees, it may be appropriate to rethink the Defined Benefit/Defined Contribution retirement plan mix. An increased emphasis on employee savings as a source of retirement income may hasten the move to Profit Sharing and Thrift Type plans. Employers with integrated plans

of the offset type will probably want to consider changes to minimize the impact of future cost increases. A close examination of alternate integration methods would seem appropriate.

#### TEFRA Qualified Plan Changes

TEFRA is the next area we would like to address. TEFRA was enacted in the summer of 1982, but most employers are still grappling with the intricate provisions of this law. We will focus on TEFRA changes to qualified pension and profit sharing plans.

The purpose of TEFRA was to enhance tax revenues. The Congressional Staff Members who concocted this law estimated that TEFRA's pension provisions would increase 1983 tax receipts by \$200 million, with added revenue exceeding \$1 billion by the year 1987. It is not too great an exaggeration, though, to suggest that legal, administrative and consulting expenses are likely to increase commensurately.

#### Key TEFRA Provisions

By this time you are surely familiar with the key TEFRA changes, so our review will be a brief one.

- First, TEFRA reduced the section 415 limitations on contributions and benefits from tax qualified plans. The new defined benefit limit is \$90,000, and the limit on contributions is \$30,000. Furthermore, these limits cannot be increased until 1986, and employees who participate in a combination of defined benefit and defined contribution plans will be subject to a lower aggregate limitation than applied under prior law.
- Next, TEFRA changed the rules which apply to loans made by qualified plans to plan participants. Under prior law, loans to participants were generally made on a tax free basis. However, TEFRA limits the amount of non-taxable loans to the lesser of \$50,000 or 50% of current non-forfeitable accrued benefits, but not less than \$10,000.
- The next two TEFRA changes go hand in hand. TEFRA greatly liberalized the rules which apply to plans for the self-employed and for non-corporate employers, so as to place such plans on an equal footing with corporate plans. As quid pro quo, TEFRA introduced a new concept, the concept of a top heavy plan. A pension or profit sharing plan is top heavy if more than 60% of accrued benefits or accumulated contributions are attributable to key employees. Plans which are top heavy will be required to provide accelerated vesting and additional benefits for non-key employees, and will be subject to more stringent benefit limitations for key employees. Moreover all plans will have to be amended to include language which is triggered in the event the plan becomes top heavy. This will be necessary even for plans which could not conceivably become top-heavy.

- Next, TEFRA changed the rules which apply to distributions from qualified plans. Generally, the purpose of these changes is to hasten the payout of plan benefits so as to accelerate recognition of taxable income. Many of the new distribution rules are ambiguous and are likely to have effects not intended by Congress. Hopefully technical amendments to TEFRA will rectify this situation.
- And finally, TEFRA changed the rules for Profit Sharing Plans which are integrated with Social Security, and
- Imposed income tax withholding on pensions, annuities and other forms of deferred income.

These changes will have the greatest impact on high income individuals and on pension plans for the self employed and for closely held corporations. However all plans will require amendments to reflect these changes.

#### Employer Response to TEFRA

What are some of the things employers should be doing in response to TEFRA? Obviously sponsors of qualified plans should be sure to adopt any required plan amendments. Most employers will be doing this during 1984.

Next a careful review of executive retirement and capital accumulation plans will be necessary, due to the cut back in the Section 415 limits, the change in distribution rules, and the reduced estate tax exclusion. In response to these changes, we expect to see an increased reliance on ERISA excess plans, Supplemental Executive Retirement Plans, and other forms of non-qualified deferred compensation. Defined contribution excess plans are likely to proliferate as more executives realize that elective 401(k) salary reductions are counted as employer contributions against the \$30,000 limit. In general an increasing proportion of executives' deferred income benefits will be provided on a non-qualified basis. As a result, more corporations will want to look at funding these benefits, using non-qualified trusts or Corporate Owned Life Insurance.

Next employers will have to determine whether these plans are top heavy. For some employers the answer may be obvious, whereas in other cases a more detailed analysis will be required. Employers with top-heavy plans should enlist the aid of their actuary to determine the most cost effective way of complying with the top heavy requirements.

And finally, you should take a close look at the new Keogh Plan rules. These changes will significantly expand tax qualified savings for the self employed. You should certainly review the benefits you provide for your Corporate Directors, who are considered self-employed for that purpose.

Mr. Tauber: As you know, last July, in the now famous Norris case, the United States Supreme Court decided, by a 5-4 vote, that Title VII of the Civil Rights Act of 1964, as amended, prohibits employers from offering under their retirement plans annuities which provide unequal monthly payments to similarly situated male and female employees on the basis of actuarial tables which differentiate between the sexes.

Because Norris was an employment discrimination case, the Supreme Court did not address the broader question, now being considered in Congress, of whether insurance companies should be required to calculate all insurance rates and benefits without regard to sex, whether or not in the context of employment. While a few insurance companies do offer annuities on a sex-neutral basis, most now pay lower monthly benefits to women than to men on the theory that women will eventually receive an equal amount over their longer life times; this practice has not yet been prohibited by Federal law.

The Norris case did not prohibit employer-sponsored retirement plans from purchasing these sex-based annuities for distribution to retirees. It did not prohibit employers

from continuing to use sex-segregated tables in calculating the contributions they must make to their defined benefit retirement plans. Nor did Norris prohibit insurance companies from using sex-segregated tables to arrive at the premiums employers must pay in order to provide group health, disability, life and other insurance coverages to their employees. All that Norris requires is that employers provide equal retirement benefits and group insurance coverages for otherwise similarly situated male and female employees. In addition, under the Supreme Court's decision five years ago in the Manhart case, employers may not require otherwise similarly situated male and female employees to pay unequal contributions for such benefits or coverages.

#### Resulting Planning Considerations

As simple as these rules sound, the Norris case left us with a problem of adverse selection which must be dealt with in adopting actuarial benefit conversion tables for inclusion in plan texts (something that, as you know, the IRS requires to be done in 1984). The resulting planning considerations are compounded by the fact that the Supreme Court allowed the use of "blended" sex-neutral tables reflecting the average employee expected longevity in view of the sexual composition of the employer's workforce. It did not require "topping up," a Title VII concept under which the lower benefit levels of one sex would have to be raised



to the higher level of the other sex. Thus, if standard actuarial tables assume that, at age 65, women have about a 19 year remaining life expectancy while that of men is 15 years, an employer whose workforce is evenly split between males and females could adopt blended actuarial tables that assume that all 65-year olds have a 17 year remaining life expectancy.

To examine the effect of such a simple approach on the costs of the employer's plans, let's suppose the blended tables are used to determine the amount of lump sum distributions in settlement of pensions under a defined benefit plan. A male employee would get a lump sum distribution, based on an assumed 17 year remaining life expectancy, which exceeds the amount he needs to buy a commercial annuity providing his pension for life because an insurance company would probably assume that he has only a 15 year remaining life expectancy. A female employee would not get enough to buy an annuity providing her pension from an insurance company that assumes she has a 19 year remaining life expectancy. The result is that the well-informed male (and fiduciaries under the plan may have the obligation to keep participants well-informed) could be expected to elect a lump sum distribution in order to "gross up" his retirement income, whereas the well-informed female could be expected to elect to receive a pension from the plan. In both cases,

employees would be electing to receive their benefits from the plan in a form which has the most cost to the plan. In the case of the male employee, the plan's cost may exceed the previously assumed true actuarial cost.

The same analysis applies to whether males or females can be expected to elect joint and survivor annuities or other forms of payment providing post-retirement death benefits where the defined benefit plan's formula is expressed as a life annuity. Well-informed males can be expected to elect such payment forms because they are buying the death benefit at below true actuarial cost. Well-informed females can be expected to stay with single life annuities to maximize their benefits.

In the case of the employer's defined contribution plan, well-informed females can be expected to elect to receive their benefits in the form of annuities which they can buy under such plans at below true actuarial cost. Well-informed males can be expected to elect lump sum distributions which they can use to buy larger annuities on the commercial market.

Consultants may differ in their opinions as to the extent of the impact of these considerations on employees' benefit elections (especially since the IRS still uses sex differentiated tables to determine the employee-annuitant's exclusion ratio under Section 72 of the Internal Revenue

Code with the effect that women will recognize more taxable income than men on receipt of each annuity payment). However, the exposure of the plan to greater costs through this adverse selection process cannot be overlooked or denied in adopting tables for inclusion in plan texts in 1984, as required by the IRS, and in determining funding costs under the plan.

#### Unisex Insurance Legislation

If Congress were to adopt unisex insurance legislation that prohibited all sex-segregated insurance rates and benefits, that would help reduce the advantages to be gained by employees of one sex over the other. Such legislation is pending in Congress, but the insurance industry has been strongly opposed to it, especially the retroactivity and "topping-up" features of the bills as originally introduced.

On March 28, the House Energy and Commerce Committee approved a bill, entitled the "Nondiscrimination in Insurance Act" (HR 100), but only after including amendments eliminating the retroactivity and "topping-up" features and limiting the applicability of the prohibition on sex-segregated insurance rates and benefits to insurance contracts which are part of employee benefit plans. Thus, even if this bill were to be enacted, sex-based annuities would, at least for the time being, continue to be available to employees outside

their plans, and employees of one sex could continue to gain advantage over the other sex by choosing between the sex-neutral benefits which the Norris case requires their plans to offer and the sex-segregated annuities available from commercial insurers outside their plans. However, the bill would at least assure plan administrators that, in complying with the Supreme Court's unisex mandate, they could purchase annuities from commercial insurers on a sex-neutral basis and, thereby, mitigate the costs of the adverse selection process.

While Federal unisex insurance legislation seems inevitable following Norris, the prospects for passage this year are not good. In a recently released report on the financial effects of a bill, entitled the "Fair Insurance Practices Act" (S. 372), which has been pending in the Senate since February 1983, the General Accounting Office concluded that the unfunded liabilities created by such legislation could lead to the insolvency of some insurance companies. No action is likely until Senator Packwood's Commerce Committee staffers devise an Administration-backed compromise bill that eliminates or modifies the more objectionable financial hardships.

In the meanwhile, not all the action is in Washington. California, Illinois, Massachusetts, Michigan, New Jersey, North Carolina, Montana and Nebraska have all adopted unisex insurance legislation.

Pension Equity LegislationStatus of Pending Bills

If Federal unisex insurance legislation has been sidetracked for this election year, Congress has been actively considering legislation dealing with other aspects of equity between male and female employees in pension plans. Although no final law has been enacted, several important developments have occurred.

On the Senate side, S.1978, the so-called "Retirement Equity Act" was passed by the full Senate on November 18, just before the 1983 year-end adjournment. Since this bill contains some tax measures which, according to the Constitution, must originate in the House, it was attached to a House bill, H.R. 2769, dealing with the Caribbean Basin Initiatives.

In the House, H.R. 4280, also entitled the "Retirement Equity Act," was approved by the Education and Labor Committee on November 16 and ordered printed this year on April 5. The Ways and Means Committee approved the bill on March 28, 1984, but with some additional amendments. However, the text of the Ways and Means Committee bill has not yet been drafted or printed. Since the only available description of the changes adopted by the Ways and Means Committee is contained in a brief press release, it is difficult to detail the differences between the two House bills.

The procedural steps to be taken from this point on are a bit uncertain. After the Ways and Means Committee formally issues its report, the House could iron out the differences between the two versions of the House bill and pass it as an alternative to the Senate bill. The differences between the House and Senate bills would then have to be worked out in conference. An alternative, possibly faster, route to enactment before the summer adjournment would be an early conference on the Senate bill which, as I mentioned, is an amendment to an earlier House-passed Caribbean Basin Initiatives bill. This would obviate the need for further House action at this point. Whatever procedural steps are taken, enactment of this so-called "women's issues" legislation is expected before the Democratic and Republican conventions this summer.

#### Participation and Vesting Provisions

Both the Senate and House bills would reduce the minimum age for participation in a pension, profit-sharing or stock bonus plan from 25 to 21. Both bills would also require such plans to credit service for vesting purposes after attainment of age 18, instead of the present age 22 rule.

The House Education and Labor Committee bill contains a so-called "look-back" provision. Under this provision, defined benefit plans which retroactively credit

service after attainment of age 21 for benefit accrual purposes upon enrollment of a participant could defer such enrollment until either age 25 or until any earlier age that an employee who would have had a vested benefit if the plan had permitted participation to commence at age 21. Thus, if a plan with a "4-40" vesting schedule providing 40 percent vesting after four years of service were to adopt a general participation requirement of age 25 and one year of service with a look-back, an employee who entered employment at age 18 would have to be allowed to become a participant at age 22 (not age 25) and would, upon becoming a participant, have one year of benefit accrual service for his or her service after attaining age 21. The look-back is intended to eliminate PBGC premiums for employees who are required to be enrolled at age 21 but who will never receive any benefits under the plan.

Both the Senate and the House bills would also alter the break in service rule known as the "rule of parity" so that non-vested employees who leave their jobs for up to five years would not lose their pre-break service credits for participation and vesting purposes. For example, under current ERISA rules, if a non-vested participant with four years of service terminates employment and is rehired after a four year break in service, a plan may treat the returning employee as a new employee. The legislation would not permit this.

These general rule changes would affect many women who enter the workforce in their late teens or early twenties and leave to raise families in their twenties or thirties. The legislation would increase the likelihood that they will have vested benefits when they leave and that service before they leave will be counted towards a benefit if they return to work.

#### Maternity and Child Care Provisions

Both the Senate and the House bills would also provide specific pension protection improvements for workers who interrupt their careers to care for children at home. Under current ERISA rules, a plan is required to credit up to 501 hours of service, which is sufficient to prevent a break in service, for a paid maternity or paternity leave. Both the Senate and the House bills would prohibit treating as a break in service an unpaid absence of up to 501 hours due to pregnancy, childbirth or childrearing following birth or adoption, regardless of whether the absence was an approved or unapproved leave.

The House bills, but not the Senate bill, would make this service credit available either in the year of pregnancy, birth, adoption or child care or, if the participant already has accumulated at least 501 hours of service in that year (so that the break in service protection is unnecessary), in the immediately following year. If an



employer provides paid maternity or paternity leave, these hours are credited under current ERISA rules prior to determining what year the new protection afforded by the House bills would be applied. Thus, if an employer gives an employee a 501 hour paid leave in one year, the employee could not have a break in that year under current ERISA rules or, under the House bills, in the following year, even though the employee did not render one hour of service in either year. However, neither the House bills nor the Senate bills would require that service credit be given for participation, vesting or benefit accrual purposes during the actual period of absence.

#### Joint and Survivor Annuity Provisions

Both the Senate and House bills would overturn the BES Associates case and, thus, require stock bonus, profit-sharing and most, if not all, money purchase pension plans to either eliminate annuity options altogether (which may not be a bad idea following Norris) or provide joint and survivor annuities as the normal form of payment. Under the Senate bill, only defined benefit pension plans would actually be required to provide annuities. Under the House Education and Labor Committee bill, this requirement would also apply to money purchase pension plans which are not "supplemental" to another plan, but existing plans that did not offer annuities on November 1, 1983 would be excepted.

Thus, some money purchase pension plans would have to provide joint and survivor annuities as the normal form of payment.

Under the Senate bill, defined contribution plans are not required to provide annuities but those that do so anyway must provide joint and survivor annuities as their normal form of payment. Under the House Education and Labor Committee bill, stock bonus, profit-sharing and "supplemental" money purchase plans are not required to provide annuities and, even if they do so, they remain exempt from the joint and survivor annuity requirements, provided that, on the death of a participant, his or her entire account balance is paid to the surviving spouse or, if the participant is unmarried or the spouse consents, to the designated beneficiary. The Ways and Means Committee press release is somewhat vague but seems to indicate that the amendments approved by that Committee would require all money purchase pension plans to provide annuities, regardless of whether or not "supplemental," but would exempt them from the joint and survivor annuity requirements if a participant's entire account balance is paid to the surviving spouse or other beneficiary upon death.

Under the Senate bill, a plan subject to the joint and survivor annuity requirements must offer optional pre-retirement survivor annuity protection to all participants who have attained age 45 and completed 10 years of vesting

service or who are within 10 years of normal retirement age and eligible for early retirement under the plan, regardless of their length of vesting service. The House Education and Labor Committee bill would require survivor annuity protection to be offered to all participants who have completed 10 years of vesting service, regardless of their age, or who are within 10 years of normal retirement age and eligible for early retirement. The House Ways and Means Committee bill would require survivor annuity protection to be offered to all partially or fully vested participants, regardless of their age or length of service. Both House bills would seek to assure that survivor benefits are available for retirement years by prohibiting the payment of survivor annuities prior to the date the participant would have qualified for early retirement if he or she had lived and continued working for the employer.

Under both the Senate and House bills, a participant must be permitted to waive both pre-retirement and post-retirement joint and survivor annuity coverage unless the employer subsidizes the cost of this coverage. However, in order for a participant's waiver to be effective, the spouse's written consent, witnessed by a plan representative or a notary public, is required, except in cases where the spouse cannot be found. The spouse's consent would have to acknowledge the effect of the waiver in language that would

be easily understood. The Senate Finance Committee report accompanying the bill indicates that this means technical terms such as "qualified joint and survivor annuity" may not be used, but rather the consent form should specify that the spouse may not continue to receive benefits under the plan upon the death of the participant as a result of the waiver.

In addition, any spousal consent is only valid as to the signatory spouse's survivor benefits. It cannot affect the rights of former or future spouses. Thus, if the parties divorce and the participant remarries, a new consent may be needed as to the portion of the participant's accrued benefit which remains after the divorce unless the participant has already gone into pay status. Another change made by the bills is that if, when annuity payments begin, survivor annuity protection is in force, a person married to the participant at that time would remain entitled to a survivor annuity upon the participant's death even if then divorced from the participant, unless a domestic relations court order provides otherwise.

The bills vary in some of the details relating to election procedures, such as the time periods during which detailed explanations of the effect of electing or rejecting joint and survivor annuity coverage must be given. Both House bills would prohibit plans from imposing a two-year non-accidental death requirement for valid joint and survivor annuity elections. However, the Senate bill would

continue this feature of present law. In addition, both House bills, but not the Senate bill, would modify the present law one-year marriage rule. Under the modified House rule, if the participant is married on the annuity starting date but for less than one year, a survivor annuity must be provided if the participant was married to the same spouse for at least one year by the date of the participant's death. Unless the employer subsidizes the cost of survivor annuity coverage, this provision would require such a participant's benefit to be readjusted after the parties have been married for one year.

The House Education and Labor Committee bill is unique in one other noteworthy way. Under the bill's special transition rules, a survivor annuity must be provided to the surviving spouse of any participant who had completed 10 years of service and attained age 45 by the date the President signs the bill and who dies between such date and the bill's effective date, but before the earliest permitted retirement age under a plan. In addition, all deferred vested terminated participants with 10 years of service who terminated employment after the September 2, 1974 enactment of ERISA and are not in pay status on the effective date of the bill would have to be afforded a special one-time election in which they would have 60 days to elect a qualified joint and survivor annuity benefit. No spousal consent would be

required for waiver, but if a notice of such election is not sent to such participants within 180 days after enactment of the bill, they will have automatic joint and survivor annuity coverage.

#### Cash Out Provisions

Under both the Senate and House bills, the level at which a plan is permitted to cash out benefits without the consent of the participant or the surviving spouse to whom the benefits are owed is raised from \$1,750 to \$3,500. Under the House bill, the present value of benefits could not be determined for this purpose at a discount interest rate which exceeds PBGC rates for valuing immediate annuities.

In the case of a cash-out of a surviving spouse's annuity, the House bills require plans to provide for direct payment to an individual retirement account or other plan authorized to receive such a rollover. The surviving spouse can request cash, of course, and the plan may make a cash payment if the surviving spouse does not elect a rollover within 60 days after receiving notice of such distribution from the plan. In addition, the Ways and Means Committee bill would require plans to notify all lump sum distribution recipients of the availability of rollovers into individual retirement accounts or other authorized plans.

#### Spousal Attachment Provisions

Both the Senate and the House bills would also clarify the controversy regarding child support, alimony and

marital property rights that has plagued the courts since 1975 under the non-alienation provisions of the Internal Revenue Code and the pre-emption provision of ERISA. The bills would permit a state domestic relations court to award a divorced spouse all or a portion of an employee's accrued benefit which would become payable on the employee's earliest permissible retirement date, regardless of whether the employee survives until then or, if he or she does survive, regardless of whether the employee continues working. (If the participant dies before early retirement age, the amount payable to the divorced spouse may not exceed the amount which would have been paid as a survivor benefit to a current spouse, and if the participant continues working beyond early retirement age, the order may not affect subsequent benefit accruals or vesting by the participant.)

Although the bills would permit a divorced spouse to be awarded a benefit for which the participant had not opted, a plan would be afforded some protection from vague orders or orders which are otherwise inconsistent with the participant's vested rights under the plan. This would be accomplished by requiring certain procedures to be followed with respect to domestic relations orders. The House Education and Labor Committee report says plans must adopt written procedures for dealing with such orders and must provide participants and divorced spouses with copies of such procedures as soon as an order is received.

Under all the bills, the plan administrator would be required to determine whether a court order is "qualified," that is whether it meets certain requirements as to specificity and subject matter and whether it requires the plan to provide a greater benefit than the participant could have obtained by retiring and making the proper election or a payment form that the participant could not have elected. The plan administrator must send a notice of its determination to the parties.

Until any clarifications necessary to qualify the order have been made, and until the spouse has been located and has supplied any necessary information requested by the notice, the plan administrator may postpone benefit payments under the order. The Senate bill provides that such clarifications and information must be received within one year in order for benefit payments to commence in accordance with the order, including a make up of any postponed payments. The House Education and Labor Committee bill contains a three-year requirement, and the Ways and Means Committee bill contains a two-year requirement. Under all bills, the plan may continue throughout the prescribed period to pay the participant the portion of benefits not due to the spouse or not in controversy and, if the matter is not settled by the end of the period, the plan must pay benefits in accordance with the plan without regard to the



order, including any benefits which had been postponed during the period. If the spouse subsequently reestablishes the right to payments under the order, no make-up payments would be required.

Both the Senate and the House bills provide rules for determining the tax treatment of benefits subject to a qualified domestic relations court order. Both bills provide that the participant's tax basis in the benefits would be allocated between the participant and the spouse in proportion to the present value of their payments. Both bills provide that the interest of the spouse is disregarded in determining whether a distribution to the participant qualifies for lump sum distribution treatment and permit a spouse to rollover lump sum payments to an IRA. The Senate and House Ways and Means Committee bills, however, would not afford the spouse lump sum distribution treatment other than making a rollover available, while the House Education and Labor Committee bill would make ten-year income averaging and capital gains treatment available.

#### Individual Benefit Statement Provisions

Both the Senate and the House bills would also require the individual benefit statements that are currently furnished to participants on request, no more frequently than annually, or upon separation from service, to include a notice that certain benefits may be forfeited if the participant dies before a particular date. The notice apparently

need not include the amount of benefits that are forfeitable but should specify the full vesting date. This is intended to permit participants to make financial arrangements for the retirement security of their spouses.

#### Effective Dates

These provisions would all be effective for plan years beginning after 1984. The effective date would be extended for collectively bargained plans to the date of termination of the collective bargaining agreement or January 1, 1987, if earlier. The bills also contain various transitional rules and provisions.

#### Accelerated Vesting

The House Ways and Means Committee bill would codify the Revenue Ruling 79-90 requirement that actuarial assumptions used in computing optional and early retirement benefits be specified in the plan and the prohibition in Revenue Ruling 81-12 against changes in these assumptions that reduce the value of previously accrued and vested benefits. Although the press release is not entirely clear, the bill may also prohibit plan amendments that eliminate or reduce a subsidy, an early retirement benefit, or an optional payment form with respect to benefits accrued before the plan amendment.

The House bill had originally included some incentives for non-top-heavy plans to adopt accelerated vesting schedules. As approved by the Education and Labor

Committee and the Ways and Means Committee, these provisions were deleted. However, the Ways and Means Committee bill directs the General Accounting Office to undertake an in-depth study of the effects of various pension rules on women and report its findings to the House and Senate tax and labor Committees within five years. So we may not have seen the end of more rapid vesting requirements for all plans.

Mr. DANIEL RUDIN: I'll be talking about pension plan terminations, in specific, the termination of over-funded plans in order for the sponsoring corporation to recover surplus assets. This is a somewhat controversial topic that has been kicked around for the past four years or so without too many people sure of the ultimate direction it would take.

However, about one month ago, this issue regained much of its previously muddled direction when the President's Council of Economic Advisors published a statement of policy on recovering surplus assets. This policy has been endorsed by the PBGC, the Department of Labor and the Treasury Department. Before I go into a discussion of the Cabinet Council's statement, I would like to go back in time, in order to put this topic in perspective:

Internal Revenue Code Section 401(a)(2) states that it must be "impossible, at any time prior to the satisfaction of all liabilities, for any part of a pension trust to be used for any purpose other than the exclusive benefit of employees or their beneficiaries."

There are three conditions outlined in Section 4044 of ERISA which must be met in order for residual assets to revert to the sponsoring company:

- (1) All liabilities must be satisfied, which is a restatement of the IRC requirement just mentioned.
- (2) The distribution or reversion must not contravene any provisions of the law. I'm not exactly sure what that means, but if there are any questions on this point we do have a lawyer on the panel, and
- (3) The plan document must provide for a distribution to the sponsoring employer in the event of a termination. This requirement will usually not present a problem since the courts have upheld plan amendments to this effect which were adopted just prior to a plan termination.

So basically, ever since the passage of ERISA, it has been possible for a company to recapture assets via a plan termination.

But, there were a few basic problems. Aside from a fear of the vague concept of fiduciary responsibility, plan sponsors were also in fear of the negative appearance that might be created by terminating a plan. The termination of a pension plan was considered an absolute last resort, and has been categorized as a burial rite of dying corporations.

Although many financially troubled companies could have used these funds, they did not wish to announce to the world that they were at the point where they had to terminate the plan. Aside from protecting the company's image as viewed by financial analysts, many companies were just as concerned with their image as viewed by their employees. Phrases such as "employee morale" and "our company's moral obligation" would undoubtedly enter into any discussion on this topic.

Most companies which terminated defined benefit plan substituted a defined contribution plan. The IRS, PBGC and DOL have always sanctioned this type of arrangement, but it has never really been the best solution. The original benefit design "promised" employees would in most cases be compromised. Long term employees near retirement would lose substantial amounts since they would not be able to accumulate meaningful account balances.

The ideal solution would be to re-establish a defined benefit pension plan with provisions similar to the plan that was just terminated, and grant past service credit to all employees. This could be accomplished by establishing benefits under an umbrella plan, that, when added to benefits of the terminated plan, would reinstate benefits to the same level as if the original plan had not terminated. Of course, excess assets would first be recovered from the old plan. But the PBGC, citing a pre-ERISA provision which prohibited this termination/re-establishment approach, refused to issue notices of sufficiency in such instances.

It wasn't long before some ingenious consultant rose to the challenge. In 1982, the AMAX Corporation split its pension plan into two plans, one covering active employees and the other covering inactive employees. The entire surplus was assigned to the inactive plan, which was subsequently terminated. Annuities were purchased for all the inactive participants. The active plan was not terminated, and therefore the original benefit design was kept intact.

Although quite a few companies have applied, the PBGC never did issue a notice of sufficiency for this spin off-termination approach. The margin of assets that existed prior to termination would be eliminated, thereby increasing the PBGC's risk of having to shoulder any potential liability upon subsequent termination. The House Select Committee on Aging reported in early 1984 that approximately \$1 billion would revert to employers if the PBGC were to approve all such pending applications.

This is where we stood in March of 1984. The PBGC, DOL, Congress, the Treasury Department and the IRS were all interested in this issue. To make matters worse, each of these agencies did not necessarily possess unified views.

The IRS was concerned with the taxation of reversions, as was its parent, The Treasury Department. But they were also worried about abuses of employees' rights and the future of defined benefit plans, as was the DOL. Congress had two jobs: to protect the welfare of the aged population and to close the budget gap. If all the pension plans in the U.S. were to terminate, tax revenue on surplus amounts would help offset the existing budget deficit.

During the week of April 2, the Administration's Cabinet Council on Economic Affairs endorsed a joint policy statement issued by the Treasury Department, The Department of Labor and the PBGC concerning pension plan terminations. The policy clears up much of the uncertainty with regard to the legality of terminating a Pension Plan solely to recover excess assets.

The Council, citing concern over the future of defined benefit pension plans, will allow sponsoring employers to use either of two previously frowned upon methods of recovering excess assets. Under both of these methods it will now be possible to continue the basic coverage and benefit design of the terminated pension plan.

The two methods are:

- (1) The termination re-establishment approach, where a sponsoring company re-establishes a defined benefit plan with ultimate benefits based on both past and future service.
- (2) The spinoff/termination approach, where all excess assets are spunoff to a newly created inactive plan which is then terminated.

This position clears up much of the uncertainty, and may even be considered a reversal of the general position that the various agencies previously maintained. But it is not without some safeguards. In order to employ either of these two strategies the plan must satisfy four conditions. These conditions are not revolutionary, and would normally be satisfied if the Plan were terminating. However, recall that in the spinoff/termination approach, the active plan is not terminated. However, these conditions must nonetheless be satisfied in order to safeguard existing benefits of employees and also insulate the PBGC from future terminations. The conditions are:

- (1) Vest all non-vested participants.
- (2) Purchase fully paid-up annuities for all vested and non-vested accumulated benefits.
- (3) Notify all participants as if the Plan is being terminated. Remember that under the spinoff/termination approach the active plan is not terminated. However, participants of the not-to-be-terminated active plan must be notified as if the plan were terminating.
- (4) Lump sums paid out in lieu of an annuities purchase must be computed at reasonable interest rates. The PBGC has the authority to formulate regulations with regard to acceptable cash out rates.

There is a de minimis exception to these four rules. Reversions of less than \$1 million would be considered de minimis and would not be subject to these criteria unless abuses develop. I guess this de minimis exemption was instituted because larger Plans could usually recapture amounts not in excess of \$1 million by simply slowing their funding rate, and smaller plans would not have that much of an impact to warrant the administrative burden.

In summary, the new termination guidelines require employers to vest and notify all employees, buy them an annuity or give them a fair lump sum settlement, and then excess assets can revert to the employer without interrupting the plan design. To my mind, this is a very liberal policy from the point of view of a plan sponsor.

This policy statement is quite a surprise from the way I expected this issue to be settled. One employee benefits manager who I talked to remarked that "we just woke up in a candy store with a month's worth of allowance".

Why did the Council come out with this position? What was their thinking:

It appears that the Council felt that the surplus assets are definitely the property of the sponsoring employer, and that companies would terminate their Plans anyway, either through business necessity or upon a sale. Unless there were some vehicle whereby the defined benefit plan could be maintained, Plan sponsors would either substitute a defined contribution plan or no plan at all.

I would like to quote from the policy statement. "In the past, companies have made contributions to defined benefit plans in good faith belief that surplus assets could be recovered upon plan termination. This belief has made them more amenable to conservative funding standards and has helped to maintain the strength of defined benefit plans. Allowing the recovery of surplus assets is also equitable because the employer is required to make up any funding deficiency of the plan".

As I mentioned, this seems to be general good news for employers. They can now get at the surplus assets without destroying their company's benefits philosophy. They have to pay the money back, but if the Plan is funding at a 7% interest assumption, for example, the reversion can be thought of as a 30 year loan at 7%, which is not bad considering today's interest environment.

In endorsing this policy, both the IRS and the PBGC each made one major concession.

The IRS had previously suggested that recaptured amount be subject to an excise tax of 10% or so in addition to regular corporate income tax. This excise tax concept has been dropped because the Cabinet Council does not consider potential abuses to be an overwhelming problem.

I happen to disagree. I think that companies will be more inclined to recapture assets in years where current or accumulated tax losses would exceed the amount of the reversion. Abuses could develop by contributing large amounts when they are tax deductible and timing reversions to coincide with a period of tax losses. An excise tax, or a flat rate tax independent of the companies marginal rate, might be effective in controlling potential abuses. As mentioned before, the IRS did reserve the right to prohibit what it might feel as persistent abuses on a facts and circumstances basis.

The PBGC, which is probably the agency with the most at risk, previously requested that the 5 year new plan phase in rules apply to the spinoff/termination approach, even though a new active plan is not created. However, the PBGC has dropped its insistence of this requirement, and they seem to be satisfied with the annuity purchase concept.

There are a few potential problems of which plan sponsors may have to be aware. The first involves vesting all non-vested benefits. Although usually not a substantial additional cost, some sponsors might object to vesting their short service employees.

In addition, a disparity would be created between those hired before the termination date (who would be immediately vested), and those hired after the termination date (who would have to wait 10 years to become vested).

The purchase of annuities might also present some problems. I know many plan sponsors would like to retain control of these assets rather than turn them over to an insurer. Under the spinoff/termination approach, it is no longer adequate to just show sufficiency. Sponsors must go one step further and purchase annuities for all vested and non-vested benefits. The PBGC insisted on this annuity purchase provision. Potential opportunity gains that could result if remaining plan funds were invested in equities are therefore necessarily forfeited. Immunization techniques, which may have produced better rates of return than insurance company annuities, are also prohibited.

There may have to be some modifications to insurance company products if this policy produces an increased demand for annuity purchases. For one, insurers would be forced to deal with subsidized early retirement benefits and other more complex ancillary benefits.

We've also had some trouble (even prior to the issuance of this statement) arranging for the purchase of paid up annuities, and this is especially true with deferred annuities due to the surplus requirements of insurers. Insurers have been in and out of this market and any increased demand on account of this statement would subsequently compound the problems associated with surplus strain.