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CURRENT DEVELOPMENTS IN RETIREMENT PLANS

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Recorder: JOHN J. PONZINI

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MR. FREDERICK C. MABRY: This is session 43, an open forum. The title is Current Developments in Retirement Plans. My name is Fred Mabry and I'll be the moderator today. This is John Ponzini, our recorder. Our speakers are J. Wells Bentley and Don Grubbs. Wells Bentley will speak first and then we'll have a chance for questions and comments. After that Don Grubbs will speak. During the course of Don's talk he has left places where he would like the audience to get up and give its comments rather than wait until the very end of his entire presentation. I also encourage the panelists to ask questions of each other as well.

Our first speaker is J. Wells Bentley. Wells is a Vice President and special advisor to clients on regulatory law and practice at G.B.B. Associates, Ltd., a diversified actuarial consulting firm based in Toronto. He is one of the outstanding members of the Canadian pension community. He was formerly the Superintendent of Pensions for Ontario

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and Chief Administrative Officer of the Pension Commission of Ontario. He has been the principal architect of most major pension legislation in Ontario since joining the Commission in 1964. Prior to his recent retirement from public service, Wells acted as a special counsel to the Ontario legislature's Select Committee on Pensions. He is one of the founders of Humber College's center for continuing studies on employee benefits and served as the first chairman of its advisory board. Wells is a prolific writer. He is currently publishing the Wells Bentley Report which is issued about six times a year. It doesn't just track current development as much as stepping back to look at the larger picture. For example, he has been interested in issues that will determine whether Canada will have a strong private sector with a strong private pension system come 1990. Wells is well qualified to bring us up to date on Canadian pension developments.

MR. J. WELLS BENTLEY: Thank you Fred.

Pension reform in Canada has been a subject dear to the hearts of a great number of people for the last 10 or 12 years. We've had much debate and an awful lot of talk. At least a dozen major reports have been issued, from Royal Commission reports to reports prepared by special interest groups. Women and economists have gotten into the field of pensions; I'm not sure the actuaries have gotten into it. I think they have sat back and provided advice for all the special interest groups including government.

However, what has happened is that the politicians have gotten involved, something that is not usual in Canada. I think that over the last 10 years, with the production of the tremendous number of reports, we can now say that the politicians are finally interested and maybe something will happen. The reports have ensured a tremendous number of conferences. I'm sure every report that was issued provided at least two conferences and three or four seminars on the recommendations of each report. What we have been very successful in doing is keeping our experts in the field of income replacement very busy, very visible and I think reasonably wealthy throughout it. We have provided a high level of employment for our actuaries.

But seriously, all this has accomplished one major thing. It has made some of our politicians, from both the federal and provincial arenas, aware of the function of the pension system in Canada and of the part that government must play if the pension system is to come close to fulfilling its function.

In the 1960's and early 1970's a great many support mechanisms were built into the Canadian economy. Medicare, the Canada/Quebec Pension Plans and legislation affecting private pension plans were built into the Canadian society during this period. It did not seem to deter the very rapid growth of employer sponsored plans. But, you have to keep in mind that these programs were born in a period of steady economic growth, relatively stable prices and relatively low rates of unemployment. The premise for all of these programs was that this would continue, but I think most of you know what did happen. Time has had a rather profound effect. Government revenues have not kept pace with the cost of public programs. Corporations have experienced difficult

times, some have gone out of business, others have had to make drastic cuts in their workforce. In other words, workers are no longer secure in their employment either for wages or for future pensions.

All of this has caused government, business and labor to look much more closely at programs that must be maintained and those that could be changed. I think there is an awareness in Canada that people, the individuals, want to maintain more control over their own financial future. We recognize that people have different expectations and employment goals. I'm not sure this was something that was recognized during the 60's and 70's. Many people are required and many people want to move in and out of the labor force. Some are forced, or wish to choose, part time work. All of these things are going to have a dramatic effect on what we do in Canada in the way of pension reform. The leader has to be government. Government has to recognize that it should adopt policies which insure that there is a balance between private pension plans, government pension arrangements and individuals' personal savings. In my view the current proposals that have been set out by the government of Canada and the Province of Ontario come very close to achieving this balance. No other province in Canada has so far come out with any papers, but I do expect that there will be a number of new papers issued by most provinces by June of this year.

I'd like to briefly set out the positions that have been taken by the government of Canada and by the Province of Ontario, the principal players in Canada. The position of the federal government is contained in the budget papers of February 15th. The Province of Ontario's position has been given in a number of speeches by the Treasurer of the province. Since I was very lucky to have some input into the Ontario position, I think I know pretty well what is going to come out in the official Ontario position paper.

On June 5th of this year the Province of Ontario will host a conference of all of the senior ministers from across Canada including the federal government. At that time it is expected the position that will be issued (and it will be a compromise), will be something that sponsors of private pension plans are going to have to live with in the future and amend their pension plans to meet the criteria that will be set through legislation. I think the politicians are quite serious this time and that they really intend to come forward with proposals which will cause private pension plans to be amended. Hopefully these changes will cause private pension plans to better meet the needs of the membership. I want to talk briefly about some of the areas that will be discussed at these June meetings.

One of the major areas of complaint in Canada has been the lack of inflation protection after the individual retires. Over the last number of years, the value of the $100 a month an individual obtained when he retired has gone down tremendously. Therefore one of the major items that will be up for discussion will be the concept of inflation protection for people who have retired or terminated employment with entitlement to a deferred vested benefit. The federal government and Ontario both propose that private pension plans will be required to provide future pension and deferred vested pensions earned after the effective date of the legislation, to be adjusted annually by 60% of

the change in the consumer price index, but with the adjustment not to be greater than 8% in any one year. There is no retroactive improvements for actives nor will there be any indexing for current retireds and deferreds. In other words, a person in retirement today will not have his benefits protected by the inflation protection. But for an individual who retires 10 years down the road and the legislation has been in effect for seven years, seven out of the 30 or 40 years of his service will be protected.

In Canada what we have had up to date is a vesting rule of age 45 with 10 years of service. Ontario and the federal government's proposals do not agree in what they would like to see in the way of changes to vesting rules. The federal government, in the budget papers, advocates that vesting should take place after two years of service with regard to benefits earned after the effective date of the legislation, i.e., no retroactivity. Ontario proposes that vesting should take place after five years of service for benefits earned after the effective date of the legislation.

We still have a very large number of pension plans in Canada which require employee contributions. The federal proposals, although they do not say so specifically, imply that employee contributions are locked in as well after two years of service. There is concurrent locking-in and vesting. Ontario doesn't agree that the locking-in concept be concurrent with the vesting rule. Ontario is proposing that employee contributions would only be locked in after the individual has attained age 40 with five years of service. What we mean by locking-in is that monies contributed by the employee are locked in to a pension account and cannot be used for any other purpose except to provide income at retirement. It can not be taken out in lump sum, it cannot be taken out in any other form, except upon death before retirement or at retirement to purchase benefits. So there is a variance between Ontario's proposal and the federal government's proposal.

Another area in Canada that has created an awful lot of problems for employees is portability. When an employee is vested, normally the money is held within the employer's plan. The employee contributions are locked in. Yes, there can be a minimal amount taken out, but normally that is not available to the employee in any other form except to leave it locked in. What is being proposed is a vehicle under the income tax laws to allow the employee to take the value of that accrued benefit and transfer it over to a non-commutable Registered Pension Account. This account would be very similar to the IRA or to an IRSP, except the Registered Pension Account would not be commutable. In other words if you transfer your money from the employer's plan to this Registered Pension Account you can control the investment. You can control the whole darn thing, but you can't get the money out except upon death prior to retirement. Ontario basically agrees with this approach. There are some variances but not significant enough to detail. I don't think there will be any doubt that this vehicle will be established under the Income Tax Act of Canada allowing an employee to transfer monies out of the employer's pension plan to an account of his own.

Canada doesn't have the same kind of spousal protection that you have in the United States. It is pretty much agreed to that survivor benefits must not be cut off when the recipient remarries. Now you can cut them off, but once the recipient (the spouse) becomes entitled to them, they will not be taken away under the proposed law.

Post-retirement survivor benefits will be required in the form of a joint and last survivor annuity, which will provide for at least 60% of the pension after the first death. It is expected that the legislation will permit the J&S benefit to be on an actuarially reduced basis.
I think it will also require the spouses to mutually agree in writing that they will take some other benefit rather than the joint and last survivor benefit. That would have to be by mutual agreement. Pension credits and pensions already being paid will be split equally between spouses on marriage breakdown, and that will apply equally to arrangements other than through marriage.

The federal government is also proposing that pension benefits will be equal for male and female employees retiring in identical circumstances. In other words the unisex concept. Ontario has been very quiet about the use of unisex arrangements. Even though I had some input into it I was taken to task by women's groups so severely that I retired and let them write that particular section. I'll argue about it after it comes out in the Ontario position paper.

Some studies say only 40% of employees in Canada are covered by private pension plans. Other people, including actuaries, sit down and compute that there is up to 86% of the people already covered by pension plans, so why are we worrying about coverage. Coverage has a very high political profile in Canada. There is a concept that the legislation should require compulsory membership in pension plans both for full-time employees, who are not currently members of a plan, and for permanent part-time employees who have a definite relationship to the employer. The federal proposal would require full-time employees to become plan members after attainment of age 25 with one year of service. Part-time employees would be required to join the plan after age 25 and three years of service. The Ontario approach is dramatically different. Ontario is proposing that the full-time and the part-time employee, after age 30 and one year of service, must be given the right to join, but there will be nothing mandatory as to whether they must join. That is a significant difference. The federal approach is simply that you must join if you meet the qualifications; the Ontario approach will be that you are eligible to join but there is no compulsion to join.

There is one other major controversial area that is being proposed by Ontario but is not being picked up by the federal government. Ontario has proposed that there will be minimum employer contributions which will pay for at least one-half of the employee's accrued pension when he terminates employment after vesting prior to retirement age. As you know in contributory pension plans, even in final pay contributory pension plans, the employee, when he is contributing five or six percent of his pay, is paying for the bulk of his pension up until age 55 or 60. What the Ontario proposal is saying is, if they are going to have vesting after 5 years, in order to make the pension meaningful at least 50% of the cost of that accrued vested benefit should be paid for

by the employer. The employee pays the other 50%. If he has contributed excess amounts, those excess amount can be taken out in cash.

Those are the principal areas that will be discussed with respect to private pension plans. Hopefully we might see some political agreement across Canada as to the direction but, as you can see, there are even areas of disagreement in the approach of the federal government and in the approach of Ontario. When we see what comes out from the other jurisdictions, we could have eleven different approaches.

We have at the same time, in conjunction with both the federal and Ontario governments'proposals for legislation affecting private pension plans, the federal government also proposing certain changes in the current tax system for retirement arrangements. The current arrangements in Canada favor defined benefit employer sponsored pension plans over defined contribution plans. In the context of the proposed changes defined contribution plans will include not just money purchase plans or deferred profit sharing pension plans, but also will include individual Registered Retirement Savings Plans which are similar to IRA's and the new vehicle, the Registered Pension Account that will be set up. The basic concept of the proposed new tax assistance system is to have all retirement and savings plans operate on the basis of an overall uniform target pension. In other words, all persons in Canada will be permitted to save, on a tax deductible basis, sufficient funds during their working life to accumulate a maximum pension of 2% of the final earnings. Earnings currently will be defined not be exceed $86,000 a year and the overall pension target will not be greater than $60,000 a year. These targets will remain in effect under the proposed changes until 1989 and then will be adjusted according to an average industrial wage concept, or some other concept, to increase the levels that will be permitted in the future.

In Canada as well, we have certain public pension arrangements; the Old Age Security (OAS) program with its attendant Guaranteed Income Supplement (GIS) program, as well as the Canada and Quebec Pension Plans. Basically the OAS and the GIS programs will not change under the new proposals. However, there will be some increases granted for single elderly people to bring their level of income up under the GIS to at least 60% of what a couple would receive. This basically means that the program will provide an additional $50 a month to single elderly people paid out of the general revenues of Canada.

With respect to the Canada Pension Plan (CPP), there will be some modifications, but the major considerations for changes in the level of benefits and changes in the current requirements for funding, will be subject to further discussions between the provinces and the federal government.

The federal budget papers indicate that certain changes should be made to the Canada Pension Plan, specifically that survivor benefits will not terminate on remarriage and credit splitting will be automatic on marriage breakdown or at the time the younger spouse reaches age 65. In other words, if this law was in effect when my wife reached age 65, she would be entitled to a check. One-half of it going to her, one-half coming to me.

Ontario basically agrees with these changes to the CPP but they are also asking for an increase in the level of disability benefits and improvements for those widowed between ages 55 and 65.

Again, in Canada we have 11 major political players in this particular game; ten provinces and the federal government. Only two have made public pronouncements regarding their position on so-called pension reform and it is clear that there are some areas that will have to be a matter of compromise between even these two. I'm convinced though that in the course of the next year, there will be significant legislative changes designed to improve the position of the individual who reaches retirement.

Thank you very much.

MR. MABRY: Thank you very much Wells. We have time for some comments and some questions. The floor is open.

MR. DONALD S. GRUBBS, JR.: I understand that any legislation regarding the private plans will be on a provincial level. So then, are the federal proposals only advisory?

MR. BENTLEY: Well, we have an unusual set-up in Canada; this is the only way I can explain it to you Don. With respect to private pension plans, which are subject to federal government legislation, you have to look at the types of organizations and businesses that are established for the general advantage of Canada. That's a beautiful word but what it simply means is businesses such as transportation, communications, banking, kinds of things that flow over the borders of the provinces are subject to federal labor laws and subject to federal pension legislation. Therefore, when the federal government enacts legislation affecting private pension plans the only ones they can affect are those plans sponsored by employers in the banking industry, communications, transportation and so on. They can't affect a pension plan that is sponsored by a manufacturer or a mining concern or whatever. Those come under provincial jurisdiction. We have this tremendous breakdown in Canada, where one government can only affect one part of industry. The provinces have the right to introduce, or not introduce, legislation affecting manufacturing, retailing, all other things that do not come under the federal jurisdiction. Consequently we can have as many as 11 different pieces of legislation. Every province can set up its own legislation in the way that it thinks best suited for its particular purposes. This means that in order to get any degree of uniformity in the legislation, our political masters and our senior bureaucrats of which I was one, have to sit down periodically and hammer out areas of compromise. So we are true Canadians, we compromise on every darn thing that we do, including the way in which we deal with pensions. The June 5th meeting that I mentioned between the senior ministers in Canada to consider future pension legislation is designed simply to try to figure out what areas will be compromised. What we end up with in Canada can be a hodge-podge or can be something that could be reasonably uniform if our political masters get together and do what they should do, that is, come up with proposals which can be enacted in every jurisdiction and proposals which are substantially uniform. Otherwise an employer who has employees in more than one jurisdiction

is faced with any number of different laws that he shouldn't be faced with.

MR. GRUBBS: In this country I think we can at least be glad that ERISA put in some preemption provisions that prevent our having 50 states making legislation for us.

MR. MABRY: Let me ask you Wells, is there now a fair amount of uniformity among the provinces?

MR. BENTLEY: We started off in 1965 with Ontario and Quebec being fairly uniform. The federal government and Alberta became involved in 1967 and they stayed reasonably uniform. Saskatchewan became involved in 1969 and they broke some of the uniformity. Manitoba became involved in the mid 70's and they broke it all to pieces. Then Ontario set up a guarantee fund, which can apply only to individuals who have service in Ontario. If you are unfortunate enough to work in Manitoba the guarantee fund is no darn good to you. If you happen to be employed in Ontario, for part or all of your working life, and your employer goes down the drain with a short fall in assets, the guarantee fund will come into play providing you with protection. It wouldn't help people in Quebec, it wouldn't help people in any other jurisdiction except Ontario. Ontario broke uniformity all apart when we put the guarantee fund in.

MR. JOHN B. MASSEY: Mr. Bentley, you mentioned a vehicle for paying deferred pension credits after a person leaves a private plan. Presumably that would be handled by a government agency. I'm curious who would determine how much money should be transferred, the private plan or the government? If it's the government, as I assume it will be, what treatment is given either a deficiency or a surplus as compared to the private plan's computation?

MR. BENTLEY: A proposal is this. Under income tax laws this vehicle will be set up, but it will not be held by government. In other words, when your pension benefit credit is transferred, you as the individual, will have the right to select an RPA with Royal Trust, or Sun Life Insurance, or whoever you choose as the holder of the vehicle. That particular company, trust company, bank, insurance company will be the holder of the funds, the investor of the funds. They will also have to meet the criteria that will be set under the income tax laws and under the pension benefits acts of the various provinces with respect to non-commutability of the monies in that vehicle. The money will not be held by government and it will be available for investment in the private sectors. It will be in the individual's name and used only for the one purpose, that is, to provide the lump sum to provide the annuity when the individual chooses to retire. There will be tax concessions. Interest accumulations and new monies flowing into it will get the same consideration that they currently get under RRSP's, the Registered Retirement Savings Programs. Was there another part to your question?

MR. MASSEY: Who determines the amount?

MR. BENTLEY: That is one that I would like very much to avoid. You've got everywhere from the valuation rate to market rate and all the things in between. I think a flexible rule should be set up by legislation, which will be fairly close to market rate, adjusted as market rates go up and down. Now that's the concept, whether that's what will come out in the end, I don't know. It may be set by taking the average rate for Canada savings bonds for the last 5 years and adjusting it once each year in June or at the end of December. I'm sure there will have to be a minimum standard for valuing the benefit that can be transferred.

MR. MABRY: We have time for a few more questions and comments. If you think of some questions about the Canadian practice or the future of Canadian pension plans there will be some time at the end to ask.

Our next speaker is Don Grubbs. Don is a Consulting Actuary and Manager of the Washington office of George B. Buck Consulting Actuaries, Inc. He is a Fellow of the Society of Actuaries, a Fellow of the Conference of Actuaries in Public Practice and an Enrolled Actuary. He was formerly a member of the Society's Board of Governors and is now its Secretary. He is a member of the Department of Labor advisory counsel on employee welfare and pension benefit plans. He is one of the 25 members of the pension research council in the University of Pennsylvania and serves on other committees of several businesses and professional organizations. Don has over 25 years of actuarial experience, most of which is with retirement plans. He was formerly Director of the Actuarial Division of the Internal Revenue Service and Chairman of the Joint Board for the Enrollment of Actuaries. He had his own practice for a while and one time was Vice President of the National Health and Welfare Retirement Association. He also serves as a consultant to other federal agencies. Don is co-author of the Variable Annuity and has written papers and articles published in a variety of journals. In addition to all this, Don is a graduate of the Georgetown University Law Center and has done graduate work at several other institutions. He is admitted to the bar of the District of Columbia and he was formerly an adjunct professor of law at Georgetown University. I think you can see that from Don's background, as well as his location in Washington, that he is well able to talk about what's going on in pension legislation in the United States.

MR. GRUBBS: Much is going on. We've had a real flurry of activity recently and certainly more coming up during the next few months. These changes have come from Congress, from the regulatory agencies and from the courts. First I thought we would look at a few things that have already occurred this year.

The IRS has taken two important actions that affect employee plans. The first, only indirectly affects plans qualified under Section 401, was its News Release (IR 84-22) regarding cafeteria plans. Code Section 125 defines a cafeteria plan as a plan that allows employees to choose among two or more benefits like medical care benefits or contributions to a 401(k) plan, but also taxable benefits like cash. If the employee chooses cash or other taxable benefits, of course, he has

taxable income, but if he chooses a non-taxable benefit he has no current taxable income. The doctrine of constructive receipt, which usually causes people to be taxed on money that you could have had but rejected, apart from other laws, does not apply to a cafeteria plan.

In the last few years, particularly in 1983, there was a great expansion of a kind of cafeteria plan called flexible "spending accounts" or "reimbursement accounts". Under the typical plan, if an employee had a medical expense that wasn't covered under his group insurance, such as a $50 dental bill, he could direct the employer to reduce his pay during the following month by $50 and instead be reimbursed $50 for the dental expense. Since the $50 reduction in salary after taxes only reduces take home pay by $30, if in a 40% tax bracket, and since he gets $50 for the dental expense he is $20 ahead. Such plans appear to be cafeteria plans as defined by Section 125 of the Code.

However, in February the IRS published a News Release stating that such plans are not valid cafeteria plans and that they are "without substance". The IRS believes such plans are contrary to the intent of Section 125 regardless of its language. The Release says that such reimbursements are taxable income, subject to withholding and includable as wages on Form W-2. Employers are liable for their failure to withhold and employees are liable for any failure to pay taxes on these amounts. Both are subject to penalties, as well as paying the actual amounts involved and interest.

IRS officials have repeatedly promised to publish guidelines in the form of questions and answers on cafeteria plans, to lay out just what kind of cafeteria plans are allowed, but so far they have failed to do so. However, it's only six years since the law was passed and it is probably too early to expect guidelines.

Some congressional leaders are considering possible legislation concerning the subject. The IRS announcement has certainly had a chilling effect upon the establishment of new cafeteria plans and employers that already have such plans are trying to decide what to do. I find many of them are just kind of sitting and waiting to see what the questions and answers say, or perhaps what the legislators are going to do before deciding what changes to make. Some expect to fight the IRS in court over the IRS interpretation.

The second IRS action this year deals with Social Security offset plans. Under a Social Security offset plan, as a practical matter, the plan has to calculate the Social Security benefit in order to calculate the benefit the individual is going to get. Unless the participant is retiring exactly at age 65, the offset under the pension plan is different from the amount that will be paid to him by Social Security. The precise calculation is quite complex and even if you have your computer already programmed to do the calculation, the data input requires salaries for up to 25 separate years and in some cases more than that. The employer ordinarily doesn't have the employee's entire earnings record over all the years he was covered under Social Security. Since the employer doesn't have the data, any precise calculation would require that the employee request an earnings statement from the Social Security Administration or authorize the employer to obtain it.

In order to reduce the work and the cost involved and in order to enable one to get the pension checks out in a timely fashion, most employers have used some approximation to estimate the Social Security benefit. Many actuaries have either developed tables or computer programs that will determine the amount of estimated Social Security benefit. In order to reduce the calculation work and because of lack of data, they have made some assumption about what past salaries were, usually with some back off salary scale, often a fixed percentage increase in salaries per year.

On March 26th the IRS published Revenue Ruling 84-45. This Ruling stated that if estimated salaries are used to calculate the Social Security benefit offset, instead of getting exact salaries from the Social Security Administration, the plan has to meet three requirements. First, the plan has to use a salary increase assumption that either equals the actual change in average wages from year to year as determined by the Social Security Administration, or it can use a level percentage that is not less than 6% per year. Second, the plan must give a written notice to the terminating employee that he can obtain his actual salary history from the Social Security Administration and submit it to the employer. Third, the plan will recalculate and adjust the amount of pension based upon the information submitted "within a reasonable period of time". There has been no clarification as to what a reasonable period of time is.

These two IRS announcements, seemingly unrelated, on cafeteria plans and offset pension plans, have something very important in common. The IRS repeatedly fails to reflect the need for lead time to adjust to new requirements. Even worse it sometimes imposes new requirements retroactively.

It was February 10th of this year when it published its new News Release on the flexible spending accounts saying that they don't satisfy the Tax Code. Now lawyers disagree about whether the new IRS position is right or wrong and courts will eventually decide that issue. But the completely irresponsible part of the the IRS action was to apply it for W-2 Forms for 1983. The IRS announcement regarding the 1983 W-2 Forms came out 10 days after all employers were required to provide everybody with their W-2's and after a lot of employees had already filed their tax returns. This was an issue that IRS was very much aware of and had been considering throughout last year. Assuming that their position was correct, their failure to announce that position last year, sometime when employers could have adjusted the withholding and turned out W-2 Forms that comply, I have to say was unconscionable.

On March 26th the IRS did it again; the new Revenue Ruling on offset pension plans, they say, is prospective. It's prospective to people who terminate their employment after January 1 of this year. That's not my idea of prospective. It is going to take employers weeks or months to adapt their system to the new calculations and then it will be necessary to make retroactive recalculations for everyone who has terminated employment since last January 1. This will cause duplication of work and expense. The Social Security issue is one that the IRS has considered from time to time for a decade. There is nothing

magic about January 1, 1984. Making the rule retroactive creates needless administrative expense and is contrary to the nation's need to increase productivity.

Most citizens and most employers want to abide by the law, but we need to know in advance what the law is so we can comply. It is only fair for government to tell us what the rules of the game are going to be, instead of announcing the rules retroactively in the middle of the game.

I think I'll stop right there and see what discussion, what questions, what opinions you have about either of these two IRS rulings. How do you think they will affect plans that you are concerned with, are they good are they bad, what difficulties will they have?

MR. DANIEL F. McGINN: We've been involved with Section 125 type plans, but we've taken a position for a long, long time, based on the concept of constructive receipt, that an individual would have to give up a certain level of income before the year in which he would have a right to receive that income. We also took the position that at no time is that money recoverable except by way of payment of benefits. What is your opinion on that? Is that something you think would be a problem with respect to the IRS ruling?

MR. GRUBBS: The News Release as you know is somewhat ambiguous, but it would appear that a program in which the employee makes an advance commitment, requires withholding in advance, and in which he doesn't have the right to recover any amounts that are left over, would satisfy the ruling.

MR. McGINN: I have a question about the recovery. Some of the plans that we have been involved with have a provision that, if an individual has an account balance at the point of termination of employment, the individual could use that account balance for legitimate reimbursements of covered expenses for a period which may vary from six months to about two years. If they haven't used their account balance at the end of that period, it is forfeited. Do you see any problems with that?

MR. GRUBBS: I think as long as there is no possibility that the employee is going to get the money back or have it applied on any basis that would ordinarily be taxable income, that ought to be acceptable to the IRS.

MR. McGINN: Well that is what we told our client and you've made my day.

MR. GRUBBS: Another recent action of the IRS dealt with an announcement on master and prototype plans. They published some new forms, for sponsors who want to get approval of master or prototype plans, that affect the TEFRA amendments. Incidentally, I would recommend against actually filing anything until we get clarification as to what changes Congress is going to make regarding TEFRA this spring. I'm not particularly interested in master and prototype plans, but there is something in this that might interest you. The IRS gives sample language which they deem to be acceptable to comply with various provisions of

the Internal Revenue Code such as Section 415 and 416 requirements. So, although designed for master and prototype plans, you might want to lift some of that language out in terms of drafts for single employer plans.

Any comments on master and prototype plans, or questions?

MR. CLYDE E. GINGRICH: Just a remark on that prototype announcement. If you compare the care in which IRS took in making TEFRA compliance easy for its people, it is in great contrast with the care they take in making other compliance hard for us.

MR. GRUBBS: The next item deals with years of service. Before ERISA most pension plans measured years of service by what we now call the elapsed time method, i.e., merely looking at the date of hire and date of termination and determining how much time elapsed between those two dates. Many multiemployer plans used an hour of service method in which they granted a full year of service for employees who worked at least a minimum number of hours during the year and usually partial credit for some fractional proportion of a year.

ERISA stated that "the 'term year of service' means a 12-month period during which the employee has not less than 1,000 hours of service". ERISA did not directly mention the elapsed time method. The Department of Labor determined that Congress did not intend to eliminate the elapsed time method and it would be unreasonably burdensome to force all plans and all employers to adopt the 1,000 hours method for all employees, particularly since many of the employers didn't even keep time records for most salaried employees. Therefore, the DOL regulations allowed employer plans to use either method.

The IBM retirement plan used the elapsed time method and required 10 years of services for vesting. Paul Swaida worked for IBM 9 years and 10 months, and in his 10th year he worked more than 1,000 hours. The plan said he did not have 10 years of service. He argued that the elapsed time rule is not allowed and is contrary to ERISA.

The U.S. District Court decided, and recently the Court of Appeals affirmed, that the elapsed time method is allowable under ERISA. One can use the elapsed time method as the IBM plan did.

Any comments on elapsed time, about whether we ought to change the law at this point in one direction or another to clarify it? Is it good, is it bad? Is this case going to end the issue?

MR. MABRY: You said that this case has gone to the U.S. District Court and the Court of Appeals. Is it going to the Supreme Court or not?

MR. GRUBBS: I believe the time has not yet elapsed in which Mr. Swaida could file an appeal or request certiorari with the Supreme Court. So I don't think we know whether he will attempt to do that, or if he did, whether the Supreme Court would accept the case. It would be possible, of course, for people to contest this in other circuits. This decides the law in this particular circuit, but someone who lives in some other

area of the country could bring up an entire new case on this if they wanted to.

The next item is social investments. The issue of investing pension assets for social purposes is one that is still with us and I believe will be with us for years to come. Recently the District Counsel of the District of Columbia determined that the retirement funds covering District employees should not be invested in any corporation doing business in South Africa. Congress has the authority to override any action of the District of Columbia's Counsel. An effort was made by one member of Congress to overrule the District Counsel, but that effort was defeated. Do you people know of any situations or developments where this issue has arisen under plans you deal with? Or are there comments on this?

It seems this action is mostly occuring in two sectors. One deals with public employee plans, where some state municipal plans have adopted various positions similar to the District of Columbia, banning investment in any corporation doing business in South Africa. The District has estimated that this will cause it to divest 40% of its portfolio. The other takes a much more moderate approach advocated by the Reverend Leon Sullivan of Philadelphia, who established something called the Sullivan Principles. Reverend Sullivan took the view that it is not whether a company is doing business in South Africa but what they are doing while they are there. He established a set of principles which he felt a responsible employer ought to follow if they are doing business in South Africa. An investment management firm has been engaged by Reverend Sullivan's organization to analyze companies doing business in South Africa and rate them in accordance with how they are complying with the Sullivan Principles. They ask employers doing business there to adopt the Sullivan Principles and so rate them. Some pension plans have taken the viewpoint that they will not invest in any corporation doing business in South Africa unless they have adopted the Sullivan Principles, as many major corporations have, and unless they fall in one of the two highest rating categories of the management consulting firm that evaluates them.

Let's look at congressional action this year. 1984 is an election year. The most important effect of this is to create lengthy recesses for the two political conventions, substantially reducing the amount of time available for Congress to deal with legislating law. This will cause them to rush through some items with inadequate consideration and not to consider others because there isn't sufficient time to do so.

Congressional concern with the federal deficit seems to override all other issues in evaluating any legislation. Decisions will be made to increase taxes both by reducing employer deductions for contributions to employee benefit programs and by increasing the taxes that employees pay.

Let's look at two specific bills which seem certain to be enacted. The first is the Retirement Equity Act, which I think certainly will be enacted this year. Three slightly differing versions have already been approved by first the Senate, second the House Education and Labor Committee and third the House Ways and Means Committee. This bill is

backed by women's groups as an aid to women, but its provisions will apply equally to men. It will probably require every qualified plan in America to be amended.

ERISA prohibits plans from having a minimum age requirement higher than age 25. This new act will lower this minimum age requirement to age 21. Two of the three versions would allow a plan to keep age 25 if they have a look-back provision that gives credit for service after age 21. In one version, I believe that credit need only apply to eligibility for vesting, while in another it applies both to eligibility for vesting and for benefit accrual. Many plans currently give credit for all pre-participation service. They would satisfy the look-back provision if such provision were in the final Act.

The Act's purpose is to provide benefits for women who enter the workforce at a young age and then drop out of paid employment for a period to become homemakers. It would also benefit both men and women who change jobs at young ages. Most employees who terminate employment at young ages are not vested and still wouldn't receive any benefits if they don't meet the vesting requirements. More of them, of course, will be vested under top-heavy plans, where we have three year vesting. The value of the benefits accrued at young ages under defined benefit plans is generally very small and thus the benefit costs of this provision would be quite limited but would help some people a little bit at a very small cost to employers. Some long-service employees will have a few more years of service tacked on as a result of this and thus larger accrued benefits. The provision will have relatively more effect in defined contribution plans than in defined benefit plans because in defined contribution plans the cost is the same in each year, whereas, in defined benefit plans you have low cost for the young people and high costs for the older people. Because the nation lacks an effective portability system, most benefits paid for those who terminate at young ages are paid as lump sums and are not preserved to provide retirement income. Thus, in my judgment, the act of creating more small lump sum distributions will increase the need for a federal portability system. However, a portability system will await another year.

The next item in the Retirement Equity Act concerns vesting service. Unless a plan's vesting satisfies the rule of 45, current law (ERISA) requires plans to give credit for all service after age 22 for purposes of vesting. Therefore, if you're using 10 year vesting even though you bring people in at age 25, for vesting purposes you must give credit after 22. They would lower this to 18. Most plans, I think, are not currently using any minimum age for the purposes of vesting service and they would be unaffected. Some plans do.

The Act also deals with a change in the rule of parity. ERISA has a rule of parity which says that if a non-vested participant terminates or has a one year break in service, the plan can ignore his pre-break service if the period of his consecutive breaks in service is at least equal to the length of his pre-break service. The new Act would not allow the use of the rule of parity until an employee has five consecutive one year breaks in service, in place of the current one year. Well, most employees who terminate employment never return to the same

employer at all. Thus, the change will have little effect on benefits of most employees or the costs of most plans. For many plans it will increase recordkeeping because no one is completely washed off the books until they have had five consecutive one year breaks in service.

The next item under this Act deals with maternity and paternity leave. Plans generally treat these like any other absence. The Act would add new rules requiring plans to credit 8 hours of service per day, or a maximum of 501 hours for maternity or paternity leave, for the sole purpose of determining whether there has been a break in service, assuming comparable rules of some sort would apply for using the elapsed time method. Now, as a practical matter, in almost all cases where a woman takes maternity leave and then returns to work, she returns before she has incurred a one year break in service. As long as she has at least 501 hours in a year she does not have a break in service. After the Act increases from one year to five years the period during which the rule of parity does not apply, the number of women who will be helped by this additional maternity leave provision could be assembled in the back seat of my Honda. It's only real effects will be to complicate plan language, summary plan descriptions and increase the amount of recordkeeping.

Under current law if a plan provides a life annuity, a married retiring employee must receive a joint and survivor annuity unless he has elected otherwise. Under the new Act both the participant and the participant's spouse would need to elect out to prevent the automatic payment of the joint and survivor annuity. The election must be in writing and it must be witnessed by either a plan representative or a notary public, a requirement that will prevent forgeries, create inconvenience for employees and their spouses and increase the business for notary publics. I've wondered if this provision resulted from lobbying efforts by the notary public lobby. I honestly don't know to what extent there might be forgeries. It is to be hoped that plan administrators will be allowed to rely upon the participant's assertion that he is not married, since the plan administrator has no other way of knowing.

Currently defined benefit plans must provide a pre-retirement survivor annuity if an active participant dies while eligible for early retirement, within 10 years of normal retirement age, and if he is survived by an eligible spouse. All three versions of the bill would lower the eligibility for this pre-retirement survivor annuity, but the three versions differ. One version would set the requirement at age 45 and 10 years of service, one would set it merely at 10 years of service regardless of age, and the third would require a benefit for any participant who has any vested benefit, (which means in a top-heavy plan anyone who has 3 years of service). The provision is a well motivated effort to protect widows, and I'm all for that. However, its sponsors fail to understand what meaningless benefits it will provide. For example, if a plan provides a monthly pension of $10 times years of service, then an employee hired at age 25 retiring at 65 with 40 years of service would get a pension of $400 a month, which would make a nice supplement to his Social Security. If that employee were to die at age 55 under current law, his widow would receive about $66 a month under a pre-retirement survivor annuity benefit. Under the new Act if he dies

at 45 his widow will receive about $23 a month, if he dies at 35 she will receive about $6 a month. If the plan is top-heavy and under the Ways and Means version, and he dies at age 28 she will get $1.27 monthly. Hardly much at all. Fortunately though many employers do have good survivor income programs, which I always encourage employers to adopt, usually funded under group insurance which can do a far better job for providing survivor annuity income than a pension plan can for young employees.

All pension plans, whether defined benefit or defined contribution plans, have long been required to make annuities available as a form of benefit distribution. However, this didn't require a life annuity since an annuity certain would satisfy this requirement. Of course, an annuity certain does not assure that the benefits will continue for the life of the participant. If a life annuity is not provided the plan is not required to provide a joint and survivor annuity. Some plans have deliberately adopted the annuity certain alternative in order to avoid having to provide a joint and survivor. To solve these problems the new Act may require all defined benefit plans, or maybe all pension plans, to provide life annuities but the versions differ on this.

Under present law a plan can pay off a vested pension for a terminated employee in a lump sum without the employee's consent if the amount is less than $1,750. The new Act would raise this to $3,500. Some employers prefer this because of the administrative convenience of not having to carry relatively small pensions. However, if the plan decides to increase its involuntary lump sum distributions this will destroy more pension income, a change generally not in the interest of participants in my judgment.

Another item in the new Act deals with alienation and assignment of benefits currently forbidden under ERISA. If Sears Roebuck wants to attach your pension because you didn't pay for the refrigerator you bought last year they can't do it. The alienation and assignment provision protects your pension. They will have to collect from you after you get your pension. But various state courts have issued a variety of orders to pension plans ordering plans to pay benefits to the divorced spouse of a participant. In some cases such orders have been related to payments that would otherwise be payable to the participant from the plan, but some orders have involved a payment in a different form, or in a different time when the participant might have gotten his pension. For example when the court ordered a plan to pay a lump sum when the plan didn't ordinarily pay lump sums. Plans have often felt trapped between the ERISA non-alienation requirement and the local court order. If you don't obey the court order you are in contempt of court and you can go to jail; if you violate the ERISA provisions then you can be sued for that violation and your plan can be disqualified by the IRS. In order to solve this problem and protect themselves, when plans have gotten one of these orders they have ordinarily gone into the U.S. District Court and ask to be told what to do. The U.S. District Court orders what they should do and then they comply with the court order, which at least gets them off the hook. This, of course, is an expensive and burdensome process. In order to solve the problem, the Act requires plans to pay benefits in accordance with a "qualified domestic relations order", which generally deals with

payment of amounts that otherwise would be payable from the plan. Under one version of the bill the spouse could start collecting even though the employee continued to work past the retirement age. That will be prevented. Unfortunately this seemingly simple change, which is needed to solve the present dilemma, is entangled in an extremely and unnecessarily complex set of rules.

The Ways and Means version would require the plan administrator to accompany any lump sum distribution with a notice to the participant about the IRA rollover provisions. I think this is a desirable facet of the Act, unless the regulators find some way to make it complex and burdensome.

This Retirement Equity Act will probably be effective for years beginning after 1984, although the versions now differ. However, it seems very clear that it will be enacted this year. What questions or comments do you have about the Retirement Equity Act? What do you see as its pros and cons? How will it affect the plans you are dealing with and the costs and benefits?

MR. GINGRICH: Do you know if the national office of IRS has heard of the Retirement Equity Act and do you think they will keep that in mind in their TEFRA amendments?

MR. GRUBBS: The IRS ignores legislation until it's passed. I am advising clients not to make any amendments to their plans until the dust settles. We have certain TEFRA amendments that generally have to be effective as of plan years beginning in 1984, but you can make those retroactively. Because of this, and because of other things coming up, which I'm going to mention in connection with the next piece of legislation, where TEFRA is certainly going to be changed, I'm inclined to wait and see.

Anything else on the Retirement Equity Act?

The next piece of legislation that I would like to consider, really two pieces, are the Tax Reform Act and the Deficit Reduction Act. They're being considered in both the House and the Senate. Provisions might be shuffled back and forth between the two acts, the House might put something in one of them and Senate in the other. However, it's certain that these acts are going to be passed this year, almost certainly by Memorial Day. They will make some important changes for pension plans. Neither House has completed action but I'm going to indicate some of the changes that have been approved either by the Senate Finance Committee or by the House Ways and Means Committee. The final legislation will probably differ somewhat from these.

Both Committees agree to extend the freeze on inflation adjustments to the Section 415 limits to 1988. These limits are now frozen at $30,000 and $90,000 until 1986. Because of inflation the freeze in effect reduces in real dollars what can be provided under qualified plans. This is bad not only for those directly affected, but also for the indirect effect on lower benefits for lower paid employees, since the owners of most small businesses are reluctant to finance better benefits for their employees than for themselves. If a doctor can put 25%

of pay into the pension plan and if he has to put in 25% of pay for his receptionist or his nurse as the price, he will probably do it. However, if you limit him to putting in 10% for himself, he is probably not going to put in 10% for the nurse or receptionist.

For employees covered under both a defined benefit and a defined contribution plan, neither of which is integrated with Social Security, the 1.25 combination limit, which we now have, will be changed back to 1.4, a liberalization for non-integrated plans.

The Finance Committee would substantially change the rules for top-heavy plans. Governmental plans would be completely exempt from the top-heavy requirements. The extra restrictions for super top-heavy plans, that is plans with over 90% of the accrued benefits for key employees, would be eliminated. No employee would be deemed to be an officer, and thus not a key employee for purposes of the top-heavy determination, if he earns less than twice the dollar limit on contributions for defined contribution plans. That is currently, someone earning less than $60,000, would not be deemed to be an officer. In determining whether a plan is top heavy employees terminated more than five years earlier would be disregarded. In determining the minimum contribution requirement for defined contribution plans, 401(k) salary reduction contributions would be included. Right now in satisfying those minimum contribution requirements for a top-heavy defined contribution plan, you can't take into account the 401(k) elected contributions. The IRS would be directed to publish model language for Section 416 amendments, which could be relied on until final Regulations are published.

Another provision in the Senate version would substantially amend the payout requirements for pension plans in Section 401(a)(9). These are the ones which mandate when to begin paying pensions and how much can be paid out. The most egregious error of TEFRA, the elimination of survivor benefits for orphans, would be corrected. The Congress, I think, sees the error of their way and they are going to allow plans to pay orphans. In addition, plans could again provide a joint and survivor benefit for a non-spouse. Top-heavy plans would no longer be required to commence their benefit payments at age 70 1/2 for key employees who keep working. The 10% penalty for premature distributions, that is distributions before age 59 1/2 which now apply to key employees of top-heavy plans, would instead apply to 5% shareholders in all plans. So 5% shareholders could not get money out before age 59 1/2 without a tax penalty.

Currently, if any employee is covered under both a qualified profit sharing plan and a qualified pension plan, the maximum deductible limit for the two plans combined is 25% of the pay of the covered employees, or the minimum funding requirement for the defined benefit plan if greater. The Finance Committee would extend this combined plan deduction limit of 25% to apply also in the case of the employee who has two pension plans, one a defined benefit plan and the other a money purchase plan. People against it, in arguing for elimination of the requirement altogether, point out that if you only have a defined benefit plan there is no limit and you can put in a lot more than 25%. The rule never did quite make sense. There is also a provision that

limits the deduction for a defined benefit plan alone to 100% of pay. But I understand this provision is going to be dropped. When I first heard about this provision I wondered are there plans for which the deductions are currently over 100% of pay? There really are. ASPA was the one that lobbied for getting the 100% limit knocked out, so some people have been plugging a lot of money into some of these plans.

In the Senate version benefits paid after the death of employees would not be subject to the $100,000 estate tax exclusion. Right now the first $100,000 of death benefits are subject to this estate tax exclusion. Actually this would affect very few people because of the recent changes in estate tax laws a couple of years ago. In a complete exemption, (the marital deduction), you have to get into rather large amounts before you have estate tax.

Some in Congress oppose employee-pay-all qualified plans, viewing them as a form of tax abuse. The IRS has approved such plans for many years. The Ways and Means version would disqualify such plans effective for plan years beginning after March of 1984. This would be a retroactive disqualification creating taxable income for thousands of rank and file employees under plans that have followed all existing laws and regulations and been approved by the IRS for years. How can anyone be expected to comply with retroactive laws? The more moderate Senate Finance version would change the taxation of partial distributions under contributory plans, rather than disqualifying all such plans. Right now if an employee receives a distribution from a plan which includes employee contributions, the rule is that you consider the first dollar out as his own contribution and therefore not taxable. Only after he has withdrawn all of his own money does he start getting taxable income. They would reverse the order, assuming the first dollars out are taxable dollars rather than the non-taxable dollars.

Fortunately the Finance Committee would correct one of Congress' prior fiascos of retroactivity. Under the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), employers were liable for withdrawals that had taken place about five months before the Act was enacted. The Senate version would amend that act to eliminate its retroactivity.

Senator Long appears likely to again succeed with his almost annual changes in the ESOP rules. The change would freeze the 1/2% limit on tax credit ESOPs. Right now the tax credit is 1/2% and is otherwise scheduled to go up to 3/4% in 1985. As a trade off for this cut-back, he is requesting a substantial expansion of ESOPs which will make them far more attractive to many employers. Those of us who have watched the ESOP legislation over the years will continue to sing, "There's a Long Long Trail Awinding".

One other provision in the Senate version I must read because you wouldn't believe it if I just told it to you. It says:

If (1) a distribution was made from a qualified terminated plan to an employee on December 16, 1976, and on January 6, 1977, such employee transferred all of the property received in such distribution to an individual retirement account established for the benefit of such employee, and (2) the remaining balance to the credit of such employee

in such qualified terminated plan was distributed to such employee on January 21, 1977, and all the property received by such employee in such distribution was transferred by such employee into such individual retirement account on January 21, 1977, then such distributions shall be treated as qualifying rollover distributions.

If anyone knows who lobbied for this one, I'd be interested in finding out.

I would say there is still an opportunity to make changes because of the differences in the House and Senate versions. You might want to contact your senators and representatives with your views. What thoughts do you have on these various provisions?

MR. JOHN GARIGLIANO: I believe Canada recently changed their laws regarding distributions as far as the first dollar being an employee's or employer's and I think they now use a pro rata approach. Is this true?

MR. BENTLEY: Not that I'm aware of.

MR. GRUBBS: I don't know either.

Another hot issue deals with the termination of defined benefit plans with the reversion of assets to the employer. In the last couple of years there has been a very substantial increase in the termination of defined benefit plans with the reversion to the employer of assets that exceed the value of the accrued benefits, commonly called excess assets. They are only excess assets upon termination. They often are not excess assets on an on-going funding basis.

Regardless of the cause of plan termination, the result is usually the loss of an important source of retirement income security for employees. One reason for this pension loss is that sometimes, upon plan termination, employees are provided with a lump sum distribution, rather than having their accrued benefits guaranteed by the purchase of annuities from an insurance company. The second part of the loss is the loss of benefits that would have accrued in the future if the plan had continued. In many cases the terminated defined benefit plan is replaced with a defined contribution plan. At least a defined contribution plan has the potential of providing an adequate retirement income for younger members, if the accumulation is applied to provide a life annuity. What I see as a draw back of defined contribution plans is that usually benefits are paid as a lump sum. But, in any case, for older workers a defined contribution plan is almost never adequate to replace the income loss on the discontinued plan.

In addition, the termination of over-funded plans reduces the premiums received by PBGC, tending to undermine plan termination insurance. Chipping away at PBGC's contribution base will gradually require a premium increase, at least somewhat higher than would otherwise have been for employers that have defined benefit plans, further discouraging such plans.

In a nut shell, in my judgment, the termination of defined benefit pension plans is generally bad for employees. Plan terminations with reversions have increased because employers need the money. However, realize that under present law termination of the pension plan is the only way to get this reversion.

The present law provides the wrong incentives. The answer is to amend the law to allow employers to withdraw excess assets from the plan, without being forced to terminate the plan, but still continue the plan with controls to assure that all accrued benefits will continue to be fully funded. I've submitted a specific proposal on this to the Senate Subcommittee on Labor.

On April 4th Labor Secretary Donovan announced that employers would in effect be allowed to withdraw excess assets if they danced the two step. There are two ways to dance the two step. One way is to purchase annuities for all accrued benefits, terminate the plan, recover the excess assets and immediately start a new defined benefit plan. The new plan together with the paid-up annuities, would provide benefits identical to those which would have been provided by the old plan. The second way to do the two step is to split the plan in two parts, one plan for actives and one plan for retirees. Purchase annuities for all accrued benefits under both plans, transfer all the excess assets into the retiree plan then terminate the retiree plan recovering the excess assets. The plan for the active employees would continue.

Senator Metzenbaum wants to obtain a nine-month freeze on all plan terminations with substantial reversions, but it appears he is not going to be successful. Both Senator Metzenbaum and Congressman Roybal propose substantially restricting terminations with reversions. Senator Metzenbaum's rash solutions would discourage employers from establishing or soundly funding defined benefit pension plans. Secretary Donovan's announcement allows employers to dance the two step to recover the excess assets while still continuing their plan, but makes no special provisions to make up the withdrawal. My one step withdrawal proposal would require employers to amortize the amount withdrawn over 15 years.

We may get a change in single employer plan termination insurance, however I doubt it. We may just get a premium increase with no other changes.

There are proposals to amend MPPAA for multiemployer plans. Except for the elimination of retroactive applications, no change is likely.

Congressman Erlenborn is again pushing the Public Employee Pension Plan Reporting and Accountability Act (PEPPRA); that is not going to make it. Similarly he has a bill to simplify ERISA and another one to establish a single agency to handle regulation.

As was mentioned in our general session yesterday we have the Fair Insurance Practices Act, apparently covering insurance but extended to pension plans and would in effect extend Norris to employers with less than 15 employees. That one is not going to make it this year.

There will be great consideration of public employee plans and what to do with all the federal employees, hired since January 1 of this year, who are covered under Social Security. There will be continuing study but Congress will take no action on that in this election year.