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VIEW FROM THE INTERNAL REVENUE SERVICE (IRS)

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Panelist: IRA COHEN
Recorder: JOHN M. FINLEY

- Current issues other than those relating to the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, the Deficit Reduction Act (DEFRA) of 1984 and the Retirement Equity Act (REA) of 1984.

MR. LEROY B. PARKS, JR.: Our speaker is Mr. Ira Cohen from the Internal Revenue Service. He is Director of Employee Plans, Technical and Actuarial Division. He has worked on a host of legislative and regulatory projects. He also teaches a course on deferred compensation at George Washington University.

MR. IRA COHEN: I will begin by talking about a change in the area of waivers of minimum funding resulting from the new law on single employer plans. There is a section of this new law relating to waivers of minimum funding requirements. There have been several changes in the requirements. I am not going to cover the changes on plan termination caused by the new law, which is mainly not in IRS jurisdiction, but just the waiver aspects.

Under the new law the IRS has to notify the Pension Benefit Guaranty Corporation (PBGC) when we receive a request for a waiver. This is something we have been doing administratively prior to this, so it is merely a codification of existing practice. You do not have to be concerned about this.

However, if you are making a request for a waiver on a plan which is part of a collective bargaining agreement, or people covered under a collective

bargaining agreement are covered under the plan, then the law has changed. You must now notify the union, and we must get some evidence of this notification to the union, which will probably be a statement that you have done this, before we can issue a waiver. Procedurally, we will be requesting this up front. The law relating to IRS disclosure has not changed, which means that we cannot tell the union anything. A request for a waiver is tax return information. As tax return information it must be safeguarded. We cannot discuss a waiver or provide information to the union because that is protected information. On the other hand, as with any disclosure situation, the taxpayer can waive disclosure rights, in which case we can make information available. This would be at the discretion of the applicant for the waiver as opposed to our discretion.

The third thing that was done dealing with waivers is in the area of security interests. The law was changed to say that the IRS may require a security interest as a condition for granting a waiver. We believe we had the authority to do it previously, and in a few situations we had done it. What has probably changed more than the substantive nature of the law is the direction of the law. As I said before, we have consulted with the PBGC when we received a request for a waiver. In some cases, PBGC has asked us to get a security interest; in some cases we have done it, and in others we have not. That would still be the case, but the fact that this has been put into the law does give some direction for leaning closer toward asking for a security interest. So I would suggest in order to save time when you are asking for a waiver on substantial amounts, you consider a security interest. There is no problem when the plan is well funded, but when the plan is not well funded the security interest may be an issue.

The last change, and one that we are not totally convinced as to what it means or what we are going to do, deals with the actual amortization payments of waivers. The issue is that when you got a waiver under prior law, the waiver, like any other base, was amortized using the valuation rate of interest. The law has been changed in that regard. What the new law says is that the rate that you have to use is the rate that the IRS would charge delinquent taxpayers, which in most cases would be a higher rate. The law does not talk about the amount of waiver; that is still determined based on the funding

requirements and the valuation interest rates. However, the payment of the waiver is now going to be based on higher interest rates resulting in larger payments. That change was made in the law because many people felt that one of the reasons why employers were requesting waivers was not because credit could not be obtained. Rather, from the employer's perspective, it was an inexpensive form of credit. The new law is going to be making it more of a market rate of credit.

As far as what the new law means, there are a number of issues that we have to think about. I do not have answers today, but I expect we will have answers shortly. One question is whether the interest rate is fixed throughout the 15 year period based on the interest rate in effect when the waiver was requested, or whether the interest rate is a variable rate (that is, you determine the interest rate for the first payment; the next year you take the outstanding balance and redetermine the payment based on the interest rate for that year; etc.). We do not know for sure what the answer is. We are not even sure which answer is easier. It may seem easier at first to say that we use the initial rate. However, the waiver is due a certain day in the taxable year. If you are changing the interest rate to be charged with respect to the waiver and the funding standard account, some adjustment logically has to be made with respect to some of the contributions that are made; if you made a contribution the day the waiver was due equal to the waiver, you should come out even at the end of the year. You would not if you credited two different rates of interest.

There may need to be some form of ordering rule; for example, perhaps contributions that are applied to waivers would be contributions that are made first. If an employer had more than one waiver, there may be different segments of contributions unless the rate for the year were not the same, which would be the case if you readjust the interest rates, as in a variable mortgage.

These are issues that we have to resolve. Clearly, as a consequence of this, the balance equation that you have in the regulation on acceptable funding methods is clearly going to be off once you start amortizing using these rates. We may come up with a formula for determining the correction.

The key things if you are dealing with waivers are the following:

1. if there is a union, make sure that you notify it and assert that to the IRS, and

2. if assets are less than the present value of accrued benefits, you may want to at least consider what your position is going to be dealing with a security interest to simply speed up the process.

A question I am frequently asked is, When a plan terminates, which employees have to vest? Possible answers are all employees, employees who are employed on the date of termination, or employees who have not yet incurred a one year break in service. The rules will depend upon whether we are talking about a defined benefit or a defined contribution plan.

In the case of the defined contribution plan, when someone separates from service and receives a distribution, and the distribution is less than the entire account balance -- for example, because the individual was only partially vested -- there are two general approaches that could be used. One approach is what I would call the forfeiture restoration approach. That is, you have an immediate forfeiture of the balance of the account, and the employee, if he returns, can repay the forfeiture and restore the account. If this approach is used, then someone who separated from service and received a distribution would not have an account balance, and there would be nothing to vest upon plan termination. The second approach would be where after making a distribution, the plan keeps the non-vested account balance for some period of time. If the employee returns to employment, vesting of the remaining account balance is based on formulas that are found in the regulations. In this case, these employees vest in the account balance upon plan termination. There is a General Counsel Memorandum (G.C.M.) dealing with these two situations.

The next question is what happens in a defined benefit plan. In the case of the defined benefit plan the only employees who have to vest on termination of the plan are those who are employed on the date of termination. Employees who have separated from service prior to the date of termination do not have to vest, whether or not these employees have incurred a break in service.

All my statements are predicated on the presumption that there is no partial termination. That is to say, I am talking about a situation where no partial termination preceded the termination. However, in some instances, when looking at the facts prior to the plan's terminating, you may see that the number of participants is being reduced significantly, and this may give rise to a partial termination. Partial termination will give rise to additional vesting, and in those types of situations employees may be vested on account of the partial termination.

People have asked what the logic is for these positions on plan termination. In order to understand the logic, one has to look a little bit at some of the history. First of all, these provisions that are now in Section 411(d)(3) of the Code were originally in Section 401(a)(7). These provisions were introduced into the law in 1962. They were introduced into the law before ERISA, before there were the ERISA concepts of a break in service and a year of service. When ERISA was enacted there were some minor changes made, but the changes did not relate to this particular issue. There were changes made on complete discontinuance with the idea that plans subject to minimum funding need not worry about complete discontinuance, but there were no changes on the basis of who vests. In order to interpret what this means, one has to look at what was probably intended and what would have been done pre-ERISA. Pre-ERISA, if we look at a defined contribution plan and you had an account balance, we believe the best interpretation--whether or not there was a break in service is that you would have to vest. The G.C.M. is based on that concept.

Suppose we now look at the defined benefit plan. Suppose you want to extend the same concept; logically, if you extend the same concept, you will come up with a drastically different result. Assume that ERISA has always been in effect, a person had separated from service with a vested benefit, and this person did not receive a distribution, which is not unusual in defined benefit plans. Assume this person separated from service 30 years ago. What is this person's accrued benefit and what is his vested benefit after ERISA? His accrued benefit has not decreased. He has an accrued benefit of a larger amount and a vested benefit equal to the vested portion of the accrued benefit.

If one were to take the position that all these accrued benefits should vest upon plan termination, the concept of break in service has nothing to do with that result. These people who have accrued benefits and who separated from service over the last 30 years would all vest in benefits, and I do not think anyone intended that amount of vesting. That concept clearly is inconsistent; the rule of parity does not affect anything, because the person had a vested benefit; a break in service does not have any particular relevance toward whether an accrued benefit exists. We looked at that result, and we said that the result is just clearly inconsistent with all reason, and therefore some other answer had to be given. The answer we have come up with is logically what would have been done pre-ERISA in this type of situation. We would have simply said that those who were employed would vest, and that is where we came up with our position.

The next area that I want to cover is allocation. A Revenue Ruling that we just put out, Revenue Ruling 86.47, deals with two things, a spinoff situation and two items that were previously considered in Revenue Ruling 81.212; one is allocation of credit balances and the other is allocation of bases.

Revenue Ruling 81.212 dealt with a plan in which the assets in the plan before you started the spinoff were less than the present value of theaccrued benefits. Revenue Ruling 81.212 did not deal with an overfunded plan. What Revenue Ruling 81.212 said is that to allocate the credit balance, you look at the assets that were actually allocated. (The asset allocation is based on Section 414(l) in accordance with ERISA Section 4044.) Then look at what would have been allocated if the assets were an amount equal to the assets less the credit balance. The difference between those allocations shows you where the marginal amount of assets went because of the credit balance. The credit balance in effect is an ability to defer funding, and therefore we felt that to the extent that plans received assets that were greater by virtue of the credit balance, that is the extent to which assets should be allocated. That was the position in Revenue Ruling 81.212.

In the case of overfunded plans, however, the result of this allocation procedure is not unique, and we did not think that just choosing any way you want to put the credit balance really makes much sense. The rule that we came

up with for overfunded plans is that you will look at the overfunding. You will look at where the surplus went, and you will allocate the credit balance in proportion to the surplus assets that were allocated. That is basically what Revenue Ruling 86.47 did.

The second issue that came up is allocation of bases. Under the allocation of bases in Revenue Ruling 81.212 we came up with a formula which allocated based on the amount of accrued liability less assets less credit balance. If one mechanically followed that rule with respect to an overfunded plan in which all the surplus went to one plan, the application of that rule would produce a result in which if there were a $100,000 credit base, a $200,000 credit base could be allocated to one plan, with a debit base of $100,000 to the other. When there was an initial credit base of $100,000, we did not think you could allocate more than $100,000 of the base to anywhere. That is basically the position that is taken in Revenue Ruling 86.47.

Having said that you cannot allocate any more than the base, after you have completed your allocation of bases you may now find the balance equation is no longer working. You may have to create another base in order to make it work, and we provide a formula for determining that base.

The next question is, Once you determine the base, what is the amortization period with respect to that base? In the existing law, you have a base that is being created on account of an amendment and amortized over 30 years, on account of experience losses that are amortized over 15 years. This balancing base does not seem to fall logically into any one of these categories. What we concluded is that the most rational amortization period would be determined by looking at what the amortization period would be if you had combined and offset all your bases. That period is the amortization period for the new base, because it is a technical adjustment to the existing bases. It does not require that you actually combine an offset under Code Section 412 rules. It is just what the amortization period would be. When we looked at that we said that is fine, except if I had a plan and I had pretty much funded all my bases, and now I was down to a two or three year period, that could be an extraordinary amount of funding. We looked at that situation and said yes, that is right; it would be extraordinary, and it would be much too large. So

what we said is that if the average period determined by combining bases is less than 15 years, then you can increase the average period for this new base to the 15 year period for experience losses. We felt that would be the most rational and least offending period.

The last topic I would like to talk about is cash balance pension plans. There are a number of different varieties. The simplest variety, which is the one I am going to be talking about, is a situation in which you define an accrued benefit in terms of a lump sum. You credit a certain amount of (for want of a better term) contributions to an account of each person. This account is then improved at some rate; the rate may be rates on treasury bills, it could be rates on some other outside index, it could be a COLA type rate, and often there is a minimum guaranteed rate.

The first and simplest question is, "Is this plan a defined benefit or a defined contribution plan?" I think it is clearly a defined benefit plan. A defined contribution plan is defined in Section 414(i) as a plan in which contributions are made to an account and the account is credited with investment experience. A cash balance pension plan does not credit investment experience; it credits at some specified rate. Under a defined contribution plan, the account balances can go up and down based on investment experience. In many of the cash balance pension plans that I have seen there is no possibility of the account balances' going down. There are a number of differences, but it is clearly a defined benefit plan.

As a defined benefit plan, one of the attractions that some people like is that it would be funded as a defined benefit plan: this may mean that the assets may be less than the present values of the accrued benefits, which would be the sum of the account balances. The ability to insure against loss is another attraction.

There are a lot of consequences from its being a defined benefit plan, some of which may be good and some of which may be bad. The first consequence of its being a defined benefit plan is that it has to satisfy the accrued benefit rules. You can demonstrate mathematically that if you are contributing a level percentage of pay in all years, this is a front loaded arrangement, and it

would not violate the accrued benefit rules. If you begin to play games and alter the rates between years, you may run into problems.

One question that has arisen for which we have not yet been able to come up with any real solution is, "Can I integrate the plan, and if so, how?" I think the first question is fairly easy. You should be able to integrate the plan, but what rules do you use and how do you interrelate them? We have talked to some people who have attempted to work out a scheme, and we have not yet reached any conclusion on how the integration can be done. The integration requirements that you would need to follow would be the defined benefit integration rules. Therefore, somehow you have to be able to start with the basic defined benefit integration rules and translate these into an account balance with adjustments and so on. It may be possible for someone to work out the mechanics to do this. We have not spent an extraordinary amount of time on the issue, and I am not saying it cannot be done.

Some people say, "Why can't I simply use the defined contribution integration rules?" The answer is that this is not a defined contribution plan. The concepts are somewhat different. The first difference is that in a cash balance pension plan you are guaranteeing a particular return. The higher the rate of return that you use, the greater the differential caused by integration. Under defined contribution integration rules, you do not worry about the rate of return, because a defined contribution plan adjusts to market conditions. Under a cash balance pension plan, where you are totally divorced from market, suppose a plan wants to credit a minimum interest rate of 25% each year. By using high interest rates you can greatly expand the amount of integration. The defined contribution rules do not accommodate that sort of thing. All cash balance pension plans have some sort of rates which are guaranteed. That is why we feel that the defined contribution rules as a starting point are inappropriate.

The next question is how to deal with Section 415 of the Code. That becomes a little more complicated, but I think it can be done. Again, these are defined benefit plans, and the annual additions concept does not apply. The policy would be the same policy you dealt with on integration. Cash balance pension plans will generally provide some form of conversion of the account balances to

life annuities and joint and survivor annuities. You would start off with the dollar limit and the percentage limit. You could use whatever the basis of the plan for conversion was to get the equivalent lump sum at retirement. You would use that rate or 5%, whichever was greater, to follow the 415 concept.

To determine benefits starting early, what rate would you use for discounting? This has been a question that we have had. The rate that we feel is probably most appropriate would be whatever rate is being credited for that particular year or 5%, whichever is greater. That answer poses a number of problems. The greatest problem that it seems to pose is that when you are talking about a fluctuating rate, a person's benefits can go down very considerably if this fluctuating rate goes up very rapidly in a particular year. We have found it disturbing that the Code Section 415 limits should behave in this fashion in this type of plan. Yet, we were trying to determine what is the rational rate for discounting. We began to look and say, "These are defined benefit plans," and "Let's try to analogize these to defined benefit plans and say what we would have done in a different type of defined benefit plan. Suppose we had a more traditional type of defined benefit plan that defines an annuity and then provides a discount rate based on the greater of a guaranteed rate or some outside index. In that case, the lump sums would behave in this fashion, and the 415 limits would be determined using the greater of whatever rate was applicable for that year or 5%."

What we are trying to do is come up with a concept that provides a logical result. We are not looking to provide new rules or different rules for cash balance pension plans, but to provide the same rules that you always had. This is what I think would be the reasonable result with respect to the dollar limit. You would also have to adjust the percentage limit. You would convert to the lump sum, but then you do not have a discount rate. You would have to limit that to 100% of pay at retirement age.

I cannot say that we resolved every issue on cash balance pension plans. We have spoken to different groups of people, and what I have discussed are some of the things that have emerged. Some of the positions we take may depend on what ideas some people come up with. We are pretty much open for suggestions on some of these things. We are really not approaching this from the point of

view of trying to come up with a rule that greatly encourages or discourages cash balance pension plans. We just want rules that are as consistent as possible on defined benefit plans, including cash balance plans.

MR. JAMES F. OBERNESSER: On a number of occasions you have explained the rules for determining who should be vested on a plan termination. However, we continue to have problems on this issue with a couple of IRS offices that seem to have alternative opinions. In fact, I have been told, although I do not know directly about this, that the Brooklyn office has some worksheet or checklist which would indicate that anyone who had not suffered a break in service in a defined benefit plan should be vested on a plan termination. We have quite a few of these under way right now, and we have not been able to get the IRS offices to agree with your explanation, which we have heard on several occasions. Is that going to change, or will something happen on that?

MR. COHEN: At this point we do not have anything published on the subject. That may be changing, because we have included some of this in different types of training material. One option that you have on an issue of this nature is that you can ask for technical advice. We have issued some technical advice which maintains the position that I have described to you. So that may be one way that you can deal with the issue.

MR. OBERNESSER: I believe it has come up at a couple of meetings such as this, or in actuarial meetings by a number of IRS representatives, that a negative unfunded actuarial liability is not permitted. That seems fairly clear in the case of the frozen initial liability method. However, in the case of something like the entry age normal method, is that something that we should be making adjustments for, or is a negative unfunded liability still acceptable with a method like the entry age normal method?

MR. COHEN: We do not think it appropriate to have negative normal costs on the frozen initial liability method. I do not think we have taken a position on what happens if the unfunded actuarial liability is negative on the entry age normal method. Of course, there may be a negative unfunded actuarial liability in the short range before you run into the full funding limit on the entry age normal method. You can run into some of that and not think there is

much that can be done on the entry age normal method. The primary objections on some of these things have been funding something using a negative normal cost and positive amortizations, which we really do not think is a rational approach to funding.

MR. JAMES F. A. BIGGS: There was a lot of discussion in sessions yesterday about the use, particularly in one person plans, of what would seem to be unusually early retirement age assumptions, such as 55 or even 45. My first question is, To what extent is the selection of an unusually early normal retirement age assumption a qualification issue rather than a deduction issue? My second question is, If a plan with an unusually early normal retirement age has a valid determination letter, does the enrolled actuary have any alternative but to recognize that unusually early normal retirement age in his computations?

MR. COHEN: First of all, I do not recall the numbers of the revenue rulings, but we did issue two revenue rulings a number of years ago. The first revenue ruling said that the early retirement age is not a qualification issue, and therefore a plan can be established with any retirement age you so desire. So that is not a problem. The second revenue ruling dealt with minimum funding and deductions. This revenue ruling said that what the actuary needs to do in determining contributions, both with respect to minimum and maximum contributions, is to consider the most reasonable pattern of retirement that is going to emerge. There can be a plan that is providing subsidized early retirement benefits, and if the actuary totally ignores the subsidized early retirement benefits, you can easily have a minimum funding deficiency. If the actuary is assuming that 100% of the people are retiring early, which may be an unreasonable assumption, there may be a deduction issue.

When you are dealing with a one person plan, the problem becomes a little more complicated in that regard. You don't have experience to develop an assumed retirement age. The position we have taken is that we will accept for deduction purposes for one person plans a normal retirement age of 65. If someone can show, on the basis of statistical evidence based on the type of work that is being done, that an average retirement age before 65 is reasonable, we will permit such earlier retirement age. We wouldn't really question certain

retirement ages before 65, for example, in the case of certain professional athletes. The cases that you are alluding to are a number of cases which I believe all related to doctors, and these cases had assumed retirement ages of 55 and 45. The only evidence that was presented when we asked for it was a written statement by the doctor of intention to retire at this particular age. We thought there was some possibility that the statement might be a self-serving statement. We did not give very much weight to that sort of thing. That is basically where we are today. If studies are made which can justify lower ages, we are not saying that age 65 is definitely the only age that is acceptable.

MR. BIGGS: Your answer hinges on the issue of retirement. Is this still relevant where the plan permits commencement of benefit payments whether or not the individual has actually ceased employment?

MR. COHEN: It still may be relevant, because even though you may recognize the fact that benefits may commence early in determining liabilities, there is nothing that says that the funding period has to end or should end at the point where benefits commence as opposed to the point of retirement. One could, for example, compute costs based on the present value of benefits including early commencement of benefits, but the funding period could be a period until the person actually retires. There will be some period in which the person is assumed to be working while payments are going in and other payments are going out.

MR. WAYNE E. DYDO: Will the Consolidated Omnibus Budget Reconciliation Act of 1986 require in the case of a spinoff termination asset reversion that temporary supplements for those who are currently eligible for them but working be annuitized?

MR. COHEN: It clearly requires that you make benefit commitments, and the interpretation of what is or is not a benefit commitment is really within the jurisdiction of the PBGC. At this point, given the newness of the legislation, I don't feel I could comment on that.

PANEL DISCUSSION

MR. HOWARD L. KANE: I have a question in two areas. One is on the negative unfunded liability. If you have a full funding limitation one year and the next year your bases go to zero, but you have a credit balance, won't you need a negative unfunded liability to balance?

MR. COHEN: The objection that we have is to the creation of a negative normal cost and positive past service benefit allocations. We don't think that is a rational scheme. In answer to your question, yes, when there is a credit balance, and if you're talking about what may degenerate to the aggregate method, you may reach a point where either the aggregate cost is positive or where you have assets greater than the present value of all future benefits.

MR. KANE: The second area involves spinoffs. When was Revenue Ruling 86.47 effective?

MR. COHEN: I do not recall that we had a special effective date in Revenue Ruling 86.47. Generally speaking, when there is not an effective date, the revenue ruling is retroactive.

MR. KANE: In other words, if you had a spinoff back in 1985 and the calculations haven't been completed yet, Revenue Ruling 86.47 would apply to that spinoff.

MR. COHEN: That is correct.

MR. PARKS: Doesn't that pose a problem in some instances? Back in the days when we had flexibility, many people thought they had a better idea as to how to split the credit balance and perhaps put all of it in the plan that was not being terminated. Therefore, some companies were able to have a few years of no contributions to the ongoing plan. If you made this revenue ruling retroactive, some of these plans would be in trouble now.

MR. COHEN: This applies in more than just terminated cases; it also applies any time there is a spinoff. I don't think it makes sense to say all the surplus assets are going to a plan that is terminating, and then the credit balance remains with the existing plan. You are able to take the surplus

assets out, but I think the proportional idea and the revenue ruling that you based it on was one that dealt with an underfunded plan, not with a superfunded plan. We've seen situations in the past where we have in fact taken that position. We've also taken that position where the bases were allocated in the manner I described. We do not feel that based on the law that existed prior to Revenue Ruling 86.47, an appropriate way to have treated it was by mechanically following Revenue Ruling 81.212 in this type of fact pattern.

MR. PARKS: Let me read a couple of the questions regarding cash balance plans that have been submitted in writing. We have all heard a great deal about cash balance plans. Approximately how many of these plans is the IRS now reviewing?

MR. COHEN: I haven't the faintest idea. I'm not even sure if anyone has ever adopted a cash balance plan. All I know is that there has been discussion about them and people have come to see me to discuss some of the issues, but I have no idea of the number of cash balance plans the IRS is now reviewing.

MR. PARKS: Under a cash balance plan, if the rate of interest credited on national accounts is set equal to the interest rate credited in the marketplace for Guaranteed Investment Contracts, this plan seems to provide the same benefit delivery as a defined contribution plan with only a DC investment option. There is no discrimination by crediting high rates of interest to high-paid individuals. Why, therefore, couldn't this cash balance plan be integrated using the defined contribution integration rules?

MR. COHEN: Even though you are talking about Guaranteed Investment Contract interest rates, that doesn't mean that all plan assets are invested in Guaranteed Investment Contracts. A defined contribution plan is one in which you get the actual investment experience; you do not have some fixed index. The rates on GICs may not be appropriate in this case. If the sponsor is interested in a DC plan which has those types of rates, it can establish one and invest in that kind of product.

MR. DAVID R. NELSON: First, what is the current thinking of the Treasury Department about post-retirement health funding and providing a vehicle for that? Second, who is going to be a qualified actuary?

MR. COHEN: I don't know, and that goes for both questions.

MR. STANLEY B. ROSSMAN: If my client's funding policy is to fund all benefits at the time that they are first available to make sure that the actuarial liabilities are protected, as well as the stockholders' residual liability from the single employer act just passed as part of the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), is there a problem with what you said about funding beyond an age 55 normal retirement age?

MR. COHEN: I don't see any problem as long as the client is not funding to the point where assets exceed the present value of all projected benefits. The next question is what you can claim as a tax deduction. That is a different issue. If the company wants to fund, take a carryover and take the deductions as they come due later on; we don't have any objection if that is the funding policy. Another point that you might want to think of when you mention the single employer leigislation, is that it seems that this legislation will have the same exclusion as Current Title IV for service organizations which have never had more than 25 participants. So COBRA may not have any real effect on that category of plans.

MR. PARKS: Let me take a few more of the written questions before we get to the questions from the floor. A corporation which sponsors a retirement plan qualified under Code Section 401(a) contracts with a sole proprietor independent contractor for specific work. The independent contractor works for the employer on a substantially full time basis for two years. After one year, is the independent contractor an employee of the corporation under Section 414(n) of the Code, assuming no third party leasing organization is involved in the contracting of the independent contractor's services?

MR. COHEN: I think we're working on regulations dealing with Code Section 414(n), and I think that those regulations will address that issue.

MR. PARKS: Here is another written question. What happens to interest rates on currently outstanding funding waivers? Will these funding waivers be required to be reamortized using IRS interest rates?

MR. COHEN: We're looking into that question. Our current inclination is that IRS interest rates would apply to new waivers only, but it's not a definitive answer at this point.

MS. CATHERINE LOUISE DROWN: Assume a plan experiences substantial gains with a decrease in accrued liabilities, the full funding limit is reached, and the bases are set to zero. In the following year, if these excesses were substantial enough that they exceeded the amount used for the full funding limitation credit or credit balance or whatever, the equation of balance doesn't seem to work. Is there a specific base you set up for amounts that were set equal to zero for the prior year, or does it get thrown into the subsequent year's experience?

MR. COHEN: I think there are some situations where the balance equation doesn't work. We have a revenue ruling which deals solely with determining bases as opposed to analyzing assumptions; this may limit the amount of experience gain or loss that may occur in order to get back to the equation of balance. We do recognize and we always did recognize that there are certain circumstances in which the equation of balance will not work. That's why the lead-in language says "except when permitted by the Commissioner," or something to that effect.

MR. ROBERT E. DOUGAN, JR.: There's been a lot of comment about negative unfunded liabilities and negative normal cost. I'd just like to point out that in the small plans area with the traditional individual level premium cost method, it is common to get a negative unfunded liability. You are not saying there is any problem with that in a case where you have a positive normal cost. There is no special adjustment or anything, is there?

MR. COHEN: No, what we're talking about predominately is the frozen initial liability cost method and the attained age normal cost method where you are producing negative normal cost.

MR. DOUGAN: Within the frozen initial liability context, if the negative normal cost results from a plan amendment's ceasing future benefit accruals where the assets exceed the value of the accrued benefits, so that due to full

funding limitation all the amortization bases are wiped out, you get a negative normal cost.

MR. COHEN: Not if you say that at that point the method degenerates to the aggregate cost method, as it would when you paid off your bases. Then if it is negative, it's only because the present value of future benefits is more than the assets. If the present value of all future benefits is less than the assets, I wouldn't really be considering it a negative normal cost. The full funding limit would apply in that type of situation. There would be no contribution being made. The maintenance of 30 year amortization bases along with negative normal cost does not appear to be a very rational funding scheme.

MR. DOUGAN: I have no quarrel with that. In the first case you have to fill out a Schedule B. Would you fill it out with a negative normal cost and with no amortization bases, or do you show a zero normal cost with the present value of benefits exceeding assets?

MR. COHEN: I would probably just show zero and just put a footnote that it's zero because the cost physically computed as negative.

MR. PARKS: I have another written question. Is it permissible to make employee contributions to a 401(k) plan a requirement for participation in a defined benefit plan?

MR. COHEN: I presume that the term "employee contributions" here means amounts in a 401(k) in which you have a salary reduction arrangement. Those salary reduction contributions would not be employee contributions under the Code, but employer contributions. Having said that, the answer to the basic question is yes, it can be done. There is nothing in the law that precludes you from doing that if the results are not discriminatory.

MR. WILLIAM J. SOHN: My question has to do with the proposed regulations under Section 412 dealing with the time in which valuations are performed. The regulations require that the valuations be performed within the plan year or within 30 days of the plan year. This has been a problem for a number of utility companies that value the plan regularly in advance of the plan year by

more than 30 days in order to use the results in the rate making process for the subsequent year. Does the IRS intend to issue final regulations or change its position from the proposed regulations?

MR. COHEN: We do intend to issue final regulations. I can't tell you when we will be issuing them. The problem in getting final regulations is the multiple changes of law that we've dealt with and other things having higher priority. Getting back to the question, we've gotten many comments on that particular aspect of the proposed regulations. We are planning to have some modifications to reflect some of these comments. The modifications would be generally in the area of giving more flexibility. One of the questions that I raised at the public hearing that we had on these regulations to virtually all the commentators who were objecting to that particular provision is whether they would think it would be reasonable if we had some sort of grading based on, among other things, the frequency of valuations, so that if valuations were done annually, there could be greater flexibility than if they were done triennially, because the material is so much staler. Almost all of the commentators thought that type of approach would be desirable. I really don't recall exactly what periods we have in mind, but the general direction is somewhat along the scheme I am describing.

MR. DONALD J. SEGAL: There was a recent private letter ruling which dealt with a 401(k) plan where there was an employer match to the employee deferrals. The ruling said that the employer match could not be counted in the determination of the 401(k)(3) test. It did not give any more details than that. The question is, If the employer matching contribution were 100% vested, would it be permitted to be counted in the 401(k)(3) test?

MR. COHEN: If they are 100% vested at all times, we do permit some employer contributions to be taken into account under the proposed regulation. You would have to meet the requirements of the proposed regulation, and also meet, I believe, some of the other requirements of 401(k) relating to distributions.

MR. WILLIAM D. MAGARO: If you convert from a sole proprietorship to a corporation and there are no other changes in the plan, is it necessary to file a Form 5310 and treat it as a transfer of assets?

MR. COHEN: I wouldn't think so; you are just having a change of sponsor.

MR. MAGARO: Under the elapsed time method, if you have a client that changes from a December 31 year end to a March 31 year end, how are the overlapping plan years calculated for vesting purposes?

MR. COHEN: I am not sure why plan years are particularly relevant under the elapsed time method. We have all sorts of rules when you are crediting hours, because you have specified computation periods when you are crediting hours. What we say when you are crediting hours is that the computation periods have to overlap. The elapsed time method seems to be pretty much independent of plan year, and I am not sure why a change of plan year would have an impact at all under the elapsed time method.

MR. JAMES F. VERLAUTZ: In a number of funding waivers that the IRS has recently granted there has been a condition imposed on the employer that if the plan were to terminate within the following 15 years, the plan must have a credit balance at least equal to or greater than the sum of the outstanding balances for the waivers granted. If you have a condition where you want to terminate the plan in five years or so, and you have $250,000 of unfunded benefits and outstanding balances of $500,000, do you need to contribute the entire amount of cash, or can you contribute just enough to pay all the benefits?

MR. COHEN: Many of the conditions that we have had have been written one of two ways. One is that you contribute the lesser of the amount that you just described or an amount sufficient to provide all benefits to the participants. In the second way, we've omitted that particular provision. However, when we put in a condition of this nature, if a plan were actually terminating and there were sufficient assets, we could always modify the condition if everybody were getting all the benefits they were entitled to. Some of these conditions may actually cease to be needed in waivers, because one of the changes that I didn't mention was that what we've been putting in as conditions is now required under law as a result of the Consolidated Omnibus Budget Reconciliation Act of 1986.

MR. VERLAUTZ: Under COBRA, if you are requesting a waiver for a plan that covers a group of union employees where the location has been shut down and there are no active employees, do you still need to notify the union?

MR. COHEN: We obviously haven't had time to think of that variation. I don't recall any exception in the law. I think the logical answer would be yes. Even if there are no active employees currently, the benefits retired employees are receiving may vary with the amount of funding. There still may be a continuing financial interest.

MR. SAMUEL S. STANLEY: Has the IRS done any more thinking about Worksheet III, and what are your own personal feelings about it?

MR. COHEN: We've done a lot of thinking about Worksheet III. I've said at other times that Worksheet III is something we had devised and it was based on a couple of fundamental aspects that we needed to have some guidelines on. We regard these as living documents. There may be changes that may be made from time to time. At present, we may be tinkering with it, but nothing in the nature of what I would call a substantial revisiting of Worksheet III. There have been many people who have made a number of comments about it. Some have actually agreed with it, but most have not. The point is that we're open to suggestion. If one starts with the presumption that a regulatory agency must deal with issues of minimum funding and maximum deductible limits, if we cannot give the impact of choice of assumptions, then how should we go about this process?

Some people have suggested that if we have a variance of over 22% on the interest rate, we can get a 95% confidence level. That may be, but it doesn't exactly point you to a working solution dealing with the problems. If people have any ideas on what should be done or on how Worksheet III can be improved so that we come up with guidelines that go after the more extreme situations but do not impact adversely on the mainstream of work that is being done, I am very much open to suggestions. We do not regard Worksheet III as the be-all and end-all. If there are other approaches, we are more than happy to consider them.

MR. PARKS: I have another written question. Comment briefly on expected changes to Social Security integration rules.

MR. COHEN: If you're talking about what we are planning to do administratively, not much. If you're talking about the changes in the integration rules that are in the Senate Finance proposal, I don't talk about pending legislation. Once it is enacted, I'll discuss it.