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RETIREMENT PLAN DESIGN

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- o Are defined benefit plans obsolete?
- o Coordination with 401(k) plans
- o Cash balance plans

MS. MARCIA DUSH: We thought it would be terribly unfair to talk about Retirement Plan Design without looking at how Tax Reform is going to impact the way we design qualified retirement plans. So, my part of the program will be to briefly summarize how I see Tax Reform impacting all the rules and regulations that we operate under. I'd like to go through four different subjects that I believe are most affected by Tax Reform. First, I would like to go over the changes in the various anti-discrimination provisions. Second I would also like to discuss how tax Tax Reform impacts benefit and contribution limitations for qualified plans. Third, I will discuss the tax treatment of distributions from qualified plans. And finally, I will make a few comments on stock ownership plans and how they are affected by Tax Reform.

I would like to start off by discussing how Tax Reform affects the area of anti-discrimination rules that we operate under. For the first time, Tax Reform gives us a uniform definition of who the "highly-paid employees" in a plan are. We finally know who we are trying not to discriminate in favor of.

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This definition is going to be used for all qualified plan purposes, including the 401(k) Deferral Test. You should also note that this is the same definition that we'll be using in the welfare plan area to determine who is highly paid for the new Welfare Discrimination Test. Under this new definition of who is highly paid, we believe that the highly-paid group will generally be about 10 to 15% of a major employer's workforce. Tax Reform has also brought us new coverage and eligibility rules. I'd like to spend just a moment discussing the new coverage tests.

There are three coverage tests. A qualified plan must pass at least one of these three tests. I refer to them as the 70% coverage rules.

- The first of these tests is that a plan must cover 70% of the lower-paid group.

- The second of the tests is that the number of lower-paid employees covered by the plan must be at least 70% of the number of highly-paid employees covered by the plan. For example, if a plan covers 90% of the highly-paid, it must also cover at least 63% of the lower-paid group -- 70% of 90%.

- The third test is very similar to a test that we work with today and that is the Fair Cross Section Test. However, under the Tax Reform, the Fair Cross Section Test includes a Benefit Test. To pass the test, a fair cross section of employees must be covered by the plan. The average benefit of the lower-paid group must be at least 70% of the benefit of the highly-paid group.

Now, it should be noted that comparable plans can be aggregated together to perform these coverage tests, and that line-of-business testing is also permitted. Remember that a corporate headquarters cannot be designated as a separate line-of-business.

In addition to these new coverage rules, Tax Reform has included another new test which is referred to here as a Minimum Coverage Test, and each plan must pass this Minimum Coverage Test on its own -- there is no aggregation permitted to pass this coverage test. This test states that a plan must cover at least 50 employees or 40% of all employees. I believe that this test was included to get at the small corporations. However, it's also going to impact those large corporations that have separate plans at different operating divisions, some of which could be small and could have fewer than 50 employees in the plan. These companies are going to have to merge plans in order to pass this Minimum Coverage Test.

Also, the eligibility rules have been modified under Tax Reform. There was an old three-year rule that allowed employers to keep people out of a plan for three years if, when they finally came into the plan, they would be 100% vested. Now, this has been changed so that the maximum wait is two years. It also says that the two-year rule is not applicable to a 401(k) plan.

Tax reform also bring us new vesting rules. Ten-year cliff vesting is going to be replaced by five-year cliff vesting, and if instead you choose to have a plan with graded vesting, the plan must vest people at least as quickly as the three-to-seven-year rule included in the Tax Reform Statute. Here there is a vesting percentage increasing of 20% per year. Tax Reform does eliminate class-year vesting, and this is going to have an impact on many defined contribution plans using a class-year schedule.

Tax Reform modifies our Social Security integration rules. We all know that working with today's rules is very difficult. When we first saw the Senate Proposal on Tax Reform, I think we all breathed a sigh of relief that the Senate Proposal was going to take a much simpler approach to integration. However, by the time the bill made it to the Conference Committee, I think the Committee must have gotten cold feet.

Tax Reform gives us new integration rules. We had hoped they would be simpler, but I don't believe they are simpler in any way, shape or form. We do not have ancillary benefits to take into account any more when we establish our integration limits, but under these new rules, *every* integrated plan is going to have to be reviewed to make sure that it meets the new tests. Offset plans no longer have to come up with an actual calculation of Social Security benefits, but the IRS is using a concept called "Permitted Disparity in Benefits." This is something we're going to have to look at more closely. We no longer have to calculate a good estimate of Social Security. We do know that the act clearly eliminates excess plans, but the statute appears to have errors in the integration section, and I really think we are going to have to wait for corrections before we go into too much depth on integration.

Tax Reform has modified the 401(k) Deferral Test and added a new deferral test. Recall, in the 401(k) Deferral Test, we are going to operate with a new uniform definition of who is highly paid. I think this is going to be a smaller group than the old one-third/two-thirds group.

After Tax Reform, the average salary deferral by the highly paid cannot exceed 125% of the average deferral by the lower paid, or 200% of the average deferral by the lower paid as long as there is a 2% or less spread between the deferral percentages. This should sound familiar because under the old rules, the 125% was 150%; the 200% was 250%; and there was a 3% maximum spread, so they just really tightened up the deferral test. But because we're using the new definition of who is highly paid, you may have some people who have been in the highly paid drop down into the lower paid, and the test is not necessarily going to be more difficult to pass.

Now in addition, Tax Reform has added a new test. You have to pass the deferral test with pre-tax deferrals, but then the new test will have to be passed again when you add after-tax employee contributions and any employer-matching contributions.

With respect to the benefit and contribution limitations, there are several things to be considered. First, after 1989, Tax Reform prohibits you from considering anything more than $200,000 of pay for any person in a qualified plan. You should note that this $200,000 limit is going to come into play in the 401(k) Deferral Plan.

Also, Tax Reform has added a $7,000 limit on 401(k) salary deferrals. For those of you who have been watching development of Tax Reform, you might have noticed that there was going to be an additional $2,500 deferral permissible for a deferral in an Employee Stock Ownership Plan. This provision did not make it into the final Bill.

Tax Reform has also modified the section 415 limits. The $30,000 and the $90,000 limits have been retained with the $30,000 for defined contribution limits, and the $90,000 for the defined benefit limits. These limits will be indexed with the consumer price index (CPI), with the exception that the $30,000 limit is not going to begin to escalate with inflation until the $90,000 limit reaches $120,000. The intent here is to have a four-to-one ratio between the defined benefit and the defined contribution limits.

Another change to the defined benefit limit is that the $90,000 limit is going to be tied to the employee's Social Security normal retirement age. The Social Security normal retirement age for anybody born before 1938 is still 65, but as you know, it's slowly going to escalate up to age 67.

And another very important change to the defined benefit limit, in addition to the fact that the $90,000 is tied to the Social Security normal retirement age, is that the $75,000 floor in the defined benefit limit which used to be there for retirement after age 55 has been eliminated. We think this is going to have a large impact for most employers, increasing the use of excess plans. I think this is going to generally impact the way companies provide open window early retirement because not as much of the early retirement benefit will be allowed to be provided through the qualified plan.

In addition to the delaying the indexing of the $30,000 contribution limit, the definition of the annual addition to an employee's account has been changed so that it includes all contributions, including all employee contributions. We used to be able to exclude the first 6%. Now all contributions will be included when going up against the defined contribution limit.

Now with this tightening up of the 415 limits, we had hoped that the 415 combined limits would be eliminated. However, Tax Reform has retained combined limits.

Finally, there is a peculiar provision in Tax Reform that says the section 415 limits would be phased in over ten years of participation for either abusive plans or abusive plan amendments. While the statute doesn't give us any direction of how to define "abusive," presumably, we're going to know it when we see it.

Tax Reform has also modified the rules governing taxation of distributions. After Tax Reform, taxes on distributions from qualified plans may be higher. Tax Reform is going to change the tax treatment for qualifying lump sums. Five-year forward averaging is going to replace ten-year forward averaging. Capital gains treatment for the pre-1974 portion of a lump sum is going to be eliminated, and lump sum tax treatment is only going to be available once and only after age 59 1/2. There is a grandfather provision for employees who take lump sums who were at least age 50 on January 1, 1986. We think that the effect of this change in lump sum tax treatment will generally increase the amount of tax paid by the individuals on smaller lump sums and will only decrease the amount on very large lump sums.

The taxation of distributions involving an employee's after-tax contribution to a qualified plan is also going to change. At retirement, we have had what we call the three-year rule. If an employee's contributions were less than three years of benefit payments, his distributions were assumed to be tax-free until an amount equal to his after-tax contributions was paid back to him. That treatment is eliminated, and a portion of each part of his withdrawal is going to be taxed as if the three-year rule did not apply.

Tax Reform has also added an excise tax to what it considers excess distributions from tax-preferred plans. A 15% excise tax is going to apply to the portion of an employee's distribution in any year in excess of $112,500. This dollar limit is going to be indexed with the CPI. There is a special limit that applies to lump sums, and it's currently at $562,500. This limit is also going to be indexed. The important thing to remember about this 15% excise tax is that it is going to apply to distributions from all tax deferred plans, and that's going to include distributions from IRAs. I think it's going to be very difficult for the individual to calculate what his excess distributions are. Now, there is a grandfather provision for this portion of the law. Excess accruals earned by August 1, 1986 are going to be grandfathered. I think this grandfather is going to have very limited applicability because you would have to have an account balance or a present value of accrued benefits of over the $562,500 for this grandfather to apply.

Regarding distributions before retirement, if an employee chooses to take an early distribution from a qualified plan, and if he's withdrawing part of his after-tax employee contributions under current law, the first thing to come out is his employee after-tax contribution. Now after Tax Reform, this isn't going to be the case. A pro-rata portion of each withdrawal is going to be assumed to be taxable. Again, the law provides a grandfather here. After-tax contributions made before 1987 are always going to be assumed taken out first. So, there's really a mixed bag of grandfather rules which I find very difficult to follow in all the distribution rules.

In addition, access to funds accumulating in qualified plans is going to be further restricted. If you have a Capital Accumulations Plan, Tax Reform wants you to make it a Retirement Plan. Tax reform will not offer any incentives for you to save in a qualified plan for any reason other than retirement.

Hardship withdrawals from 401(k) plans are going to be limited to an employee's pre-tax contributions. Earnings on an employee's pre-tax contributions cannot be withdrawn. This provision is going to be in effect in 1989.

A 10% excise tax is going to be imposed on any withdrawals made before age 59 1/2, in addition to the regular income tax that applies. There are a several exceptions, some of which include that the excise tax won't be applied to retirement distributions as long as you're over 55 and as long as the distribution is in the form of a pension; or, an excise tax won't apply if you're making a withdrawal to pay catastrophic medical expenses. Those would be deductible on an individual's income tax. No income tax is going to be applied to people who terminate in 1986 but don't receive the distribution from the plan until 1987, as long as that distribution is made before March 16, 1987. No excise tax is applicable to distributions made from an employee stock ownership plan as long as that distribution is made before 1990.

My final comments regarding Tax Reform are directed to employee stock ownership plans. Tax Reform has really continued the trend of the past few years, to expand the role for Employee Stock Ownership Plans (ESOPs) despite the fact that Tax Reform discontinues the Payroll Stock Ownership Plan (PAYSOP) provision one year before current law would have. There are a number of changes in Tax Reform which encourage the formation of ESOPs. The 1984 Deficit Reduction Tax Act introduced a provision that allowed a company to deduct dividends paid to employees through an ESOP. Now, Tax Reform extends this provision so that the company may take a tax deduction if dividends contributed to the plan are used to help pay off a loan in a leveraged ESOP. A leveraged ESOP is a plan which borrows the money to buy company stock that it holds. Also as I just mentioned, Tax Reform levies no excise tax on distributions made from the ESOP before 1990. The 1990 sunset provision was put in at the House's insistence. Tax Reform concessions to ESOPs really represent a continuing Senate commitment to ESOPs, and we're sure that the 1990 date will be subject to House and Senate action before it expires.

DEFRA also permitted a bank to exclude from its own income 50% of the interest that it receives from loans to leveraged ESOPs. As a result, an ESOP could obtain financing at about 80% of what was available. Now, Tax Reform has expanded this preferred tax treatment to income from loans which have been refinanced by the ESOP and to income from loans which have been provided by other regulated financial institutions.

Tax Reform has really provided companies with a more flexible financing tool when they use an ESOP. This is the result of the partial waiver on the interest income beyond banks to regulated financial investment companies. We may see leveraged ESOPs financed by commercial paper or by other instruments besides a bank loan.

Finally, Tax Reform has provided an advantageous way of recovering surplus assets from a terminated defined benefit plan. Ordinarily, a surplus recaptured from a defined benefit plan is taxable, and a 10% excise tax is tacked on. Both the income tax and the excise tax are waived if the surplus is deposited in an ESOP before January 1, 1989. The employer can then take up to seven years to distribute the stock purchased with this surplus transfer. But, of course, the surplus transfer still requires the termination of the defined benefit plan.

MR. RICHARD T. TANI: I am going to talk about cash balance pension plans. In our firm we call them Individual Account Pension Plans; in Marcia's firm they are called "PERCS," or Pension Equity Retirement Credit Plans. There are a lot of names that people have been calling this type of plan.

Exactly what is this type of plan? It is a defined benefit plan that looks like a defined contribution plan. It looks like a defined contribution plan because each participant in the plan has an individual account, and annually contributions are credited to the account. They are based on pay usually, and each year, the account grows with interest. So, from a participant's standpoint, it looks just like a defined contribution plan.

One major difference in these type of plans is that the interest credited in these plans is specified in the plan document. It's usually geared to a T-Bill rate, prime rate, or inflation rate. This means that the employer takes the investment risk. In a lot of situations, that's what the employer wants; the employer wants to take the risk so that it can use a much more aggressive investment policy to reduce plan costs. Generally speaking, in defined contribution plans where employees are given the option of investing the money; they choose very risk-free investments.

The cash balance or individual account pension plan does have a lot of the flexibility of the defined benefit pension plan. For example, you can put early retirement supplements into this type of plan, or even an early retirement window. This would be very difficult to do in a true defined contribution plan. Past service increases can also be given. Also, minimum benefit provisions can be included in the plan. This is often done to provide a grandfather from a previous defined benefit formula.

The Individual Account Pension Plan is a defined benefit plan, and I'd like to spend most of my talk discussing some of the technical issues to be addressed. This plan looks like a defined contribution plan with defined benefit plan rules.

First, I'd like to describe an indexed annuity which is a key part of the cash balance pension plan. The Bank of America is probably the most well known plan of this type, and in that plan the indexed annuity is the normal form of benefit. To convert an account balance to an accrued benefit under this type of plan, you divide the account balance by a fixed number to get the indexed annuity. In the Bank of America plan, for example, you divide by 18 1/3, which is described as the life expectancy at normal retirement age. So, really, what you're doing is dividing by life expectancy; you have an annuity value which is based on 0% interest.

There is no interest discount, either pre-retirement or post-retirement. However, interest is credited to the account annually. As the account balance grows, your annuity grows. The annuity increases every year before retirement and after retirement. What we're talking about is a variable annuity. Under the Bank of America plan, the increase to the retirees is the same as the interest credit given to active employees. I believe it would be better to use a conversion factor which includes a 2 to 3% discount after retirement, and then, the post-retirement increase would be geared just to the CPI increase. The advantages of this would be that you would get larger benefits to start out with when you retire, and the increases would be geared to the retiree's needs. The 2 or 3% interest factor reflects a conservative real rate of return which could be expected to be earned.

I would also like to add another side issue. When I counsel someone who has to make a decision between a lump sum and an annuity, I explain that if you take the lump sum, you must assume that you are going to live forever, and that you have to live on just the income from the lump sum. If you start eating into the principal on the lump sum, there's a chance you are going to run out of money. Generally, it means that if you take a lump sum and spend the income on it, you are going to be able to spend about 20% less than you would receive as an annuity. Another way of saying that is if you are willing to give up death benefits, the principal part of the lump sum, you can increase your retirement income by 20% or 25%. You have a choice between a lump sum and an indexed annuity. An indexed annuity provides inflation protection. In other words, if you take the lump sum and say, "If I'm going to have to live on this, I'm going to have to budget my money so that I can get an increase to cover inflation increases every year," you can compare that with an indexed annuity -- with which you get about 50% more income you can spend every year. I feel that some of the studies we have done agree that the indexed annuity, which pool the risks of both mortality and inflation, can fill a very important social need because it counters inflation.

There are several IRS issues that have to be addressed when you design this type of plan. One is the benefit accrual rule of the defined benefit plan. A defined benefit plan needs to meet at least two benefit accrual rules. One is that benefits cannot be decreased and also the rate of benefit accruals cannot be backloaded more than a certain amount.

If you convert account balances to just a plain fixed deferred annuity, it may be possible for someone's accrued benefit to actually decrease. This could occur, for example, if the rate of interest credited to an account was less than the discount rate used for conversion. For example, if you are only crediting 7% to an account, it is possible for somebody's accrued benefits to go down if you are converting annuities using a 9% discount rate.

Since the account balance and hence, the indexed annuity, increases geometrically, how do you justify no backloading? One argument is that interest credits are either inflation adjustments or just past service increases, so they need not be taken into account. An argument for this is that a terminated vested employee still receives the interest credit until his account is paid out. In other words, it is not really part of his benefit accruals; he is getting this interest credit just like somebody who is working.

Another issue is integration. The Bank of America plan provides contributions of 5% of pay over one-eighth of the wage base. Under the new tax bill, this would not meet the "one under-two over" integration rule. This is easily solved by adding 2.5% of pay up to one-eighth of the wage base; having 2.5% under and 5% over.

However, another requirement under the new tax bill is that the difference in accrual rates above and below the integration level cannot exceed 3/4% of pay per year. If the contribution spread is 4% of pay (you might have 4% of pay up to a certain level, and 8% of pay above that level) and if you have a conversion factor of 16 (which you divide your account balance to get your accrued benefit), the benefit on the spread is only .25% of pay. In other words, you take 4% of excess contribution, divide it by 16 to get .25% of excess pay as the benefit you are earning that year. That would meet the .75% test. In fact, you can go up to 12% of pay under that kind of scenario. This is kind of interesting because under the defined contribution plan, the maximum spread is 5.7% and next year it will be 6%.

The integration rules provide that increases based on a recognized cost of living index (pre- and post-retirement) do not affect the integration. However, if you provide interest credits above the rate of inflation, the cumulative effect must be watched so that the integration requirements will still be met. This is one of the arguments that I've used to limit the post-retirement increases at least to the rate of inflation. Otherwise, ten years after somebody's retired, you might hit this integration limitation.

Some people argue that you might be all right if you meet the defined contribution integration rules, in other words, the spread can't be more than 6% of pay. That's fine if you can convince the IRS of this, but until the IRS issues rules on this, you should be prepared to use defined benefit plan rules.

In regard to Section 415 limits, can you provide an indexed annuity of $90,000, or more importantly, can you pay a lump sum equivalent of an indexed $90,000 pension? I believe you can pay a pension which does not exceed the annual limit each year. However, if you're going to pay a lump sum, it must be the actuarial equivalent of the $90,000 pension (adjusted for age). This means that a participant under a plan like this could receive his full benefit if he takes it as an indexed annuity, but it may be cut back if he takes a lump sum or a level annuity. Note that because it is a defined benefit plan, you are not restricted by the annual defined contribution addition. In another words, the contribution credits on somebody's account could exceed the $30,000 limit because it is a defined benefit plan.

In drafting a plan, you have to write in the top-heavy minimums even though the plan may not ever be top-heavy. Top-heavy minimums really don't work very well in this type of plan. I think it would be best to write this as a separate minimum benefit rather than try to incorporate it into the account balance.

Again, some people say you might be able to use the defined contribution minimum, which is the contribution of x% of pay. I think if you are trying to qualify as a defined benefit plan, you have to use the defined benefit plan rules.

I've worked on one client who is in the process of developing conversion factors. Setting conversion factors will depend on whether the employer wants to encourage or discourage certain forms of benefits or encourage or discourage early retirement. In other words, you can make one form of benefit more attractive than another one by the conversion factors. There are a couple of points to remember. The factors for joint and survivor annuities and other forms may be different for indexed versus level annuities. Generally speaking, there is a greater reduction for optional forms under an indexed annuity since death benefits are more valuable. Conversely, adjustments for early retirement are much less under an indexed annuity. Note that this may affect your integration rules.

Another issue in these conversion factors is that you have to comply with the IRS limit on maximum interest rates for converting pensions to lump sums. Since this is a defined benefit plan, the normal form of benefit is a joint and survivor pension and the lump sum is just an option. Really under the plan, you're converting a lump sum into a pension. But you have to make sure that the IRS looks at the reverse. It needs to see that the pension is the normal form, the lump sum is the option. You have to make sure that you meet the conversion factor rules and that you are not using interest rates greater than permitted.

One of the first things a client will ask about this plan is what it costs. And because we have new FASB rules, we have to try to figure out how to calculate the pension expense under such a plan under the FASB rules.

Since this is a somewhat unusual type of plan, I feel that I can argue with an auditing firm that the plan requires special treatment, and I have developed my own FASB 87 cash balance pension plan rules that are really based on common sense. My formula is that the PBO equals the ABO which equals the sum of the account balances at any point in time; that the service cost is the contribution credits for a year less expected forfeitures for that year (you will be in balance with your PBO); that interest cost under FASB is just the interest credited to accounts in that year, and that if you have a supplemental or other minimum benefit in the plan, it should be valued like a floor plan.

Funding methods and assumptions also need to be reviewed carefully. If the expected return on assets is higher than the expected rate credited to the accounts, you will generally find that under most pension cost methods, the accrued liability will be less than the sum of the account balance. In other words, you are projecting these account balances, at say, 7% interest, and discounting it back at 9% interest. You get something smaller than what you started with. This means you can hit the full funding limitation before assets equal the termination liability of the plan. To counter this, you have to be careful to use assumptions that are conservative enough so that your accrued liability will at least equal the sum of the account balances.

How do you terminate one of these types of plans? Terminations have to buy annuities, and the normal form of annuity in this plan is the indexed annuity. I don't know of any insurance company that currently sells indexed annuities. If you adopt this type of plan, you may be stuck without being able to terminate.

I have talked about the interest rate several times. However, I would like to review some of the issues that revolve around choosing the interest rates for the plans. One of the first things you have to worry about is that you don't use too low a rate because employees will feel like they are being ripped off. There has to be a higher kind of rate so that the employees feel that it is a reasonable rate of return. The employer generally wants as low an interest rate as possible because the interest rate definitely affects the plan costs. I feel that, as under the Bank of America plan, the interest rate used for the actives is the same for retirees, and as I mentioned before, you can use a different adjustment factor for retirees and actives.

Also, if you're going to use a high interest rate, you have to be careful about the integration rules and possibly the benefit accrual rules.

In conclusion, the question that always comes up is, "Is this a gimmick or is this something that's going to stay?" I really feel that after working with this type of plan for a while, I think it will stay. I think that there are some real pluses in this type of plan. Obviously, it's not going to be for everyone, but it will be a perfect fit for employers which think that their employees want the defined contribution plan but the employer wants the flexibility and the control of a defined benefit plan.

MR. ROGER C. SISKE: Clients really don't like this form of Tax Reform amendment that we are discussing. Very little of it can be justified from the client's perspective, and even if it could, my clients say, "Give us the rules and then leave them alone; don't change them. So let us design our plans, let us communicate them, and then let us turn back to running our businesses. We don't want to spend as much time on employee benefits plans!"

With that in mind, a little closer review of some of the changes is in order. First in the 401(k) area, as noted earlier, there is a $7,000 per person per year 401(k) contribution limit starting January of 1987. Now, this limit is not based on a single employer's plan or all the plans of a controlled group. It involves an aggregation of all 401(k) participation by an individual with all employers. So, if a person has two totally independent jobs with two totally independent businesses, one $7,000 limit applies.

Second, there is a one-time escape hatch -- a transitional rule, if you will -- that your clients ought to know about because this rule is going to be fairly strict. With regard to 1987 contributions which relate to 1986 services, there is an opportunity to exclude them from the $7,000 limit. So, for example, your clients may have people who have bonuses accrued which are going to get deferred into a 401(k) plan. This is for 1986 services. If their employees, before January 1, 1987, elect the special rule, and the plan provides special identification of this 1986 bonus amount, which isn't contributed until 1987, the amount will not count against the $7,000 limit in 1987.

These new $7,000 restriction rules have real teeth in them. Two sets of penalties exist. The first penalty set is on the employee; if the employee exceeds the limit, the contributed amounts will not be pre-tax, but rather after-tax. And if he pulls the money out after April 15 of the year following, the employee will not only be taxed for the year of the deferral, but he is taxed when he is required to take the money back at ordinary income rates. Then, if he's under 59 1/2, he'll pay a penalty tax for taking a premature distribution. In addition, the employer will pay a penalty. If the employer doesn't get this money back to the employee by the end of the year following the year of the deferral, the employer will pay a 10% excise tax for having excessive contributions in the plan.

There are tougher discrimination rules as noted; the old one-third/two-thirds rule, that is, comparing the highest one-third to the lowest two-thirds, will be tougher in two respects. First, as indicated, you may be comparing the top 10 or 15% with the bottom 85 or 90%. Specifically, instead of one-third and two-thirds, it's a comparison of highly compensated people with everybody else. The highly compensated consist of 5% owners; anybody earning more than $75,000 per year, any officer earning more than 1 1/2 times the defined contribution dollar limit (that is, $45,000 a year); or anybody in a so-called top-paid group which is anybody who earns more than $50,000 a year and who is in the highest paid 20% of the employees of this particular employer.

The one that will govern most groups is the so-called top-paid group, and basically, it will be governed by people earning more than $50,000 a year or the highest 20%. If the highest 20% is at $50,000 or more, it will be the highest 20%. If the highest 20% cuts at a different point, that is, below $50,000 a year, then it will be a percentage smaller than 20%.

So, first of all, we have a smaller, more select group, for the high paid purposes of these non-discrimination rules. Second, we have tougher non-discrimination rules. Instead of the 1 and 1/2 times rule, we have a 1 and 1/4 rule. Instead of the 2 and 1/2 times, 3% spread, a two times 2% spread is used. Much stricter rules, and tighter groups exist, in most cases making it tougher for the plan to meet these rules. The plan has to meet these rules or distribute the excess. Again, if a plan doesn't distribute the excess, all of the various penalty taxes will become applicable.

401(k) loans become stricter. There were some questions raised by various people with the IRS and the Department of Labor as to whether 401(k) accounts could be used as security for loans with tax-deductible interest. Tax Reform answers the question: You can have the loan, but if you do, the interest isn't tax-deductible; it's treated as an employee contribution which is added to the employee's basis. When the employee withdraws money ultimately, an amount equal to his non-deductible interest will eventually come back on a non-taxable basis.

There are a few areas of liberalization -- they are few and far between. One of the problems that many of us experience -- when a client sold a division or sold a subsidiary -- was what to do with the 401(k) contribution accounts attributable to the employees who were sold. An easy answer was to spin off a piece of the plan and have the buyer adopt it. Some buyers didn't want to do that. The problem, then, was what to do with the accounts. It was illegal under pre-Tax Reform law to just make a distribution because distributions couldn't be made until an employee had a separation of service, and there is a long line of cases in the lump-sum taxation area that said, if you changed employers but had the same job, it wasn't a separation of service -- so no distribution was allowed. The selling employer had to maintain these accounts with a massive recordkeeping problem until these employees left their new employer. These types of distributions on sales are now permitted.

Coordination of 401(k) plans with other plans becomes either more difficult or prohibitive. No benefits or contributions may be conditioned on 401(k) elective contributions except employer matching contributions.

Plans that say you don't become eligible for the profit sharing contribution unless you participate in the 401(k), unless they're done on a matching basis, are no longer permitted.

The ESOP area was substantially liberalized in some areas but not that liberalized in others. One of the changes will affect those of you who have privately held clients, and for that matter, large corporations with large single shareholders. There's going to be a fundamental change in the planning in this area. We have Tax Reform designed to try to simplify the rules and certainly to be revenue neutral, not to open new loopholes. And yet, a major ESOP loophole was opened.

A 50% federal estate tax exclusion is offered in conjunction with ESOPs. If an individual dies owning a lot of stock in a corporation and if the individual's estate sells that stock to an ESOP, half of the proceeds are excluded from the individual's taxable estate. Take an example of somebody who has ten million dollars of stock in a publicly held or privately held company. Today, he can escape estate taxation by leaving that stock to his wife, but if she's roughly the same age, and he lived a normal life, she'll die soon and estate taxes will soon after be paid. There is no way of getting it to the children or grand-children without paying substantial estate taxes. Estate taxes start at about 50% and go up rapidly.

Under these new rules, if an individual has his company set up an ESOP and after his death, the stock is sold to the ESOP, half of his estate can be passed on to his children without taxation. I'd suggest that for many of your clients, public or private, this will almost become an automatic consideration in benefit planning. It will also lead to some interesting potential complications with their pension plans in terms of how to pay for this, because after all, selling it to ESOP is just the start. Somewhere the money has to come to the ESOP to pay for it. And generally, companies don't want to increase wages and benefits. The problem becomes getting it elsewhere, substituting it for another plan benefit. One of the ways used in the past was the floor offset arrangement that I alluded to a little earlier. That is, you've got a pension plan, a normal pension plan, something like 50% of pay after 30 years of service, maybe with a social security offset. How can you use that to pay for the ESOP to purchase some stock? Well, one way is just to terminate the pension plan and use the contributions, but that usually causes a lot of unhappiness to the employees. Another way used is flipping a coin -- "heads" the employees win, and "tails" the company loses. That is, you can't get less but you might get more. Now, everybody wants something for nothing and that's why it works.

This is the sort of approach that says we guarantee the pension you were always promised. We're also putting in a new ESOP. If the ESOP is as good as or better than the pension we promised to you, when you retire you just get the ESOP; otherwise, a pension plan will make up the difference. The ESOP is your pension. And so, for example, a person entitled to 50% of pay who earned $2,000 a month, has $1,000 a month pension at 65. Maybe that's got a lump-sum value of $100,000. If this ESOP value is $100,000 at 65 -- his pension is zero. If the ESOP is worth $80,000, the guarantee of $100,000 has the pension plan pay the remaining $20,000 or $200 a month. And so, the employee is assured of his pension and yet he gets his ESOP. What actually happens in funding is that the actuary says, well, the contributions to ESOP are 10% of pay, and we expect the company stock to go up 12% a year. If that happens, it will fund mostly all the benefits, so the contribution level is maybe 1% of pay into the pension plan.

Now, what could be wrong with that? After all, everybody wins and if the company stock value doesn't go up rapidly enough, well, everybody is protected anyway, and of course, we have the PBGC standing behind the pension commitment. Well, that's part of the problem.

First of all, for those of you who have thought about it before or who have just started thinking about it now, this plan is a highly leveraged -- highly risky -- arrangement. It's as though the entire pension portfolio were invested in a single stock of a single company. Worse, that company's responsible for funding the pension. The events which produce a decline in the stock value, that is, which cause the ESOP to be worth less than you hoped, are events that suggest that the company is doing badly.

When the stock goes down, there will be actuarial losses. Those actuarial losses will eventually have to be made up in increased pension contributions. Pension contributions will increase at the very time that the employer can afford them the least. And, by the way, the ESOP leverage loan contributions have to continue during the same period of time. So, this is one of those arrangements that promises a lot, but it only has the employer standing behind it. If the employer can't deliver, the pension plan is deficient and it gets terminated.

You might be interested in what the agencies reactions to this are. There is no formal authoritative pronouncement, statute, or regulation that prohibits this. There was about eight years ago, a notice of intent to propose regulations, in which the Department of Labor said that this type of arrangement would be illegal because it allows the pension plan to hold more than 10% of plan assets in employer securities. That is, the Department of Labor aggregated the two and treated them as one plan. It withdrew this because there wasn't authority, it felt, under ERISA to say this.

Recently, as more and more large publicly held companies have started to have leveraged buy-outs, often with ESOPs, structured with a floor pension offset arrangement, the agencies have started to worry because these are no longer small privately held companies with modest liabilities, but substantial companies with hundreds of millions of dollars in pension liabilities.

The IRS, the Department of Labor and the Pension Benefit Guaranty Corporation have each separately formed task forces to study the problem, and while none have in an official pronouncement said that the arrangement is illegal, they've essentially said that they will either find a way to make it illegal or they will ask for legislation to make it illegal because it passes too much risk off on the PBGC; it circumvents a lot of the intentions of ERISA. Whether they succeed or not may in part, depend on how much longer Senator Long, who instituted this Tax Reform, and his followers are around, because after all, they are an important component of the ESOP area.

A number of other areas dealing with ESOPs need to be discussed. First of all, there is a continuation of a pre-Tax Reform rule that allowed tax-free sales by a shareholder to an ESOP. If a shareholder or a group of shareholders sold stock to an ESOP (and they did nothing that could qualify for capital long-term gains treatment, which, of course, after Tax Reform, is ordinary income tax treatment because capital gains are taxed the same way), the tax-free rollover rules indicated that if the selling shareholder took the sales proceeds and bought common stock or bonds of a domestic company that was an operating company, there was no requirement of recognition of gains, at least not until the securities purchased on reinvestment were ultimately sold. While it was proposed that this be cancelled, it was continued.

For banks and financial institutions, savings and loans and the like, half of the interest is tax-exempt to the financial institution, and these were commonly syndicated. The whole thrust of Tax Reform is to get rid of these types of preferences or to narrow them. Instead, they were expanded. They can be expanded to regulated investment companies -- that means mutual funds. In effect, this tax-exempt interest can be offered to the public. Any investment advisor can put together a mutual fund and buy up the ESOP notes and the ESOP notes produce 50% tax-exempt interest that can be passed through to the common shareholder.

Further, the types of ESOPs that can do this are expanded. The type that used to be able to do it was the so-called leverage ESOP that borrowed money and bought stock, had no money, had nothing before the transaction, put the stock in a collateral or suspense account, paid off the loan over a period of years with employer contributions, and as the loan repaid, allocated the stock to participants' accounts. Now, under Tax Reform, non-leveraged ESOPs will be allowed to do tax-exempt financing. The way that works is, the money gets borrowed, the contribution is made currently, that is, in stock within 30 days of the loan, and the stock needs to be allocated in full within a year after the loan. The employer can, at tax-exempt rates, take up to 7 years to pay off the loan.

Privately held companies get some bad news; at least those that were fairly aggressive. Starting with stock purchases in 1987 and later years, independent appraisers that are qualified, have to do the appraisals.

Moreover, ESOPs can't be ESOPs forever. There is a diversification requirement. If you tie up all of a person's retirement in an ESOP, particularly when he gets close to retirement, even if it's a good company, it could have a temporary down period. It was decided to let him have an opportunity to get out of the investment -- at least partially -- and diversify. And so, ESOPs, at least with regard to stock acquisitions after 1986, will have to offer a diversification opportunity to ESOP participants.

When an individual is at least age 55 and has participated in the ESOP for at least 10 years, he will have a right to elect diversification for 25% of his account. And within 5 years later, 50% of his account. Diversification means you've got to give him a payout including the right to cash, or you have to offer him three broad investment alternatives, which might be, for example, like a defined contribution set of choices -- stocks, bonds or GIC, for example. Now, this is required as a qualification pre-condition for ESOPs.

A number of ESOPs were maintained in a way that one could continually control the corporation, and the employees really got very little ownership control; all they got was the appraised value incremental increases. In many cases, ESOPs delayed distribution until the person became 65 which might be 20 years later. There are now stricter rules on distributions. For death, disability and normal retirement, distributions have to be out within a year. For other terminations, distribution must be within 5 years. This cuts back the degree of control management can assert through an ESOP. One important exception, though, is that stock acquired with a loan to an ESOP which hasn't been repaid yet, isn't subject to these payout obligations.

There is an erosion of employees' rights in ESOPs. ESOP stocks always had to be voting with common stock, at least until Tax Reform. At the last minute, non-voting stock was permitted under Tax Reform. If there is a class of non-voting common stock which has been outstanding at least 24 months, before the ESOP acquires it, it will be a permissible holding for a leveraged or non-leveraged ESOP.

Additionally, in the area of ESOP stock for privately held companies, there is always an obligation that there be a put option to employees, that is, the employee had a right to get a distribution of stock, and for a two-year period after he got the distribution, he had the right to put it to the company and receive the appraised fair market value of the stock. This rule didn't apply to stockholders' plans which are much like ESOPs. They had to distribute stock to the employee, and the employee might have been stuck with unmarketable stock of a privately held company. Starting with stock acquisitions after 1986, the put option applies to the ESOP stock.

On balance, when one assesses the changes to 401(k) and ESOPs, the general theme of Tax Reform is there. There is generally a narrowing, generally tougher non-discrimination rules, generally more participant protections, and yet there there is a noticeable contra theme in the ESOP area. When you review it, you can't help but notice and perhaps conclude, how it got there.

MR. ROBERT L. PAWELKO: We've talked about three different topics -- ESOPs, cash balance plans and the Tax Reform Bill. Let's see if we can weave them together.

First of all, one of the comments posed was, "Are defined benefit plans dead?" I really don't think so. I don't think Tax Reform is going to kill them, but it will give us a lot more work to do for a while.

It's going to take us some time to learn all of the implications of this, but I don't see it as necessarily changing the defined benefit pension plan. In fact, my own personal feeling is that the defined benefit plan will pick up a little bit more steam.

The demographics of our society right now are such that all the Yuppies are going to start realizing that defined benefit plans have a lot of power, a lot more than defined contribution plans, particularly if you job-hop a little bit and don't have a lot of accumulated balances, or if you happen to hit a bad year. Not too long ago we experienced 1973 and 1974 when the stock market went down 50%. When you have a defined contribution plan that crashes down to 50% of its value, and you're 45 or 50 years old, you start thinking that those defined benefit plans don't look so bad after all. I don't see defined benefit plans caving in at all; in fact, I see a lot of interest coming back. I don't see companies running away from them. I agree with Roger's comment that most companies are very upset with changing things all the time and that if anything is going to kill them, it will be the constant legislation. They might as well give everybody cash and tell them to go save for their own retirement. But for those of us who spend our paychecks faster than we get them, that doesn't work. As soon as we get up to retirement, we realize we don't have any money. Again, I don't see pension plans ever dying; I see us always having defined benefit pension plans. Regardless of whether a company has a large tax deduction or a smaller one, companies will continue providing pensions.

Regarding the issue of retirement plan design, we didn't talk about some of the items we assume you already know. People will still need a certain percentage of their pre-retirement income to live on after retirement. The ratio typically ranges from 70% down to 50%, from the low paid to the high paid people. When you strip out the social security benefit, the pension plan has to provide from 50% of pay for the high-paid person down to maybe 20% for the low-paid person. Something still has to provide the money that a person needs to live on to maintain his standard of living.

The percentages might change after Tax Reform, but the dollars aren't going to change. People are going to live, and they are going to need those dollars. Although the tax rates have changed a little bit and the definition of income has changed a little bit, there is still a core underneath -- the requirement of specific benefit needs isn't going to change.

What I really see happening with Tax Reform is that actuaries and attorneys are going to have a lot of work to do for four or five years. A very large number of companies are going to be saying they redesigned plans and relooked at them philosophically. But when we look back five years from now, there aren't going to be that many fundamental changes to the plan. Now, that's me speaking, not necessarily everybody else. I'd like to hear some thoughts on this.

MR. DWIGHT K. BARTLETT, III: I speak from a peculiar perspective because our company does business only with not-for-profit, primarily social service agencies that are all tax-exempt. We're expecting a real explosion of non-qualified top-hat defined benefit plans to, in effect, get around the section 415 limit, and given our peculiar market, of course, the loss of the tax deduction to the employer is of no significance. But we do continue to recommend to our clients the maintenance of their defined benefit plan, and by and large, they will continue to maintain their plans, and more and more of them will adopt the non-qualified top-hat defined benefit plan. I wonder if you think we might see the same thing in the for-profit community?

MR. SISKE: That's an interesting problem. It's clear that with excess plans, that is, plans providing benefits over the 415 limits, most major public companies have them, and a greater proportion of benefits for a lot more people are going into them. In fact, in some companies, the liabilities will be quite substantial. There are hidden costs in them, too, you might note, in the sense that the employer implicitly is accruing interest and isn't getting a current deduction. And so, if the employer credits interest at, for example, the amount of money or the rate of its return -- its internal rate of return -- it's paying on its internal rate of return. Since there is no deduction, the accumulation to pay this is an after-tax rate that most companies credit pre-tax to these things as a hidden cost. In some top-hat plans, so-called supplemental executive retirement plans (SERPS), there are a number of problems with them that haven't been fully solved.

First of all, you have an ERISA Title 1 problem or two. Plans that are not governed by the qualified plan rules (the ERISA pension rules which require that a plan be funded, and that it have assets set aside in the trust in the same fashion that the qualified plan funding rules do) are a general exception which is a bit slippery, at least to define. It is an exception for plans *primarily for a select group of highly compensated or management employees.* And nobody knows exactly what "primarily for a select group of high compensated or management employees" means. A few rulings that are out are private, and the agencies say not to rely on them because they are unique facts. The purpose of the exception in ERISA was, if you have people that are paid highly enough or that are senior enough in management to protect themselves by directly negotiating with the company, they don't need ERISA's funding protections. If they're not that high, they do.

Well, if they really mean that, there are very few people within a company that can really effectively, one-on-one, negotiate their own protections. I suspect that eventual interpretations won't cut that high, but there will be a fair number of people in the middle or upper-middle management or lower-senior management who may not meet this rule and who will need additional benefits and who won't be able to be covered by supplemental plans. If the supplemental plan covers them, then it will have to be funded and vested, and if a person's benefits are funded and vested in a non-qualified plan, they are immediately taxable. And by the way, if they are funded and it's not an individual account plan, the employer never gets a tax deduction.

So, there are some problems there; one could fall outside the rules quite unintentionally. There is another problem for companies. About 8 years ago, the IRS proposed to change the rules about taxation for non-qualified plans. It effectively wanted to do away with many of the rules that allowed deferrals to people under non-qualified plans. And it got to the point of proposing regulations under Section 61 of the Internal Revenue Code.

In the 1978 Tax Reform Act, Congress prohibited changes in these rules, but the prohibition only applied to taxable entities, not to tax-exempt entities. Congress left a door open for the IRS to change the rules for taxable constructive receipt for tax-exempt entities. The IRS hasn't done much to try to finalize or change these rules with respect to tax-exempt entities, mainly because it's been too busy trying to deal with more pressing legislation and regulations. But this is an area that has some problems; the IRS might assert that the benefits are taxable or, at least, that the employees have a choice about the benefits -- that the benefits are taxable.

Another area that is a problem for many taxable employers is the 401(k) area. Can you provide something over the $7,000 limit? The IRS will tell you no, that it's going to be taxable; 401(k) exclusively occupies the field, and in the most senior levels of the IRS that's their view. On the other hand, the IRS was told it couldn't change the constructive receipt rules that pre-existed 1976, and it certainly allowed elective deferrals, where the election is made irrevocably before the earnings were earned. In fact, the IRS has outstanding published rulings that say that. So, there are a lot of questions with regard to those tax-exempt and taxable companies.

MR. HOWARD A. FREIDIN: You were talking before, Roger, about floor plans and you indicated that in combination with an ESOP, you thought it might be outlawed by legislation or some other means in the future. Does that apply only to that combination or would it apply to all floor plans?

MR. SISKE: I've only heard the agencies speak with disparagement towards floor offset ESOPs. For example, take a real easy case. The floor offset arrangement works with a normal profit sharing plan, and the normal profit sharing plan has a broad diversified portfolio of stocks and bonds. It might resemble a pension portfolio or in the case of most defined contribution plans, will be somewhat more conservative, because the employees don't have the stomach to see the ups and downs, and look towards the long-term results.

In that type of case, none of the policy concerns really exist -- all you have is the defined benefit promise -- and to the extent that one says that the profit sharing assets are much like pension assets, the volatility is no greater than the pension volatility. There is one aspect to the PBGC objection, and that is if there are periods where the defined contribution plan outperforms the actuarial assumptions, the employees take the gains with them, and in periods where the defined contribution plan underperforms the actuarial assumptions, the pension plan has to make up the shortfall. Ordinarily, the well-designed floor plan, though, will have a floor that won't be set at the middle of the road for expected actuarial assumptions. It will be set at a level below expected returns, so that, for example, only a small percentage of the participants will be expected to get a benefit, and only in fairly extreme down-side situations would the floor plan kick in very hard. But, none of them have addressed it yet, so I'm speculating as to what they might do.

MR. FREIDIN: One other problem that might occur from the PBGC's viewpoint, I find, is if in the defined contribution plan, the employees had any investment choice, they might tend to go for a riskier investment with greater reward possibilities knowing that if they mess up, they still have a defined benefit plan.

MR. SISKE: That's a real design problem with floor plans. Bob and I, with our respective perspectives, advise one such plan, and the problem becomes -- do you design a floor plan that says go ahead and gamble because if you win, you win for yourself, and if you lose, the pension plan makes up your losses in terms of the floor? The other alternative is to come up with some sort of hypothetical earnings, like a 50-50 or even more conservative stock bond portfolio, and tell a person that if he's gambling that he doesn't get a floor.

For one particular client, we provided a bit of a floor and let him gamble. The reason we did that was because the anticipated defined contribution level was so much above the floor for most people that the person had to not just earn somewhat less than expected, but he had to undergo an absolute disaster, and so most of the first dollars were the employees'. It really took a fairly severe loss to get into employer money. It was felt it wouldn't disrupt the normal pattern.

But it really is a tough design problem, and that design problem can be exacerbated when you have a contributory plan with employee contributions and employer contributions that depended on them. There you get into the problems of hypothetical accounting, that is, coming up with a defined contribution account that the person would have had, had he made his own contributions and had the employer matched them, and had them invested in whatever the plan's investment experience was.

MR. CHARLES E. LYNCH: I'm wondering about the new 40% - 50 employees rule. If you have a defined benefit plan offset by a plain vanilla profit sharing plan, and the result was that very few people actually accrue the benefit in the defined benefit plan, can you run afoul with that rule, or is that academic?

MS. DUSH: As long as the people are covered by the plan and are eligible for benefits, if there had been adverse experience, I think you're okay.

MR. SISKE: Let me start by saying there is a question on that, at least for those of us who have designed some of these special plans that one of my partner refers to as the Beverly Hills plastic surgeons plan. That is, plans designed with very large benefits to a key person which are comparable under Revenue Ruling 81-202, to a fairly cheap defined contribution plan for the young receptionists and nurses. That is what the participation rule is aimed at. The participation rule says that any plan standing alone has to cover at least 40% of these employees or at least 50 employees, whichever is smaller. And when you read the legislative history, it says we expect the IRS to issue regulations to prevent it.

Now, a number of us have been scratching our heads and trying to figure out how far this goes, and as Marcia said, it would be rational to say -- if you can have people in a defined benefit plan, and if you can have floor offset plans, and if you could have everybody also in separate defined contribution plans, why can't you coordinate the two, even if the result is that the projected defined contribution pension equivalent totally zeroes out the defined benefit account for everybody but the high-paids? The problem with that is that you achieve exactly what they say you can't. The basis for the rule was that you proved, when you assumed certain interest and salary assumptions, let's say a 10% contribution to a profit sharing plan, you would deliver more than 60% of pay to the average rank and file employees of the employer, and therefore, the high-paids could have a comparable plan delivering 60% of pay to them. I've had some that have gone as much as $350,000 a year into deductible contributions per individual on a level premium annuity basis. That would be equivalent of a 7% to 10% profit sharing plan for the rank and file. And that's exactly what this rule is trying to prevent. Now, if that's what the rule is trying to prevent, and if that's what the calculations indicate, if I set up a floor offset arrangement, all of the rank and file who have a 60% projected benefit, from their defined contribution plan, will get a zero defined benefit plan benefit after the floor offset.

I'd like the answer to be what Marcia said it was and maybe it will be, but it provides a fairly easy circumvention to what the IRS and Congress perceive to be the abuse.

MR. TANI: Could you get around that by just providing a minimal minimum benefit floor plan, regardless of the offset?

MR. SISKE: Ask me when the IRS issues the regulations describing an abuse.

MS. DUSH: That's what I was going to say. Presumably that's where we are going to look for ideas on what an abusive plan is, what an abusive plan amendment is, and how the IRS is really going to treat the phasing of section 415 over 10 years of participation because some people would just design a plan two years or three or four years before they retire, in order to give themselves the full $90,000 limit. Now, hereafter, in this type of plan for small corporations, the participant will have had to have participated in the plan for at least 10 years in order to get the full benefit of the section 415 limit.

MR. SISKE: It's strange that major plans covering tens of thousands of employees are governed by considerations designed to prevent abuses in one-man corporate plans. You might have thought that the IRS could have come up with a way to prevent this.

MS. DUSH: Going back to the idea of excess plans, one of the things that we have been trying to think of is, if more of the higher-paid employees' benefits are going to be delivered in a non-qualified way, the emphasis for the benefit consultant is going to be how to secure these benefit promises. Are we going to see more people trying to set up semi-secured trusts such as Rabbi-trust arrangements? Will we see escrow arrangements or bonding types of arrangements which will fund or set aside corporate assets to fund non-qualified plans, or even the concept of group-universal life plans being used to fund non-qualified arrangements? We think that's where a lot of our planning for delivery of highly-paid benefits is going to be in the next couple of years.

MR. SISKE: An interesting problem that Tax Reform interposes in that area is in the area of corporate owned life insurance (COLI). A lot of salesmen have made some nice seven-figure incomes over the last five to ten years by selling very large whole life policies under a minimum premium arrangement where the first four out of the seven year's premiums are paid, three out of the first seven are borrowed, and every other premium under the policy is borrowed, and the interest on all the premiums is deducted. This creates a double-tax arbitrage; that is, the internal reserves on a policy accumulate on a non-taxable basis.

The interest on the loans by the employer are immediately deductible and then when the person dies, the proceeds come over on a tax-free basis which really means the employer got to deduct the interest on the loans and got it back on a non-taxable basis, and then when the employer paid the benefit, the employer deducted what it gave to its employee's estate.

Congress finally woke up to this and prohibited the deduction of interest on any single policy on any single officer where the policy loan is more than $50,000. When you take a look at most of these COLI arrangements, in order to make them a zero premium policy after the first seven years, it substantially eliminates this as a means of accumulating funds which makes the funding a lot higher. A Rabbi trust is treated as assets owned by the employer, and so all the income is taxed to the employer. The benefit of an insurance policy is that the income wasn't taxed to anybody during the accumulation phase.

This will only work under Tax Reform where policy loans are less than $50,000. That means an employer has to come up with substantially more funds, and it has to come up with them on a nondeductible basis. That is, the employer contributes to the fund, but it doesn't reduce its taxable income at all. That makes the cost, under the present law, approximately double, and under the new law, about 60% higher.

MR. KEVIN O'SULLIVAN: I'd like to ask Mr. Tani to discuss the characteristics of cash balance plans. What kind of reaction are you getting from clients and employers, and what do you see as the prospects for these plans?

MR. TANI: I see a lot of interest. I have talked to several clients who had read about them, and they all want to talk about them. There have to be somewhat special situations for them to really apply. One employer I'm working with had a defined benefit plan. This employer was already talking about converting to a defined contribution plan two years ago, and in the process, the idea of the cash balance plan came up, which was a perfect compromise for it. The employer had an overfunded pension plan and it really wanted the reversion of assets; so by converting to a cash balance pension plan, it could just use the excess to fund this plan continually over time.

I think, in terms of general retirement plan design, the cash balance plan is going to fit in like a defined contribution plan. The costs are similar to defined contribution costs relative to the defined benefit you are providing. I think for most larger clients, we still like a balance between defined benefits and defined contribution plans. I think that for large companies that do have a defined benefit plan and a defined contribution plan, that's already perfect for them, and I don't see why they should change one of their plans to try to fit this thing. It's more for clients who are unhappy with the defined benefit plans they have right now, and are thinking of switching to a defined contribution plan.

PANEL DISCUSSION

MR. PAWELKO: For all the talk that I've seen on this, I've not had anybody even get close to adopting one. Marcia, have you seen any companies go into a cash balance plan?

MS. DUSH: No, I haven't seen anything yet, but I remember reading of a case where the employees sued when their account balance in the defined benefit plan, the cash balance plan, hadn't grown as fast as the GICs in their savings plan. The employees sued, and I thought on the first decision, that the employees won, and I really haven't heard anything more. I may be misstating some of the facts, but there was a direct comparison by the employees of what has happening in their 401(k) or savings plan and what was happening in their cash balance plan. There was a lot of misunderstanding in being able to compare the rates of return on their account balances.

MR. SISKE: Was that a cash balance plan or was that a defined benefit plan with employee contributions? I think it was employee contributions in a defined benefit plan, and the statute says you've got to pay at least 5%, but I think the analogy is a good one. My recollection is that the argument was that, if the employer was earning much more than 5%, was it reasonable for the employer to take the earnings from the employee contributions and, in effect, subsidize the employer side of the plan? The court, at least to some extent, felt no, and as I recall, required that the employer share some of the excess earnings. So, it would seem that one could say, if you go too far in only applying the minimum to an employee's account, maybe some sympathetic judge (remember, judges aren't pension lawyers, much less pension actuaries) wouldn't understand this stuff.

MS. BONNIE O. MUDD: There was a recent article in *Crain's Chicago Business* about cash balance accounts in which the companies' reactions to cash balance accounts was discussed. The impression I had, after reading the article, was that most companies were looking at them as an interesting product, but they weren't doing anything until they saw what Tax Reform did with these accounts, and they weren't really sure if it was a gimmick or if it really worked. I think cash balance accounts are a really interesting concept, not because they are a new product to go out and push with a client, but because they let you go back to basics and look at what makes a defined benefit plan and approaching retirement planning from that effect rather than saying, well, let's see if a cash account balance plan is really what we want to do here.

In fact, I have seen a plan document for a plan that used a cash balance account idea and set up a floor plan within the plan itself to use up the excess assets, and it was all within one plan where the account balances were growing, but they got the greater of a defined contributions plan account balance when they retired or of their alternative defined benefit that was in the plan also.

MR. HOWARD YOUNG: How does the 50 employee, 40% rule apply if you have small units that are not highly paid people, for example, small bargaining units? Are there any details available on how the actuarial equivalents are to be calculated for the 415 limits?

MR. SISKE: On the first part of the question, there are no rules on the face of the statute that offer an exception. One would hope that the IRS would observe the purpose of the rule, and provide exceptions, for example, whether it be for union employees. There are broad 410 rules, participation rules, that provide exceptions to the normal participation rules anyway, and perhaps the IRS would construe it as overriding this.

Even in a non-union area without the collective bargaining special statutory exemption, one would think that if you wanted to offer a plan just to a group of low paids, it ought to be allowed if it could be justified, freestanding. Yet on the face of the statute, there is no provision for it -- it is absolute.

MS. DUSH: We noticed when looking at the statute that the IRS really has confused the idea of coverage and participation. If you remember those 70% rules, they are called coverage rules, but they have to do with how many of the low paid are participating in the plan. Only the fair cross section is a direct coverage test. So, I think, this is an area where we've got to wait for corrections because the IRS has really muddied the water as to what is coverage and what is participation. My initial feeling would be that there would be the statutory exemptions for collective bargaining groups. I really think this is also going to apply to large employers which have small non-union groups at different operating locations, with individual plans covering less than 50 employees.

MR. TANI: There are some interesting things on these small plans. It is said that if you ever terminate one of these small plans because you don't meet these participation tests, you may do so and be exempt from the excise tax on the reversion, but you would have to compute the 415 limitation for high-paid people, and I think it would be in the $50,000 category person using the maximum interest rate permitted under lump sum rules which would be perhaps 120% of the PBGC's rate. So, I think the IRS is leaning towards trying to cut down lump sum distributions or distributions on plan terminations on high-paid people as plans must use the highest permissible rate under the law to compute that lump sum.

MR. SISKE: There's an interesting problem with that, too. Many people are scrambling to get out of these plans that won't meet the 40% - 50 employees participation rule. Legislative history suggests that maybe jumping out in advance won't work; in other words it is suggested that the IRS ought to come up with rules that prevent you from using, say, 5% as an actuarial assumption when there would be a 120% of the PBGC rate, say 8 1/2% or 9% in a year or two when you fall under these new rules. So, there is going to be an interesting scramble, and my guess is that the IRS won't give any guidance.

You run the gauntlet and hope that whatever you do gets approved and not shot down by regulations; otherwise, you take the conservative route and go with 120% of PBGC rates.

MR. TANI: The maximum PBGC rate rule is effective, I think, August 16, 1986, so it's already gone.

MR. SISKE: No, that's only for cash out purposes. When you're talking about increasing the distribution, what people want to do in these small plans is use a lower rate. The lower the interest rate, the larger the lump sum distribution. And for purposes of this special rule, on getting out of these small plans, they're saying just the opposite. Not that you can't use a higher rate, but that you have to use that higher rate, and that rate isn't applicable yet. In other words, that rate for the small plans comes in only the year before the participation rules kick in, which is not until 1989.

MR. LYNCH: I'm confused. We've got all kinds of bad news there. I've got a question on the 401(k) plans with the new $7,000 cap and all the other changes. I'm wondering if anybody has run many tests on employee groups to see if, under the new rules, the tests will not be passed. This would be large groups with hundreds or thousands of employees.

MS. DUSH: We have been holding seminars with our clients and we have asked whether they had started thinking about running the tests, and we asked then to see if they would pass. Everybody is still so stunned that nobody has started yet, but they are going to have to within the next couple of months.

MR. TANI: I have two fairly large clients who passed the old tests, and when we ran the new tests, they did not pass the new tests. They thought that because the high paid would be limited to $7,000, they would pass. They were close under the old tests, but they do not pass the new tests.

MR. SISKE: I've had three clients that have run the new tests. All of their tests were worse; two of them met the new rules, one didn't. In each case whatever margin of safety there was went down significantly. If you look at the new $7,000 rule, everybody says, "Well, it's going to help you because the high paid is limited to $7,000. A$200,000 employee only gets 3 1/2% of pay." But there aren't that many that are making $200,000 or more. That's 7% of pay on $100,000. At $70,000 that's 10% and so, it really doesn't help the percentages that much.

MS. AMY J. ABRAHAMS: As an addendum to that question, I am wondering if any of you are experiencing mass withdrawals from 401(k) plans? That is, people who are anxious to get their money out before the tax rules go in?

MS. DUSH: We've been wondering how to counsel plan administrators on that because if people withdraw their money this year, they get a couple of advantages, and that is, they are able to take withdrawals of their after-tax money, perhaps before dipping into their earnings, and get it out on a tax-free basis. If they actually do dip into taxable money, they take it out this year without the excise tax, but they pay the current marginal tax rate which may be higher than next year's tax rate plus the excise tax.

I think the rules are so confusing that to counsel somebody to make a withdrawal just to avoid some sort of tax implication, would be giving tax advice which would really put the employer on the line. The one thing, though, you might be thinking about is those plans which allow participants to make after-tax, unmatched contributions as a catch-up provision -- to allow them to fund up to 10% of their pay for all years of participation in the plan. You might want to counsel people who are considering making after-tax contributions as a sort of catch up, to do it this year so that, if they do want to eventually take early withdrawals, they come out on a tax-free basis.

MR. SISKE: There's an interesting problem that clients aren't willing to step up to, which is -- should people quit and take their distributions this year? If you look at the overall rules, people get capital gains treatment for pre-1974 dollars, that is, 40% of the current rate. Somebody who's in the 25% bracket is taxed at a 10% rate. The transitional rule is that everybody is in the 20% rate, even if their individual capital gains rate would have been lower. Further, while there is a grandfather rule on the excise tax, (the 15% excise tax on distributions in excess of $112,500), only the pre-August 1986 amounts are exempted, and then every additional dollar is not exempted. That is, you can grandfather what you've got now, but everything accumulated in the future gets excise-taxed. If you take it now and go to another employer, you get a whole free clean $112,500 exempt from that excise tax.

I haven't had a client yet that's been willing to say that a nice early retirement window is appropriate (retiring now and getting your benefits), but there's an implicit window of opportunity between now and year-end, which only the most sophisticated employees who have their own tax advisors will take advantage of. The rank and file, by and large, are going to get left out. Even the exemption from the 15% excise tax only applies to large distributions; that is, more than $562,500 in accumulation as of August of 1986. There are a whole lot of "What should I do?" kinds of questions.

MS. DUSH: Another thing we've been talking about, too, is that if you have qualified plans, you have to be careful of your definition of compensation in the next couple of years because companies may throw open the window deferring compensation into later years so that people can take advantage of the new, lower marginal tax rate. And if they defer compensation, you have to make sure that that's not going to have a tremendous effect on their retirement benefits if their higher paid, older employees are deferring pay for two or three years. Deferred compensation typically, isn't part of the qualified pension. So you have to know how you're going to provide the lost accrual. But I think that if your company adds this sort of deferred compensation agreement, it should be aware of the fact that the person is going to lose pension accruals.

MS. KATHLEEN E. MANNING: This is a kind of tax reform question and has to do with tax-exempt organizations. There's a provision in the law that says that tax-exempt organizations can't adopt a 401(k) plan unless they have already done it before July of 1986. What it doesn't say is what constitutes adopting a plan. I wonder if anybody has any knowledge about what the lawmakers were thinking about in the conference reports for adoption, whether it was a Board resolution or a House requirement, that the plans have already been submitted to the IRS for approval?

MS. DUSH: I would think it's a Board resolution, but I defer to Roger.

MR. SISKE: Well, if you look at the qualification rules, which is what I think the IRS would probably look at, a plan isn't adopted until it is reduced to writing (a formally adopted plan document) and communicated to employees by the end of the relevant year, within which the employer's tax return due date after the end of the year had funding. In other words, the historical rules under the 54 code and 39 code, were that formal legal adoption was needed of a specific plan spelling out who is eligible, when they are eligible, what they get, and when they get it; then tell the employees about it.

If you haven't gone that far, there is a lot of litigation in revenue-rulings and court cases that say you haven't adopted a plan in the 401(k) sense, and I would think they would naturally look at those old 401 rulings. The only exception to this is the collectively bargained plan where, if there is a bargaining agreement in place specifying that a plan would be adopted, and if the plan was adopted after the end of the year, it would relate back so long as there was a binding bargaining agreement within the year. But, other than that, there were no exceptions, and the IRS was very tough on litigation positions on this and always won.

MS. MANNING: I'm not sure I understand. If a plan is in operation on July 1, but adoption hasn't been executed, even though there could have been a Board resolution before then, and the actual document hasn't been signed and executed until after July 1, which isn't uncommon, how is this handled?

MR. SISKE: This is strictly a legal concept, not an administrative concept. Legal concepts don't recognize something until it's in some formal binding fashion. Now, there are cases which suggest that you don't have to have something called a plan, if you have enough employee communications which spell out all the essential plan terms. But, essentially, something in writing is needed with sufficient specificity, so that it would set forth all the fundamentals: who are the participants, when they participate, what they get, how the assets are invested, and when they get it. If it was just something that was thought about, the employer had it in his head, he and his consultant had talked about it, but there were no written materials, the plan is not adopted.

MR. DONALD G. RISING: With all these concerns about the new 401(k) restrictions, are there any advantages to perhaps setting up deferred compensation as an option under a section 125 cafeteria plan instead of doing it as a standard 401(k) plan?

MR. SISKE: Section 125 does not allow deferred compensation plans except 401(k) plans, so it would lose its' tax-qualified status to the extent that you allow deferral of anything through anything but a 401(k). Many cafeteria plans allow a 401(k) option, but still a 401(k) option would have to be limited to the $7,000 and thrown into all of the other 401(k) restrictions. But, if what you are suggesting is, why not just say in lieu of one set of benefits, you can have a non-qualified, unfunded compensation account that would probably not work under constructive receipt principles; the IRS would say it would disqualify the cafeteria plan.