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CURRENT PENSION LEGISLATION

Moderator: DONALD S. GRUBBS, JR.
Panelists: M. DAVID R. BROWN
PAUL H. JACKSON
Recorder: BONNIE J. MARR

o A review of the major pension legislation in Canada and the United States in 1986, and its effect upon plans.

MR. DONALD S. GRUBBS, JR.: In the United States, as you all know, we've just had the Tax Reform Act passed by both the House and Senate. The act is now awaiting certain approval by the president. In Canada, they have been just as busy with changes which may be as sweeping as ours, and most of us have been too busy to observe them.

Ideas developing on one side of our border have had a tendency to creep across to the other side. One thing we might think about today as we hear about both of them is which ideas we'd like to encourage to creep across, and which ones we might like to build a wall against to prevent invasion.

All three of our panelists are Fellows of the Society of Actuaries. First, Dave Brown is going to tell us about the Canadian developments. Dave is with Eckler Partners Limited. Then Paul Jackson of the Wyatt Company is going to tell us about most of the more important developments under the Tax Reform Act as they relate to qualified plans and, particularly, the requirements of a qualified plan. And then I'm going to talk about a few aspects of tax reform that relate to qualified plans and other plans that Paul doesn't cover.

PANEL DISCUSSION

MR. M. DAVID R. BROWN: I'd like to start by reviewing a little of the background and history of the pension legislation in Canada. We're not going back to the dawn of time, but I am going to go back about twenty years because that's when the system that's now being rather drastically reshaped originally took its form. Before 1965, the only sorts of regulation that existed were the requirements of the Department of National Revenue for tax-qualified plans. The old *Blue Book*, as it was called, had all the rules that you had to comply with in the space of a few pages and it makes one nostalgic to look back at those times. But, eventually we came to know and love the Ontario Pension Benefits Act, which was the first real piece of pension legislation and was enacted in 1965 in the province of Ontario. In Canada, under our constitution, matters connected with pensions come under the jurisdiction of the provinces. Prior to 1965, the tax department had been sort of filling a vacuum in this area, but since 1965, they lowered their profiles substantially and the provinces became much more active.

Following the Ontario law, five other provinces enacted substantially similar legislation. The only way the system can work is for everybody to have more or less the same law. The original legislation focused on just three things: a standard vesting requirement, some funding requirements, and some quality and diversification requirements for pension fund investments. With a fairly limited scope, it was something that people agreed was improving the environment, and it wasn't that difficult to live with it. The way it was administered was that if you were a national employer, you registered your plan in the province that had the most employees and they administered the legislation on behalf of the other provinces, so you didn't have to deal with all of the provinces.

In 1971, the tax department, after some backing and filling, came out with an information circular which stated the requirements for tax qualification, and which has remained substantially unchanged. It's a very peculiar piece of business. It's not actually in the law. This information circular is issued by the authority of the Minister of National Revenue to put some flesh on the registered pension plan definition in the act. It is defined as a plan that is accepted by the Minister for Registration, a completely circular definition which gives the tax department all kinds of tolerance for writing its own

rules, which is what its done. The circular is aimed primarily at tax abuse by owner-managers and other small plan sponsors. It has some inconvenient aspects for larger plans because of its aim, but I guess we've been living with it for such a long time now that it doesn't seem too bad. In any event, compared to the Internal Revenue Code, it has some things that might seem like advantages. There is practically nothing on the question of discriminating in favor of the highly paid. There is virtually nothing about rules for integration. If you set up a new plan and you have some past service liabilities, you can contribute the full amount and get a tax deduction right away without having to spread it over 10 years. And so there is a fair amount of flexibility in the system as we have known it.

Well, that's the backdrop for the events that are going on currently, which really have been unfolding now for a very long time. I understand from talking with Paul briefly yesterday, that things move at such a pace in the U.S. that sometimes nobody even realizes what's happening before they find themselves under new legislation. It's taken us about 10 years to come to where we are arriving in 1986.

There was something that was popularly known as the Pension Reform Debate which began in about 1976. The issues that were involved in the debate revolved around three or four key perceived weaknesses in the private pension system. (1) The question of coverage was an issue -- only 40% of the labor force participates in a privately sponsored pension plan and, in the private sector employment, the percentage is even lower than that. (2) There was a question of inflation protection. In the late 1970s that became a hot issue as the public sector employees tended to be in plans with inflation indexing and everybody else tended not to be. (3) The question of portability was another point -- that is, not just vesting but the right to carry some benefit with you from one job to the next. (4) Other items collectively came to be known as women's issues, the question of spousal pensions, unisex, splitting of pension credit upon marriage breakup, etc.

On one side of this debate were those who advocated the radical expansion of the Social Security system, because it seemed to deal effectively with at least the coverage, the inflation protection, and portability problems. On the other

side were those who said "No, we should try to reform the private system and make it more effective in dealing with some of these problems." Then we had a long series of studies and reports by governments and others proposing various packages of reforms. Each of the major provinces commissioned a study, the federal government had an interdepartmental task force, two of the provinces had royal commissions, the Economic Council of Canada ran a study, and it looked like we were just going to study the thing to death and nothing would ever happen.

Well, finally in 1981, the province of Saskatchewan, one of the smaller provinces in western Canada, became impatient and amended its legislation to try to address some of these problems. They broke the mold as far as uniformity was concerned. Most national employers had to make separate provisions in their plans or have a separate plan to deal with the Saskatchewan amendments. Manitoba did something similar a couple of years later. But this still didn't really affect most people in private plans. There are actually more Saskatchewan employees who belong to plans registered in the federal and Ontario jurisdictions than there are in the Saskatchewan jurisdiction, so the fact that they did these things, because of the reciprocity in the way the legislation was amended, really didn't make that much of a dent.

Finally we come to the events of the very recent past. The federal government in June of this year finally gave a third reading to a complete revision of the Pension Benefit Standards Act. Now, although I said earlier that the Constitution gives jurisdiction to the provinces in this whole area, the federal government does get into the act to a limited extent because certain categories of employment are considered to be covered by federal rather than provincial law. These categories include areas like banking, interprovincial transportation, and federal Crown Corporations. There are some very large plans that are subject to the federal law and the federal legislation seems likely to be the pattern, in many areas at least, for the provinces that are contemplating changes.

The province of Ontario introduced a draft bill in the spring of this year, and the minister who is responsible for it has said on a number of occasions recently, that he still intends to make it effective at the beginning of next

year. Some of us think that is going to mean a pretty tight scramble to try and comply but that's the position he is taking. The province of Alberta has also introduced a bill which they intend to make effective January 1, 1987. The province of Quebec, I understand, is probably going to introduce legislation next year. Nova Scotia has a bill to be effective at the beginning of 1988. There is a substantial degree of similarity to the legislation that these provinces are bringing in. That's what I want to spend some time describing to you now because it looks as though this is the new consensus, if there is a consensus. The main features of all of these pieces of legislation are as follows.

First of all, to deal with the coverage issue, they have introduced some eligibility standards, and that's something that's never been present in the law before. Basically, it requires that with two years of service, an employee has to be offered membership in the pension plan. That also will include part-time employees. The part-time employee is subject to a definition that is based on their earnings which is tied to the maximum covered earnings under the Canada Pension Plan. In 1986, the Ontario definition would be at the level of about $9,000 so that a part-time employee earning $9,000 or more in two consecutive years would have to be offered membership in the pension plan. This is an area that hasn't had much public discussion, but I think that many employers are now realizing, as they sit down to look at implementing the laws, that this area is fraught with a lot of difficulty. Part-time employment is not going to be easy to fit into typical plans. And the continuity of membership is also going to be a difficult problem to deal with. There does appear to be a provision in most of the acts to allow the employer to set a "comparable" plan for the part-timers. The solution may be, in many cases then, to have some kind of defined contribution plan, once we know what the supervisory authorities will accept as comparable.

Second, the law deals with what is actually three or four related things that I've just grouped together because they're all interlocking in their effect. There's been a significant change in the vesting standard. Participation in the plan for a minimum period of two years will result in a vested benefit. The province of Alberta has taken a different position on this; its standard

is five years of service. It would have been very nice if they could all have had the same standard; however, they couldn't agree on that apparently.

Going with the vesting standard is a portability feature under which the terminating employee will have the right to elect a cash transfer of the value of his vested benefits into a noncommutable vehicle, a locked-in type of individual vehicle, similar to an IRA in the United States. There will be some restrictions on his right to do that if the plan is not fully funded. The question of what values should be used is one that employers are going to have to deal with. It looks as though, in the draft regulations that we've seen from the federal government, they are planning to rely on the Canadian Institute of Actuaries to devise a set of recommendations as to how these values should be determined. So that sort of puts the ball in the actuarial profession's court at the moment. I have nothing to report to you on how that's being dealt with, but it's a real challenge for us.

Also associated with this new set of rules, are some provisions for contributory plans. Contributory plans are still very common in Canada, although not quite as common as they used to be. And that is traceable partly to the fact that employee contributions are tax-deductible. One of the requirements of the new pension legislation is the so-called 50% rule, under which the employer is required to pay for at least half the benefits on termination with vesting or on retirement. So, again, the question of how you calculate that value will be an important one in determining the effect of this rule. When Saskatchewan brought in their changes in 1981, they had a version of the 50% rule in their act. The other provinces have come in with a different version. If the employee's contributions with interest amount to more than 50% of the value of the vested benefit, he is permitted to take the excess out in cash and still have his full vested benefit as well. There will be some requirements in the law as to the rate of interest that is allowed on refunds of employee contributions. This strikes me as an area where there is going to be some overkill. There was abuse in some plans. Some plans were not paying any interest on employee contributions and some only a nominal rate. So, I think there was an issue to be addressed there alright, but it looks as though we're going to get very detailed rules as to how the interest rate is to be determined and how it's to be calculated. And there is a very good chance that the rules will be

different in each of the provinces which seems like a messy solution to a fairly minor problem.

Another item in the law, and this one may sound familiar to you, is that married employees must elect a joint and survivor benefit on retirement, which can be actuarially reduced, unless both spouses waive it. This requirement is in the Saskatchewan and Manitoba laws already, so it seems to be more or less uniform across the country now, or it will be when these laws have all come to pass.

There is also going to be a requirement, and there are some variations on this, for a preretirement death benefit which essentially will be equal to the portability transfer value that the employee could have received if he terminated on the date of death. The federal bill has a provision for some offset of group insurance benefits. It also has a bridging provision in the years immediately preceding retirement which is somewhat different from the other provinces. This is an area that each employer will have to look at according to the particular legislation that applies to them.

There is a requirement for unisex in money purchase plans, and in the determination of option factors. This is one that always creates a certain amount of consternation among actuaries, partly, in this case, because the pension system isn't sealed off that tightly. There are still going to be sex distinct annuity contracts available in the marketplace. It's not certain yet whether there will be unisex annuities available in the marketplace. No insurance company has come forward offering them.

I heard a story told last week which illustrates the situation that we may be in with this unisex requirement. The province of Newfoundland became part of Canada about 30 years ago. They had been a British colony before that and as a result, according to this joke, they used to drive on the left side of the road. They thought that when they became part of Canada, it would be a pretty good idea if they switched over and started driving on the right side of the road the same way other Canadians did. And after thinking about it for awhile they said, "Well, let's have an experiment; let's just try it with the trucks for a while first." And that may be the position we are getting ourselves into with this unisex situation: we have an experiment here that may not be operable.

The legislation also includes, in various forms in different jurisdictions, some attempts to require the formation of representative committees of employees either to get information about the operation of the plan or actually to participate in the administration of it.

There is a significant increase in the required disclosure about the plan. This is an area where I think the requirements in the United States, for a long time, have been quite a bit heavier than they are in Canada. That's going to change now.

Finally, there is some attention paid to the special characteristics of multi-employer plans. They were really ignored in the earlier legislation and had to try to fit themselves into the requirements for single employer plans in the best way that they could. That situation will be repaired in the legislation. In practical effect I'm not sure it's going to make all that much difference; it simply will be a recognition these are a significant feature of the whole private pension system. There will be more appropriate methods of regulating them, rather than have them comply with the single employer legislative requirements.

Even after all this list of items, which as I say appears to be pretty common among all of the bills and laws that are coming in from the various jurisdictions, there are a couple of significant issues that are still unresolved, at least in the central province of Ontario. Ontario accounts for about 65% of all of the pension plan membership in the country, so an issue that arises there has a very significant effect on the whole system. Two of these issues are mandatory inflation protection, which many of us thought had died a year or two back, and the question of reversion of surplus to pension plan sponsors. They're linked, in some people's minds at least. And I think in the minds of the politicians in Ontario who are addressing them at the moment, there are definite connections between the two of them.

The federal bill that has just come in has a provision for an employer who wants to escape from the requirements of the 50% rule, as I described it earlier. If the employer agrees to index the vested pension during the deferred period, between the time the employee terminates and the time he comes to

collect the deferred pension, he can avoid the requirements of the 50% rule. The indexing is according to a standard that's related to the Consumer Price Index, and it's not the full 100%; I think it's 75% minus 1%. This seems to me like a politician's attempt to sort of give a nod to the idea of legislating inflation protection without effectively doing anything about it. It obviously has some real flaws. First of all, it doesn't have any impact on the non-contributory plan because they're not subject to the 50% rule. Second, by making it optional, it looks as though nobody is going to pick up the option on the basis of what I've heard so far. Third, it's not mandatory after retirement, so the whole point of the exercise seems to have disappeared. Other jurisdictions, in looking at the question of mandatory inflation protection while working out all the various compromises on the way to developing their law, have dropped this item off their list. There was a lot of very heavy lobbying from the plan sponsors and others that this was not an appropriate matter for legislation, that it would impose too heavy a cost on the good guys, people who already had plans, and so on -- all the familiar arguments. But, we have a minority government in Ontario at the moment, and they are sensitive to all kinds of pressures. I have been told that they still have this item on the table in some form, so when the final version of our bill is introduced next week, there may or may not be some provision for mandatory inflation protection in it.

There has been, in Ontario, a set of rules as to how you deal with requests from plan sponsors for reversion of surplus in a going plan. This may be an alien concept in the United States. As I understand the situation down here, if you want to get surplus out of your plan you have to at least go through the motions of winding it down, taking out surplus and then starting it up again. Rather than go through that exercise, in Ontario, if your plan permitted, and that's an important if, and if you had enough surplus in the plan so that you could leave at least 25% of the liabilities or 2 years' normal costs in the plan, whichever was greater, then you were allowed to withdraw the extra surplus. The withdrawal was not subject to excise tax or any other special tax consequences; it was taxable to the employer of course, if you were subject to tax. The federal and Alberta laws seem to be following the same approach Ontario has been following, but in Manitoba the law was recently changed. The amendments to the Manitoba legislation were very obscurely drafted; it's not

certain exactly what their effect will be. On the basis on the statements that were made by the minister at the time the law was introduced, it appears that the intention there is to prohibit surplus withdrawals from ongoing plans altogether. There have been some very highly publicized legal disputes in Ontario and elsewhere in the last year or two. I think the key ones are still unresolved. There is a case involving one of the supermarket chains in which there is a whole series of court cases going on. The first one was decided recently and all it decided was that the supervisory body had made a mistake in allowing the employer to withdraw the surplus. It has not resolved the question of who the surplus belongs to yet. There is another court case currently going on to decide that question, and whatever comes out of it is likely to be appealed, so it may be quite sometime before the courts get around to resolving all of this. In the meantime, there is a good chance that when Ontario introduces its law next week, that it will be intending to make some changes in the ground rules on this whole question. So, in the sense of the importance of Ontario, we're kind of holding our breath on these two issues to see where the government comes down. We're also, in a less important way, holding our breath to see when the law is going to be effective because if it's January 1, 1987, we're all going to have to move very quickly.

One other aspect of the whole picture of interest to actuaries in Canada that is going to be changing, and it looks as though this is going to happen in all of the jurisdictions, relates to some of the aspects of the funding rules. At present, past service liabilities have to be funded over a period of not more than fifteen years. If you have experienced something that's called an experience deficiency, which was really defined as anything else, then you were given a period of five years to amortize that. Under the new regime, the intention is to get rid of this distinction between experience deficiencies and other kinds of unfunded liabilities. The way the regulations are going to be written is that you'll have 15 years to fund all of them on what's called a going concern valuation basis. However, and there is always a "however" to these changes, you will not only be required, if you are the actuary of a plan, to do a going concern valuation and give your numbers on that basis, you will also be required to report results of a solvency valuation. This is a new concept, the solvency valuation, which is essentially a determination of what would happen to the plan if it was terminated on the date of the valuation. So, there will

be no salary projections for final pay plans or no future terminations of employment and a triggering of any special benefits that are payable on a termination of the plan, like early retirement benefits. And, if the solvency valuation shows that your plan is not fully funded, you will be allowed for this purpose to take credit for any amortization payments that are scheduled on your regular valuation over the next five years. Then you'll be required to accelerate the funding in order to become fully funded on a solvency basis over the 5-year period.

Now, I think for most of the plans in Canada that are on a final pay basis or even a career average, this isn't going to have any particular significance. But many of the flat benefit plans which are frequently renegotiated with the benefit level being increased, will have to fund at a more rapid pace than they have had to do under the existing regulations. That's what we think. Nobody seems to have done any extensive testing with this or really given it any very deep thought before going ahead with it. But the major jurisdictions, Quebec, Ontario and the Feds, have all sort of reached agreement on this so it seems that that's what we're going to have.

There's one other area that I just wanted to touch on, and that is the tax law. In the federal budget in May of last year, 1985, the Minister of Finance announced that he was going to introduce a number of changes in the Income Tax Act. The changes deal with what we call registered retirement savings plans and other kinds of defined contribution plans. The thrust of those changes would be a substantial increase in the dollar limits on the amount that would be tax sheltered through those plans with a target of $15,500 per person with an 18% of earnings cap by 1990. But, there were some problems with his proposals and they have not yet seen the light of day in the form of legislation. The problems are in the area of interaction between defined contribution arrangements and defined benefit arrangements. We have a position now that if you're a member of a defined benefit plan, you still have some room to contribute to a registered retirement savings plan. The questions are how much room should a person have under the new regime, and also what do you do if the employer sponsored plan is a composite with the employee contributions on a defined contribution basis and the employer sponsoring a defined benefit piece? The Federal Department of Finance has been wrestling with those questions and

how the reporting is going to work ever since that budget came down in May of 1985. I understand sometime this week there is going to be a concrete proposal published from the federal government as to how they are going to implement all these things. That will be a new ingredient in the whole process that the plan sponsors are going to have to deal with.

I just want to wind up with some observations about what I see as the probable impact of all these things on the existing system. First of all, I think it's clear that both the pension legislation and the tax proposals reinforce the already fairly strong trend away from the defined benefit arrangements, that I'm sure, is paralleled down here. Second, some plan sponsors are going to see the legislation as an incentive to change from contributory to noncontributory plans. You can finesse a lot of the pension legislation problems, like the 50% rule, the early locking in and the minimum interest requirements, if you don't require employee contributions. But I'd qualify that a little bit on the basis of how the tax law finally comes out. Third, the lack of uniformity among the jurisdictions is potentially disastrous for the system. It's going to mean in many cases that national employers will have to set up a different plan in each jurisdiction in order to meet the requirements. Even those who might like to adopt the strategy of going with the most generous possible arrangement for everybody, in order to satisfy the various requirements, may find that to be impossible because of the way in which they conflict with each other. The question of the interest on employee contributions is a good example of the conflicting requirements. We've tried to devise a formula that would meet the most generous requirement, and in some years it does, in some years it's one, and in some years it's another; you just can't do it. Fourth, I think it's worth noting that most plans are in very good financial health right now. They've come through very good investment markets and a period of decelerating inflation. Many plans are fully funded which is a really new situation for us. Some plan sponsors may think about applying some of the pension reform changes to prior service benefits.

I should have mentioned that most of these changes in the pension legislation are prospective only in their effect. In other words, the new vesting rule for example only applies to benefits for service after the law becomes effective so that you are permitted to continue with your old vesting rules for prior

service benefits. But that's obviously going to be a bit of a drag and I think some employers will apply the new standards to all the benefits even though that's not required.

I guess the thing that hits you most is how much regulation we're going to have at the end of this. Just the quantity of it, the level of detail and the scope is discouraging. I've always been grateful to be in Canada when I look at what goes on down here and I'm not sure that I can feel that way anymore.

My final closing comment is that, although it's taken us a long time to arrive at this point, we seem to have everything happening to us at the same time. We've got the pension legislation coming in. We had some other things that I haven't even mentioned. The Canada Pension Plan had some fairly significant changes made in it which become effective at the beginning of 1987. We've got the accounting profession developing a new standard for reporting pension expense and we're affected in some cases by the U.S. pension accounting changes as well. We have to try and deal with both. And so, it seems clear that many employers will reach a point in the very near future where they are going to sit down and take a look at their whole approach to pension planning and the kind of vehicles that they have been using in the past and perhaps rethink some of their basic philosophy. And that's not something you can do in a hurry but unfortunately I think it's a position that many will be in.

MR. PAUL H. JACKSON: Dave gave you the good news, basically the happy part of the program. I have the sad part to start in on. I'm not really sure why Don selected me for this topic because it relates to the qualification of plans in the United States and the tax laws. I'm not an expert on the tax laws and the regulations. I'm an actuary, not a lawyer. And what I've enjoyed and concentrated on in the actuarial area is the mathematical side, not the regulations. I view law and regulations as a necessary evil, and as I hear the story in Canada paralleling that in the U.S., I can see that as the laws and regulations became less necessary by virtue of the declining tax rate in the U.S. from 92% to 70% to 50%, now to 33% or 28%, the law and the regulations multiply. They're unrelated to the need for them. They have a life of their own. In a sense, one could predict an effect comparable to an increase in the minimum wage. If people are being underpaid, it's an easy thing for Congress

to pass a law to say that they should be paid more. They can go back every 2 years and get re-elected having done something. Milton Friedman once observed that the fellow who was underpaid at a dollar an hour was then unemployed at $3.50. And that typically happens with laws; they are passed with certain intent and the end result is the exact opposite. So we have ended up in the United States with fewer plans, simply because each plan has so many more requirements imposed on it. Small business is especially hurt by the complexity and there's no way they can handle it. In fact, something like 85% of the individuals working for firms with 25 or fewer people are uncovered at the moment, and the percentage has been heading south for some 15 years now. Basically, the difficulty at the small end of the scale is that government is making an effort to limit the doctors and the lawyers, highly compensated professionals, and every rule that they thought of that will handle them also lands in the mom and pop stores, the garages, small manufacturing plants and so on.

Getting into the law itself, I'll first mention the minimum coverage requirements. One of the positive features of this law was that the law finally gave a definition of who was a highly compensated employee and what the prohibited group was. In the past, the phrase "officers, shareholders and highly compensated people" has been used and it's meant one thing in one group and another thing in another group. Now, highly compensated employees are defined. They include 5% owners. Obviously, this is a limitation that doesn't apply to General Motors or U.S. Steel but it does apply to a lot of small businesses. Also included is anybody earning $75,000 or more in annual pay, anybody earning over $50,000 in the top paid group, and generally that's the highest paid 20%, and anyone who is an officer whose annual pay is 150% of the defined contribution limit, which is now $30,000, so 150% of that is $45,000. Why the difference between the $45,000, the $50,000 and the $75,000? Heaven only knows.

To help the large company with the problem of finding out who is in this highly compensated group each year (because it is by individual now, not for the group as a whole -- for example the highest paid one-third) there is a two-year test. Five percent owners have to be counted if they are now a 5% owner or were at any time during the current year. However, the last three of these, the

$75,000, the $50,000 and an officer earning over $45,000, who are currently in that group but who were not in that group one year ago, don't have to be counted unless they are in the 100 highest compensated people. Once again, small employers will have to keep track of everybody in the group and do it precisely. The large companies will have to keep track of only the top 100 as they move in and out.

These rules are applied on a control group basis. You don't take one little company and just apply them to that company. If it's affiliated with others, you have to combine them all for this purpose.

You don't have to take all of the officers earning over $45,000; you don't have to take more than 10% of the group with a minimum of three officers and a maximum of fifty officers. However, if no officer earns over $45,000, you have to count one anyway.

And, finally, there are special rules for family members. Family members are lineal ascendents or descendents of the employee and the employee's spouse. So if your grandfather or your father, your children or your grandchildren are working for the firm, they are treated as though they are nonexistent as employees and their benefits are added to yours. It's not known just what this does. For example, you have a small company and the son of the owner goes to work for the employer and the father happens to be at the 415 limit already. If the son works for 5 years and terminates, he will possibly accrue no benefit at all because you combine him with the father and the father's already at the limit. Or, if the father leaves, what do you do with the son's service? This will no doubt be clarified by later regulations.

To give you an illustration of how the minimum coverage requirements might work, see the three different distributions shown in Illustration 1.

Company A is, let's say, a moderately paid group, 400 people in the lowest category and 100 at the highest. And in company A, the highly compensated group is 10% because only 10% of the people earn over $50,000. In company B, it's 20% because the $50,000 top paid group has to apply to the 20%. And then, for company C, all 1,000 are highly paid because they are all in over $75,000.

Now, these aren't practical illustrations but they will give you some indication of how the highly compensated rules work.

Illustration 1

Highly Compensated Employees: Example

Number of Employees	Company A Compensation	Company B Compensation	Company C Compensation
400	$ 30,000	$ 30,000	$ 80,000
300	35,000	50,000	100,000
100	40,000	60,000	110,000
100	45,000	70,000	120,000
100	60,000	100,000	150,000
1,000			

Company A: 100 Employees (10% of Total) are highly compensated.

Company B: 200 Employees (20% of Total) are highly compensated.

Company C: 1,000 Employees (100% of Total) are highly compensated.

The minimum coverage rules, of course, refer to these highly compensated people and the minimum coverage requirements refer to who is eligible for a plan, not who actually participates in it. And there are three basic tests that are now to be used. One is the percentage test; if the plan benefits at least 70% of all the nonhighly compensated employees, it meets the coverage requirement. There is a ratio test; if it doesn't cover 70% of all of them, if it covers 70% of the percentage that the highly compensated group is covered under in that plan, the coverage requirement is met. And, finally, there is the average benefits test; if their benefit is at least 70% of the average benefit for the highly compensated under the plan, the coverage requirement is met. For these purposes, you can exclude union people, nonresident aliens with no U.S. income, and employees who are under 21, with less than one year of service, and so on.

For some examples of how the minimum coverage requirements would apply see Illustration 2.

Company XYZ shown here has one division with 200 low paid people and no highly compensated people. If that company had a plan for Division I, the plan would satisfy the coverage requirements because it satisfies the percentage test.

More than 70% of the people not highly compensated are covered under the plan.

Illustration 2

Highly-Compensated Employees: Example

Company XYZ	Not Highly Compensated	Highly Compensated	Total
Division I	600	200	800
Division II	200	0	200
Total	800	200	1,000

Company ABC	Not Highly Compensated	Highly Compensated	Total
Division I	500	200	700
Division II	300	0	300
Total	800	200	1,000

It also satisfies the ratio test because the percentage of those not highly compensated is at least 70% of the percent of highly compensated. If, however, that company's employment mix were to shift and Division II were to grow by 100 and Division I shrink by 100, as is shown under Company ABC, all of a sudden it doesn't meet the test. So when these tests apply to a company that has separate plans by division, the company is going to have to watch how the growth of the company takes place. In the latter case, for example, if they could find 25 of the highly compensated people who they didn't like, they could shift them to Division II, where there is no plan at all, and now their plan under Division I is qualified. Getting back to the Company ABC, which is failing the test, it can also meet the test if it can meet the benefits test. If it could put in a plan for Division I that covered employees not highly compensated with a benefit that was 12% greater than the highly compensated, it would meet the test. That's not a very practical solution, however, because the highly compensated group is changing each and every year as salaries shift, so the individuals would be shifting in and out of plans. It's simply not clear what approach is going to work there.

There's also a minimum participation requirement for a plan. A plan must actually benefit no fewer than 50 employees or 40% of all employees, but here again you can exclude the unions and the nonresident aliens. Aggregation of

plans is not permitted. This is a plan-by-plan test and each plan must meet it, and it must meet it on every single day of the year. You might ask, how will anybody know? That's a good question. Nobody will. It does not apply to multi-employer plans. The penalty for failing to meet many of these requirements, by the way, rather than disqualification of the plan, is the taxing of the benefit accruals to the highly compensated group.

There are new vesting requirements in the law. There are 2 new alternatives which are full vesting at 5 years of service and graded vesting from 3 to 7 years of service. If you have a high turnover group, it's possible that for every 100 employees reaching the 5-year service point and being eligible for a full benefit under the 5-year vesting, there might be 150 or 175 people reaching the 3-year point. Of course under this vesting rule at 3 years of service the individual would vest in a benefit that is 6/10ths of one year's accrual. That's a teeny tiny benefit and half of the people or a third of the people getting vested rights would be getting these, so its quite likely that almost all plans will now simply shift to the full vesting after 5 years. This is referred to as "cliff vesting" in the United States. It's a pejorative term. The belief is that the individual at 4 years and 11 months is standing at the foot of a cliff and with just one more month of service, he's up on the broad sunny uplands of a happy retired life. But there he is down in the pits. I've always been puzzled with why people have taken that view of this. Using the same terminology, we have for example cliff voting ages in the United States. The person who is just under 21 doesn't get a chance to vote and the one just over 21 does. Also, so far as I know, there are no local jurisdictions that phase in the beer drinking age 20% per year. Collectively bargained plans can still use ten-year vesting. Class vesting is no longer permitted and there are some savings plans, some stock purchase programs, that have used this and will simply have to be changed. If you had full immediate vesting, you could have used a 3-year eligibility rule; now you can only use a 2-year rule. So these things have become much stiffer. Vesting is not really a major cost item, but it does involve an awful lot of record keeping.

The most interesting and confusing of the new revisions are the integration requirements. For a defined contribution plan, you are now permitted a step up at the integration level of 5.7% or the OASDI tax rate, if that's greater.

Unlike the past, however, and this parallels the situation in Canada, the excess contribution cannot exceed two times the base. In other words, you can only step up an amount equal to what you're providing on the base income. That also applies to defined benefit excess plans where the excess benefit rate is limited to a 3/4% step-up, but the step-up cannot exceed the benefit rate on the base coverage. For defined benefit offset plans, the offset must be less than 3/4% of final 3-year average pay, generally limited to 35 years. And the total offset can't exceed 50% of the benefit before offset. In other words, if you work out the gross benefit you can't offset more than half of it this way. These are unrelated to the level of Social Security benefits received by the employee, so if you have a Social Security offset plan you calculate the Social Security offset one way and then you have to go back and calculate the limitations the same way that you would have if you'd had an excess plan based on a percentage of the individual's own pay. This means that if you do use a Social Security offset, you end up with less integration than you would have had otherwise. Now, I personally am not loath to see the Social Security offset go. I've tried to calculate a few Social Security benefits in my day, and fortunately we had lots of assistants around who could recalculate them and re-recalculate, and get them right eventually. So maybe this is a good move. But it does mean that the plans in the U.S. that have offset half of Social Security or some percentage of Social Security, I would think, would shift over to offset the 3/4% of final average pay.

Now you'll notice in both the defined benefit excess and offset plans, benefits must be based on average annual compensation. Average annual compensation is defined in a rather strange way, but basically for an individual with more than 3 years of service, it is the highest average over consecutive years of service of 3 or more in the individual's career. That's what the law says; if you want an integrated plan, the benefit must be based on that. So career pay integrated plans, for example, are out. Also, of course, at the present time there are many integrated career pay plans in the U.S., and the rules had given them a 1.4% integrated factor versus a 1% factor for final pay plans. Well, a 40% additional advantage is wiped out totally. And, in fact, you can't even have a plan that is career pay and offset. The 35-year maximum that applies to the 3/4% offset or step-up adds up to 26.25% maximum. That compares with the old

law limit of 37.5%, so obviously besides eliminating integration for career pay plans, the limits are sharply cut back as well.

The test for the benefit rate or annual offset is done separately for each year of service. It's also done in the aggregate. The integration level for any year has to be less than the Social Security base and the level has to apply to all participants, and so on. All integrated plans have to be aggregated, the law says, by the principles in Revenue Ruling 81-202. That happened to be a particularly unprincipled ruling in my judgment, so I don't know what's likely to happen there.

You get no credit for employee contributions in benefit testing. At the present time there are some contributory excess plans, for example, where the step-up is too great. However, the highly paid are contributing a percentage and you test the employer percentage. The new rules assume that the employee money, as with 401(k) plans and savings plans, is going to add benefits for the employee, and since you want to control the amount bought by employee money, you test all contributions with the 401(k) tests. You'll notice I haven't included any of the 401(k) tests. They're perhaps equally simple. I don't understand them though, and I don't work with them and don't pretend to be an expert on them. But contributory plans essentially are going to have to go by the boards in the U.S. because for the most part the contributions won't test under the rules that are used now for testing 401(k) plans. For example, one of my clients has a preretirement spouse option which was offered with reduction. This is an ERISA spouse option, which has since been amended to meet the requirements of the Tax Act of 1984. The option calls for a reduction in benefit at the normal retirement age or whenever retirement takes place to cover the cost of the coverage. The employer also offered a cash contribution for those individuals who didn't want the "Fly Now-Pay Later" approach of getting the cost of their insurance protection paid out of their pension every year after they retired. That cash preretirement spouse option is going to have to go by the boards, because it's a contribution and when you put it in with the other contributions, it won't satisfy the requirements.

Finally, I'll discuss limits on contributions and benefits. The limit for a defined contribution plan is essentially the same as it was. It's $30,000. It

will rise to 25% of the defined benefit limit whenever the $90,000 benefit limit gets up above $120,000. The defined benefit limit is $90,000, and that's the same as it has been, but it has been $90,000 reduced for retirement prior to age 62 with a minimum of $75,000. Under the new law, reductions are geared to the Social Security retirement age and without the $75,000 minimum. So at this point, benefits available at age 55 are roughly half what they were. Another interesting touch is that the pay that can be taken into account for benefit purposes under these plans will be limited to $200,000. That prevents the employer who earned $500,000 himself from putting in a benefit, counting his full pay and taking the maximum benefit that he could get and dividing it by $500,000 and then saying, "Well, that's the percentage that we'll give everybody." The belief is that the employer ought to be providing the low paid people with more, and the interaction of many of these rules reflect an effort to provide greater benefits to those who are low paid.

The last item on the list is the proration of the $90,000 limit based on participation. It had been based on service. The belief of the IRS was that many individuals who had over 10 years of service and effectively were running these small plans, would wait until just before their retirement and put in a benefit improvement. This would cut out all of the people who had terminated prior to that date from their proper vested benefits. And so, the proposal as it originally stood was to limit benefit improvements and to require that they be spread over 10 years. Some unions and other employers were able to convince the Senate staff that these provisions were simply unacceptable. The only advantage the defined benefit plan has is that if the benefit is inadequate you can raise it. The requirements are that you can only raise the benefit 10% per year, but you have lost the last advantage of a defined benefit plan. This is restricted, however, to the maximum limit at this point. It does mean, however, that the biggest increase in benefits that you could give somebody who's about to retire at 55 is $300 a month which isn't very much.

This act comes on the heels of ERISA, the multi-employer bill, TEFRA, DEFRA and REACT. It's pretty obvious that Congress has found something they can do here in election years. They're faced with the drug problem and international terrorism and apartheid in South Africa, and they can't do anything about those things, but they can pass laws about pension plans and people who have them

have to change. And this gives them some sense of satisfaction and it gives them something to talk about when they go back to their constituency to be reelected.

It's pretty obvious, however, that there is no longer a thing in the United States that could be called a private pension plan. Anybody adopting a pension plan in the United States is buying in on the front end of something that is going to change at 2-year intervals and no one knows what the next changes will be. If you look at how complicated our pension legislation is now and think that's as far as it can go, you ought to read the Railroad Retirement Act or the Social Security Act. Legislation can get much more complicated and it probably will.

The tax advantage of these programs is one that emerges only after a fairly long period of time. If you're going to keep a plan in for 10 years, the tax advantage probably isn't worth it. The individual could take his money and invest it in common stocks and hold them for the 10-year period and make out almost as well. The tax rates are now lower. In fact, in 1988, if indeed the rates are 28% at the top, you might ask yourself why an individual who was then in that top rate would want to defer any income into some later year. And the answer is, he wouldn't. So by lowering the personal income tax rates, we have taken most of the tax evasion reasons out of the adoption and maintenance of private pension plans. The only plans that will be left are the plans of employers who want to provide their work force with a pension.

Finally, I would observe that, being in Washington for a number years, our system of passing laws is failing. We end up with young people coming to Washington who are bright, they want to change things, they want to make their mark, they have ideas and they want to get them through, and their congressman wants to get them through. So legislation gets rolling and the ideas get tied in, and the legislation gets more massive. The tax reform bill, as passed, runs some 900 pages long and it covers all sorts of things. When it comes up to the floor of the House and Senate, nobody can say some little feature is wrong and it shouldn't be passed. You get everything in here at once, it's an up or down vote, and at that point everybody is tired, so it gets passed. And the drawback is that almost all of the details, at least the ones

that do the most damage, come in at the last minute. When the House and Senate conferees met and approved a bill, they didn't have the language for the bill. In fact, the language wasn't available more than 5 days before the House vote and I'm not sure who can read the 900 pages in 5 days and understand it; but I certainly know the congressmen did not. And this is the drawback; there are untested ideas that get into the legislation. Hopefully, if we can find something in the next year or two that is wrong, patently wrong and everybody agrees it is wrong, there can be a technical corrections act, the type that's supposed to insert commas and change misspellings, and so on. That could undo some of the bad things that are in this legislation. But there must be a lot of corrections in there because the legislation does not agree with the Conference Committee Report in a lot of respects. It doesn't agree with either the House or the Senate bill. In fact, there are many sections in the conference agreement on the bill that says "House bill, no provisions; Senate bill, no provisions; and each starting from nothing they agreed on something.

Well it may be a bad system, but it's my country, it's a good country. It's worked so far and I think it's up to all of us to see if we can't help these people get their act together now and end with pension legislation that works and that leaves the rank and file worker in America with some security in his old age.

MR. GRUBBS: I will start by mentioning where you can find the answers to your questions that Paul and I don't answer today. There are three volumes published by the Government Printing Office. First is the summary of the conference agreement that was published before we got the final act. While not a perfect document, it has a reasonably good summary of the provisions, but it's fairly brief. The other source is the two volume set, called the *Conference Report*. Volume I is the statute itself and Volume II is the report of the *Statement of Managers* in which they try to explain what they did. As Paul mentioned, we're expecting a technical corrections act. Nobody knows when that will come. Other sources of information are the commercial publishers who will soon publish consolidated copies of the Internal Revenue Code that incorporate all of the changes that are spread through the Tax Reform Act.

I have spent a lot of hours studying the act, and I'm still having trouble understanding it. I don't claim to have all of the answers. There are so many details that it's mind boggling. I certainly can't retain them all. There are some provisions that no matter how long you study them, you won't be sure of what the law is. There are some of them that are clearly wrong and they didn't intend to mean what they say, but what they did intend or how the IRS will interpret them remains to be learned.

I've concentrated my attention just on the pension and welfare plan aspects of the act. Some of the other provisions of the act, like the tax rates themselves, may have more impact upon pension plans than the provisions that directly relate to employee plans.

Now on to the parts that directly effect retirement plans. Let's start with the one that has the earliest effective date, the 10% tax on asset reversions from terminated plans. There's an exception to that. If you transfer the assets into an Employee Stock Ownership Plan (ESOP), you not only escape the 10% excise tax, but the employer escapes having taxable income on the reversion itself. However, you may ask, "What good does that do when the whole object of terminating the plan was to get the cash and not put the cash into an ESOP?" But after the employer puts the cash into the ESOP, the next thing the employer does is issue stock to the ESOP in exchange for the cash. Thus, the employer gets the cash; he has neither a 10% excise tax nor taxable income on the reversion itself; and he gradually allocates the stock to the employees providing a nice additional benefit with no additional expense. But you say there must be a catch somewhere. You can't get something for nothing. Well, indeed there is. Compared to getting a reversion, you do have to issue extra stock. You can say this is somewhat like watering the stock by having more shares outstanding. But it's something that ought to be considered. There are some opportunities there.

How do distributions from plans get taxed? Right now, as you know, lump sum distributions are subject to very favorable rules under old law. We have 10-year averaging and to the extent that the distribution consists of pre-1974 money we have capital gains treatment. This treatment is eliminated. Now, on lump sum distributions you can make a one time election, after you're 59-1/2,

to get 5-year averaging. Five-year averaging is not as good as 10-year averaging, but the tax rates are lower. The rest of your distributions will generally be ordinary income, but we have some exceptions.

There's a 6-year phase out for the capital gains provisions I mentioned. If you are already over 50 at the beginning of 1986, you can make one election during your lifetime regardless of age to either get the 5-year averaging with the new tax rates or to get the old 10-year averaging using the higher 1986 tax rates. And also, if you are over 50, you can preserve the capital gains treatment on the pre-1974 money, paying 20% on your capital gains portion.

There is also a new tax on early distributions from plans. If you receive a distribution before age 59-1/2, there is a 10% additional income tax on that distribution, with some exceptions of course. You can get your money out with no extra tax after 55, if it's in accordance with the early retirement provisions of the plan. If your plan doesn't already provide for early retirement at 55, you might want to amend it to do so. If your benefit is paid in the form of a life annuity, it doesn't matter when it starts; there is no extra tax. There is also an exception to the 10% tax for ESOPs and an exception for distributions which are used to pay deductible medical expense.

What is the effect of all this? On the one hand, note that pensions, which are taxed as ordinary income, are going to be at lower tax rates, while lump sum distributions and early payouts are going to be treated less favorably than in the past. Thus, the emphasis is upon pushing participants to take money as pensions at retirement, rather than to have plans in which people take lump sum distributions at early ages when they terminate employment. I think that the long term effect of this is going to encourage kinds of plans that are really designed to provide pensions, and that's not all bad. I think this will tend to encourage defined benefit plans, as distinguished from defined contribution plans.

Another change in the taxation of distributions deals with contributory plans -- those plans that have employee contributions that were not tax deferred contributions. We will look at those distributions in two parts: the amounts you get before an annuity starts and the amounts you get after an annuity

starts. Under present law, if you have a profit sharing plan and get a distribution of part of your money before you really retire, the rule is that employee contributions come out first. You don't have taxable income until you have withdrawn all of your employee contributions. That rule is out. Any distributions now will be a prorata proportion of employee and employer money.

With respect to distributions after the annuity commencement date, we currently have two alternative rules. A general rule says that you determine what part of the employee pension comes from employee contributions and that percent of each month's pension comes out tax-free as an exclusion allowance and the rest of it is taxable. But we have the special 3-year rule under the old law that says that if you can get back all of the employee contributions within three years, you don't have to pay any taxes until you have recovered all of the employee contributions and the excess is taxable. Well, the 3-year rule is gone. Now we have only the prorata rule. All benefits have to be treated through the exclusion ratio, and that, among other things, is an administrative nuisance. The three-year rule was awfully handy, since in most contributory plans the employee contributions came out within 3 years and you didn't have to calculate the exclusion ratio.

The exclusion ratio rule itself has changed. Under the present rule you have tables from which you get an exclusion ratio that applies on a lifetime basis. It applies to every payment no matter low long you receive it, and there are winners and losers. If you die early, you lose not just because you have died early but you haven't recovered all of your employee contributions tax-free. But if you're one of those people who might live to be 103, you're a big winner under present law. You keep recovering that same percentage tax-free even though payments continue long past your life expectancy and more than your total employee contributions are recovered tax-free. Under the new law, once you have recovered all of your employee contributions, everything after that will be taxable. All of the rules regarding distributions I've mentioned thus far are effective in 1987.

We have a requirement effective in 1989, called the Uniform Minimum Distribution Requirement. Currently we have requirements on the minimum amounts that have to be distributed and when they have to be distributed --

which differ for qualified plans, IRAs, tax-sheltered annuities, and government deferred compensation plans. Congress decided there should be one uniform rule for all plans. Distributions must begin no later than April 1 following the year the participant attains age 70-1/2, regardless of whether the participant retires. So if participants are still on the payroll at that time, they must start receiving their pension, regardless of whether they are owners. The minimum amount that must be paid each year will be determined under regulations very similar to present law. The penalty for noncompliance has changed, however. You must have a plan provision providing for the minimum required distribution or your plan doesn't qualify. But, if you have a plan provision that has the required wording in it, but somehow you slip up and someone doesn't get the distribution they're supposed to, the plan will not be disqualified. That's the good news. The bad news is that the participant will have to pay a tax of 50% of the amount that should have been distributed to him.

Loans to participants have survived, but with some changes. This affects primarily defined contribution plans. The limits on how much you can borrow are the same, but the amortization rules are changed. You must amortize those loans by level payments which are payable quarterly or more frequently. You will not be allowed to continually refinance without limit as you can presently. At present, you could be amortizing monthly, making a principal payment and borrowing it back again. In the future you will not be allowed to borrow back principal payments that you have made within the last year. More important, for certain loans there will be no interest deduction on the interest that the employee pays. This applies to loans that are made after December 31 of this year. So some of you might think about taking out a loan before December 31 if you are interested.

Paul mentioned the new $200,000 limit on includable compensation for determining benefits. That limit also applies for determining deductible contributions to plans. Although the $200,000 is projected to increase, for purposes of valuation in determining maximum deductible limits, you cannot assume that it's going to increase. Your best estimate must be that there is no inflation in the future and that the limit will never increase, similar to the assumption that we're now forced to make regarding the 415 limits.

If an employer makes an excess contribution, i.e. a contribution above the deductible limit, under present law it is no problem. If an employer contributes more than it can deduct this year, it can carry the excess over and deduct it next year. For employers who are in strong cash positions, at times that's a wise thing to do. After all, it gets their money into a tax-exempt fund. But under the act, a penalty will apply to those who contribute more than they can deduct.

Under present law, if you have both a pension and a profit sharing plan, you can't contribute more than 25% to the combination of the two. But that limit does not apply if you have a defined benefit pension plan and a money purchase pension plan. Under the new law it will apply to a combination of defined benefit plans and money purchase plans.

There is a new rule regarding top heavy plans. To determine if a plan is a top heavy plan, we look at the ratio of the value of the accrued benefits for key employees to the value of accrued benefits for all participants, and if the ratio is over 60%, the plan is top heavy. How do you measure accrued benefits? Under present law you simply look and see what the accrued benefit is in accordance with the plan. You can still do that under the new law if you just have one defined benefit plan. But, you have to aggregate two or more defined benefit plans for the top-heavy tests and if they don't have the same accrual rule, you're required to assume that both plans were using the fractional rule, which prorates the projected benefit by years of participation, for purposes of determining whether the plans are top heavy.

The next rule is one that I think is going to be of particular interest to people in this audience. It's called Penalty for Overstatement of Liabilities. If the employer claims a deduction that the IRS determines is too large because the IRS determines that the actuary was too conservative in determining the plan costs, there is a penalty tax of up to 30% of the difference in taxes due. The percentage used to determine the penalty tax is dependent upon how large the overstatement is. This provision is less than clear. The employer has no such penalty if his claimed deduction is too big for some other reason. For example, if you sent the employer the actuarial valuation report and he didn't bother reading it, but decided to contribute more than the deductible limit,

this penalty tax does not apply. There is a penalty tax, though, if the over-stated deduction was due to your valuation. This is a reaction to the very conservative approach that some actuaries have taken for small plans. Now the good news is that the actuary doesn't have to pay the tax. It's the employer who has to pay the tax. The bad news is that if the employer pays the tax, he may be unhappy with the actuary. He might fire the actuary. He might even decide to sue the actuary.

I do want to mention the Simplified Employee Plan. The Simplified Employee Plan (SEP) has been with us for a while. It's an alternative to the qualified plan for providing benefits. It's really designed for small employers to help them avoid some of the cost associated with qualified plans. Most small employers have instead adopted qualified profit sharing plans. Compared to the qualified profit sharing plans, SEPs have been very similar. In either type of plan you can make a deductible contribution of up to 15% of pay, not exceeding $30,000. The coverage and vesting requirements have been approximately the same, since most plans of the smaller employers were top heavy anyway. Also, many of these smaller employers had already figured out that if you have to have 3-year vesting with one year of service, it's really better to have a 3-year service requirement for eligibility, which is allowed if the plan provides immediate vesting. Well, SEPs are approximately the same. But the qualified plans have always had some advantages over SEPs and vice-versa. The SEP advantages were fairly obvious. The employer didn't need a plan document, except for a one-page IRS form that it signed. It didn't need approval from the IRS; it didn't even need to mail the form to the IRS. It didn't need a summary plan description. It didn't need to file a Form 5500. It didn't need a summary annual report. It didn't need an attorney and it didn't need an actuary. But the qualified plan did have advantages in the past. One advantage was favorable treatment of lump sum distributions, an advantage which is now largely eliminated. In addition, the qualified plan route in the past offered us the opportunity of salary reduction 401(k) plans. Salary reduction provisions have been added to SEPs, not without limitation, but in some cases they can be quite useful. SEPs can now have the same integration rules as qualified plans.

Consider a small employer who has a pension plan. He is faced with a new round of plan amendments and the fees associated with them. Perhaps he should consider terminating the plan, starting a SEP and allowing employees to roll over their distributions into the SEP. Does it have advantages? Yes. They're worth weighing. For insurance companies and banks, I look at this as a great marketing opportunity to point out the advantages of SEPs and actively sell them.

MR. VICTOR MODUGNO: Do you see another wave of plan terminations after this bill becomes law as we saw after ERISA and TEFRA?

MR. JACKSON: I don't see another wave of plan terminations. Most of the plans that would be terminated because of all the fuss and bother have already been terminated. I think there will be a gradual decline in the number of plans, but I don't see any real shock wave.

The real question comes in 1988, when a lot of the small companies which have plans and which have been disgusted with all the red tape that's involved, and all of the changes that are taking place, ask themselves, "Will I ever pay taxes at a rate lower than 28%?" And if they can honestly say, "Yes, I expect that after my retirement I will," then they ought to be deferring income. But I suspect a lot of them are going to say, "Never." And if you're never going to pay taxes at a lower rate than you are in the current year, what is the advantage of deferring anything? Those smaller employers faced with that sort of situation may well drop out of the plans themselves or they may terminate them for all their workers. But that's not this year, that's 1988.

And there is less encouragement to start new plans. I have been worried about this situation for a good many years. When ERISA was passed, the American pension movement was stopped dead in its tracks. There was almost no net growth of new plans for about a 3-year period following the passage of ERISA. But, people of today are much more acclimated to a whole set of rules than they were 20 years ago. In everything that you do, whether you run a business, take out a loan or buy a home, you have 10 times as many rules as you had 20 years ago. Into every facet of life, Big Brother has injected just a few more rules every year to correct this inequity or that. These rules have a cumulative

effect to the point where the population is now numb. An over-regulated state is what you now consider normal. When you consider everything else and then turn to pensions, we may be no more over-regulated than anything else.

MR. GEORGE N. WATSON: I want to make two comments. There's a lot of gloom and doom here at this meeting; at least I sense it. In regard to Mr. Jackson's comment about 28% tax rates, I still think the squirrels will hide away their nuts, whether there's taxes or no taxes because the squirrel must always provide for the future. And, in the case of human beings, I think there will always be a pension plan regardless of whether there are taxes or no taxes.

The longer I live and the more I see of the complexities of life and the more I understand the great advances of the microcomputer, I am beginning to realize that the actuary's intelligence must be supplemented by a computer at his beck and call. The computer will be programmed so as to absorb all these complicated and funny rules we have, and this set of problems will amount to nothing if we only have the right computer programs.

MR. CHARLES E. LYNCH: I'm trying to understand these new, extra taxes on distributions. An annualized distribution in excess of $112,000 is going to be hit with an extra tax. Does that mean then that if you start a healthy plan, for example a simple defined contribution plan with good rates of return over 20 or 30 years, the participant may see himself hit with these extra taxes, although it wasn't a matter of a greedy plan or anything like that? Is that correct?

MR. JACKSON: That's true.

MR. GRUBBS: I think it's one more factor that will push people to take their money out in the form of an annuity rather than as a lump sum distribution.

MR. JACKSON: On a lump sum distribution, you get 5 times that dollar amount. The present value of course is more like the factor of 8 or 10. So, the lump sum distributions are getting hit much harder than the annual benefit.

There are so many excise taxes now going out. You do this and you get hit with an excise tax. These are excess contributions that aren't returned.

There are many rules and while I agree that you can have a computer program that takes all of them into account, I guess my concern would be that, if in fact they are changing annually, or every 2 years at worst, you have to reprogram every 2 years. And while this is work for the programmer, you must consider the individual who is sitting at the front end. Let's take one person who controls a small company and that individual is wondering, "Should I put my money in this vehicle?" He can see what is happening in other vehicles. He can also see that we live in uncertain times. The tax laws change. The tax rates went down, but they may go up. Taxes on capital gains went up, but they may go down. There are all sorts of things that can happen. The drawback of the pension investment is that once he puts the money in, it's there until something happens in his employment. He can't get it out and the premature distribution penalty and other things are just nuisances on top of it. But you are in effect tying your money up in something where the real tax advantage takes 15 or 20 years to emerge. And, if you look forward 15 or 20 years and ask yourself, "What are the tax laws likely to be 15 to 20 years from now? -- if you can generalize from the past, the one thing you can say is there will be lots of changes. The people who think about this are likely to say, "I'm not going to put all of my nuts in this tree." The tree is now slowly sinking under the ground. I agree that pensions are not going to go by the board because there are going to be a lot of people who react to this purely on a reflex basis. Well, these tax shelters were wiped out, but here are the ones that are here now so you just move from here to there and you keep shifting back and forth. And there will always be people in business selling these things and there will always be pensions. The large companies do not have pension plans because the employer is trying to defer taxes for his hourly rate workers. They have pensions because the workers want pensions and they've negotiated for them. And as long as unions want pensions there will be lots of pensions.

MR. GRUBBS: Dave, if I understood you correctly, for the registered retirement savings plans you have in Canada the limits are going up, while all our limits

are coming down. Now, how do you account for that difference? How do you avoid the pressure?

MR. BROWN: I don't account for it at all, particularly since the Minister of Finance in recent months has started talking about tax reform a la United States. Before he started talking that way, he had already announced that he was going to increase the limits on these defined contribution vehicles. He announced it, but he still really hasn't done it, which is giving some cynical people cause to believe that he may not in fact get around to doing what he said he was going to do. I've heard something recently that suggests that they are going to go ahead with this on a phase basis beginning with the 1988 tax year. They're going to skip a year from the original schedule but it is still their intention to do it. I don't think that politicians in particular are ever worried too much about consistency of approach and that's the only explanation I can give.

MR. GRUBBS: One of the things we need to sort out are the provisions effective in 1987 that your clients are going to need to act on immediately. Considering all of the uncertainties that there are out there and the potential technical corrections act, it would certainly be my reaction not to change anything you don't have to change before 1989, although you will want to consider the 1989 requirements in making changes in the interim.

When it comes to offset plans, I do not have the foggiest notion as to how to design an offset plan now if I wanted to, because the act says that the 3/4% limit is going to be adjusted downwards for anyone earning over the covered compensation. Covered compensation has even changed although the report says it's going to be the same as present law. Actually it got reduced from $15,000 to about $13,300. But how is this 3/4% limit going to change? Do you have any idea, Paul?

MR. JACKSON: I would assume it would be prorated downward. The offset for Social Security obviously doesn't apply to $100,000 or $200,000 in pay, and for somebody earning that much you just have to prorate down to the level that is appropriate. Now, all of us are spared the trouble of thinking this problem through, because the law very clearly states that the Social Security

Administration will hand the Secretary of the Treasury a table, and we can all use the table. So just wait until the table comes out and use it, Don.

MR. GRUBBS: But until that table comes out, none of us could design an offset plan.

MR. JACKSON: Well, you can design an offset plan and do what you think is right and then go back and make the adjustments at a later point. My point on the offset plan was that in the past people who wanted an integrated plan, and wanted full integration, did not take the excess plan route. The excess plan is a plan where there is a step-up benefit at some level, and is based on the employee's rates of pay while he worked for that employer. Under an excess plan all of the needed information is contained in the employer's files. There's a formula and you can calculate it. But the integration rules under the current law, which is now about to go by the boards, favored the offsetting of Social Security. The limits are greater, and if you wanted the full advantage of integration you ought to be offsetting Social Security. But in the new law the offset of Social Security has to be tested by a limit, and the limit is in effect an excess plan limit, so you may just as well base the whole offset on the new limit to start with rather than base the offset on Social Security at all.

MR. PETER B. BRESLIN: I was wondering if the panel could comment on hardship withdrawal rules under the new tax law.

MR. GRUBBS: Hardship withdrawals with respect to a 401(k) plan are going to be restricted to elective contributions and will not include any interest or investment earnings on the elective contributions, so they'll be more restrictive. I don't recall other details.

MR. LORNE FRANK COHEN: Mr. Brown, if plans are under the jurisdiction of the province where they have the most employees, what difference does it make if each plan in each province is different?

MR. BROWN: I didn't give the full detail on that. What happens is that if you're a national employer or an employer with employees in more than one

province, the location where you register your plan is determined by the province where the plurality of the employees resides. However, what actually takes place is that the law of the province where the particular employee resides still applies. For example if I'm an Ontario company and I have people in Manitoba, I register my plan in Ontario, but the Ontario Pension Commission then applies the Manitoba law to the Manitoba employees on behalf of Manitoba. So this was really my point about uniform legislation. The systems works fine as long as the legislation is uniform, but as soon as you start getting holes in the uniformity, you still have one location for the registration and supervision, but the applicable law is still different for people in different parts of the country.

MR. GRUBBS: Let me just say a word about 401(k) plans since the new rules become effective January 1, 1987. We have the new maximum limit of $7,000 that will effect some of the people in this room and also effect the chief executive officer of some of your clients, who are rather important people. In addition to that, we have new percentage tests for testing discrimination, the Actual Deferral Percentage (ADP) test. The most important change may be that the definition of highly compensated employees has changed. It used to be the highest-paid one-third, but now we have this new definition that Paul talked about, which may make it either easier or harder in a particular case to pass the test. The percentage tests themselves have become stricter. You used to be okay if your high-paid didn't have a deferral percentage that was more than 1-1/2 times the low-paid. That is reduced to 1-1/4 times. There used to be an alternative rule that said the high-paid rate of deferral could be up to 2-1/2 times the low-paid rate as long as the difference between the high-paid and the low-paid did not exceed 3% of pay. Now, the 2-1/2 times has been reduced to 2 times, and the 3% of pay difference has been reduced to 2% of pay. Is it harder to pass? It is very hard to say. The percentage tests certainly make it harder to pass. As I said, the change in highly compensated may make it harder or easier. But, the fact that the high-paid people can't put in more than $7,000 will tend to bring their percentages down, and that by itself will tend to make it easier to pass the test. As in the past, you can elect to include the employer matching contributions and the employer non-matching contributions, if these are immediately vested and meet the payout restrictions that apply to elective contributions.

As Paul mentioned, these same restrictions are generally going to apply to employer matching contributions, as well as applying to any employee contributions that were not elective contributions under a defined contribution plan, and to voluntary employee contributions under a defined benefit plan. For example, you may have a defined benefit plan that had a provision that almost no one used, that allowed employees to make voluntary contributions. There's still a few of them around. It's probably only the highly paid that make the voluntary contributions. You probably don't pass these percentage tests.