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RECENT RULINGS AND REGULATIONS

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What has the IRS done to us (for us) lately?
- o New Laws
- o Final Regulations
- o Proposed Regulations
- o Overdue Regulations
- o Revenue Rulings and Procedures
- o Revenue Notices and Announcements

MR. EDWIN C. POLSDOFER: I am going to talk about the Code Section 415 10-year participation phase-in rule, as outlined in IRS Notice 89-45. This is the rule that requires an employee to have a full 10 years of plan participation (as distinguished from "service") in order to have the full defined benefit dollar limit applicable to his benefit. If he has fewer than 10 years, then he only has a proportionate part of the full dollar limit applicable to his benefit. The thing that has caused the most complexity is the fact that the 10-year participation phase-in is supposed to apply not only to the initial benefit that someone is accruing under the plan's initial benefit structure, but also to changes in benefit structure. The one thing that is helpful with regard to the 10-year phase-in based on participation service is, of course, that it does not apply when you are determining the combined plan limits. So, if you are determining the defined benefit fraction in order to run the combined plan limit test, you do not need to worry about the 10-year participation rule. You can disregard that completely.

When it comes to changes in benefit structure, however, the calculations to determine someone's benefit and the limitations get a bit more complicated. There are a couple of basic rules that you should understand when you're approaching the application of this limitation, one of which is that you always get .1 of the limitation. So, if someone has been in the plan for less than a full year, that person, nevertheless, will have .1 of the

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dollar limit applicable. However, if the person is in the plan for a year and three months, then the second year is counted only to the extent of his participation. So, if he only has three months, he would have .25 of a year for the second year, but he would, of course, have the full .1 for the first year. You do not automatically get .1 for each year in which you have any participation; the rule is simply that you always have at least .1, even if you have less than one year.

The other basic rule that's important to keep in mind is that when you're applying the phase-in fraction to a particular individual, the dollar limit that you're using is the dollar limit that's current. Let's say, for example, you're going back to the first year of participation. It's not that you're using .1 of the dollar limit that was in effect in that year, and then in the second year using the second year's limitation. You can always use the current year's dollar limit as the basis for calculating what portion of that is applicable to a particular benefit structure.

The complication comes up because of the way that the 10-year phase-in is supposed to apply. If you have several benefit improvements that have occurred, then when you are going to apply the 10-year phase-in, the first thing that you have to do is apply the total of the benefits against the 10-year phase-in that commenced with the first benefit structure. So, if year one is when the first benefit structure came into play, and if in year three there is a second benefit structure improvement, the benefit formula is modified, and now there's a benefit improvement, then you would cumulate the total benefit under both benefit structures and measure that against the phase-in that had started with the first benefit structure. So, if you're in the third year, you'd have a .3 fraction at that point. Then the second step would be to apply the second benefit structure improvement against the phase-in that would begin with the second benefit structure improvement. So, in year three, if you had a second benefit structure coming into play because the plan was improved, then you would have .1 in the third year applying to the second benefit structure and you would have a .3 applying to the first benefit structure.

And then, of course, if you have still a third benefit structure coming in because of a third plan amendment which granted an additional benefit improvement, then what you would have to do is apply the first benefit structure's phase-in, which in year four now would be .4 of that limit, against the total benefit. You would have the sum of the benefits attributable to the second and third benefit structures measured against the 10-year phase-in that started with the second benefit structure. You would have the third benefit structure piece measured against the 10-year phase-in that had commenced with the third benefit structure. These are the steps you have to go through in order to calculate the portion of the benefit that is available under the 415 maximums.

The example in 89-45 (Table 1) was, of course, a very simple and unrealistic example, but the good thing about the simplicity of the example is that it's an easy way to demonstrate the mechanics of the rule. Now you'll see that the facts given in the example in 89-45 are that the employee has a salary of $200,000, and it's assumed that will never change. It's also assumed that the dollar limit was $90,000 and that would not change. And then you have the three benefit structures. The first one is simply 1% of pay, and that lasts for four years. Then the plan is amended and it provides a 4% of

TABLE 1

IRS Notice 89-45

The following facts are assumed:

Employee's Salary:	$200,000 per year (with no change).
415 Dollar Limit:	$ 90,000 (with no change).
1st Benefit Structure:	1% of pay for each of years 1-4.
2nd Benefit Structure:	4% of pay for year 5.
3rd Benefit Structure:	8% of pay for year 6.

	Year 1 1988	Year 2 1989	Year 3 1990	Year 4 1991	Year 5 1992	Year 6 1993
1st Benefit Structure						
Phase-In Limit	9,000	18,000	27,000	36,000	45,000	54,000
Initial Benefit (1% of pay)	2,000	4,000	6,000	8,000	10,000	12,000
2nd Benefit Structure						
Phase-In Limit					9,000	18,000
Benefit Increase (additional 3% of pay)					6,000	12,000
3rd Benefit Structure						
Phase-In Limit						9,000
Benefit Increase (Additional 4% of pay)						8,000
Total Allowed Benefit	2,000	4,000	6,000	8,000	16,000	30,000

pay, but 4% of pay in the example is not retroactive. The 4% of pay is only for the fifth year. The 1% of pay applies for the first four years. And then the plan is amended to put in still a third benefit structure. That's in year six, and that, again, is not retroactive. So, you have an 8% of pay formula for the sixth year and a 4% of pay for the fifth year and 1% for the first four years. In year one, the phase-in limit, assuming $90,000, we're assuming that doesn't change, even though, it does, of course, with a cost-of-living adjustment (COLA), is $9,000, and the amount accrued under that benefit structure is $2,000. So, it's clearly within the limit. And that's true in year one, year two, year three and year four. Two thousand dollars is accrued each year in addition to what had been accrued in the previous year, and the total accrued benefit in each of those years is considerably less than the phase-in limit.

Now, in year five, the year in which the second benefit structure came into effect, the phase-in limit that applies to the first benefit structure is $45,000. The benefit attributable to the first benefit structure is $10,000. The benefit increase that's attributable to the second benefit structure is $6,000. Now, the first thing you do in step one is to take the sum of the $10,000 and the $6,000 and make sure it doesn't exceed the first benefit structure's phase-in which is $45,000. The second step is to make sure that the amount attributable to the second benefit structure, the $6,000, doesn't exceed the phase-in limit that begins with the second benefit structure or the $9,000.

In year six, a third benefit structure is added to the plan. Now, again, the first step is to take the total of the three benefit structure amounts. So, you have the $12,000 attributable to the initial benefit structure; you have an additional $12,000 attributable to the second benefit structure; and, you have $8,000 attributable to the third benefit structure. The second and third benefit structure amounts are the additional amounts attributable to these new benefit structures. The total of that is $32,000, which is less than the $54,000. When you measure that amount against the initial phase-in limit, there's no excess.

When you move to the second benefit structure phase-in you'll see that we're in the second year of the phase-in as to the second benefit structure. Now you have $18,000 as the limit, because again we're using $90,000 as our base, and we're not adjusting it for any COLA. Now, the $12,000 benefit increase that's attributable to the second benefit structure, along with the $8,000 benefit increase that's attributable to the third benefit structure, of course, is $20,000, and that exceeds the $18,000 limit that started with the second benefit structure. The $8,000 that came in with the third benefit structure has to be decreased to $6,000, and then you'll have the total equalling the total allowed benefit, which is $30,000. One thing that's interesting to note, because of conversations with some people on this, is there's some confusion about how much you can accrue as additional benefit in any year. It's perfectly okay for the difference in the benefit between years five and six to be $14,000. The benefit was $16,000 at the end of year five, but it increased to $30,000 at the end of year six -- that's certainly more than .1 of the then-dollar limit, but that's a perfectly permissible increase. Now, if you carried this out to year seven and continued the benefit structures that are in place, and you did not add a fourth benefit structure, what you should get would be a total allowed benefit of $41,000.

Now, let me mention a couple of things about the application of this 10-year phase-in rule that will cause some problems, and most of the problems I'm sure many of you are familiar with. If you have a defined benefit plan that's terminating and has a considerable amount of excess assets that the employer wants to allocate among the participants of the plan, you'll find that it's quite possible, if the excess is fairly substantial in relation to the benefits under the plan, that you'll violate the 10-year phase-in when you try to allocate the assets. This is because when you allocate the assets and convert the addition that comes about because of the excess allocation to an annuity, it will exceed the 10-year phase-in in many cases if the excess is large enough.

What the IRS said in the notice 89-45 was that it might be, in certain circumstances, that the 10-year phase-in could be waived for certain people. The IRS has since mentioned

at some meetings where they've had spokesmen speaking about this that it's quite possible that, some time in the future, the 10-year phase-in rule would be waived for nonhighly-compensated participants, but not now. Whether it would go beyond that, I don't know. But that could be helpful in the case of a plan that's terminating. I've had experience with a plan that is terminating which happens to be a governmental plan (it is also subject to the 415 limit). They want very much to allocate all the excess assets, but they are running up against the 10-year phase-in. What they've decided to do is to submit it to the IRS, making it very clear that they are violating the 10-year phase-in, and see if the IRS will accept. If they don't, then they'll probably just continue the plan for a few more years. It's perhaps not 100% clear, but my feeling is that if you continue the plan, even though it's frozen (then you're just continuing it for the purpose of allowing people to grow into the 10-year phase-in) that that could be accomplished, i.e., that your participation wouldn't automatically stop when the plan terminated. I don't know that that's absolutely clear, but that's the way that I would see it.

The other thing that's very unfortunate about the 10-year phase-in is the fact that it will come into play if you amend a plan not to increase the accrued benefit payable at the normal retirement age, but to increase early retirement benefits. So, if you want to amend your plan to put in a subsidy for early retirement or you want to amend your plan to put in an early retirement window, the phase-in can become very substantial because then what you're talking about is .1 of the dollar limit as reduced for that early commencement. The worst case would be if you wanted to have a fully-subsidized benefit available at age 55. If you amended your plan to permit that, you would undoubtedly run into the 10-year phase-in limit for a number of employees.

I wanted to mention one other thing about the operation of this rule that is somewhat interesting, but I think it's just a natural consequence of the operation of the rule. This comes up if you consider, for example, that most of the defined benefit plans are integrated with Social Security under the old rules. On January 1, 1989 those plans had to be amended to put in a new benefit structure, and probably in most cases we still don't know what that benefit structure's going to be. Whatever it is, for purposes of calculating the amount of benefit that's attributable to the first benefit structure (by first benefit structure I mean the benefit structure that was in effect on December 31, 1988 in a calendar year plan), you're really going to be calculating that under all of the old rules. Presumably you would calculate the benefit attributable to the first benefit structure as the December 31, 1988 benefit structure without the $200,000 cap, without the new integration rules, but using the old integrated formula. That would be the amount that's attributable to the old, original benefit structure. Then, if under the new benefit structure there happens to be some excess over that, it's only the excess that will be subject to the 10-year phase-in.

I think that's about all that I had on the 10-year phase-in. I had a couple of other things I wanted to talk about briefly because I thought they were fairly significant. One of them has to do with the requirement that benefits commence at age 70 . . . or the April 1 following 70.5. Notice 89-42 came out last year that allowed those commencements to be delayed for non 5% owners until April 1, 1990. There are, of course, the 5% owners who have had to commence their pensions even earlier than that. But one of the things that's an interesting consequence of how this rule works is that if you have someone

whose pension is now supposed to have commenced on April 1, 1990, if this person is highly compensated or super highly compensated, in most cases that benefit probably has been frozen under the Notice 88-131 rule back to the end of the 1988 year. Presumably the benefit that has to commence on April 1, 1990 is the benefit the person had accrued through December 31, 1988 in a calendar year plan, and that's presumably without any recognition of 415 COLA that have occurred since that date.

Another item that I wanted to mention has to do with the $200,000 cap. I think we're all pretty clear now that the IRS has said that once there is a COLA to the $200,000 cap, you'll be able to apply that retroactively. The one thing that was said (I think it was Holland or Wickersham from the IRS who said this) about the $200,000 COLA is that, unlike the 415 COLAs, you would not be able to recognize any of those adjustments as to an employee who had terminated employment. When an employee terminated employment, if his compensation was well in excess of the $200,000 cap, but in the next year the $200,000 cap was adjusted upward, and the year after, apparently you will not be able to recognize those COLAs to increase his benefit in later years. That's a very big distinction between the way it operates for 415 purposes.

The other thing I'll mention with regard to the 401(a)(26) regulations, is they're being worked on. The thing I understand to be true is that they're going to be simplified and they are really not going to be so concerned with discrimination issues since the IRS feels that it's taking care of all the discrimination issues in the 401(a)(26) regulations. So, maybe because of that there's a good chance that the (a)(26) regulations really will be somewhat simplified. I think that's everything that I have at this point.

MR. GARY B. LAWSON: I'm going to cover a bunch of items quickly, The first is not mentioned in the material that was in the outline, and that is Private Letter Ruling 89-40013. You all know that private letter rulings are not binding on the surface. They warn you when there are problems and when you ought to back off or at least seek your own private letter ruling. This ruling is of interest because it dealt with expenses which could be paid by an employer with respect to qualified trusts like the trustees' fees, managers' fees, brokers' fees, accountants' fees, counsels' fees, or other agents' or fiduciaries' fees. As you may recall, last year there was a ruling that said that the fees associated with trading securities in a plan, the commissions, could not be paid for separately outside of the plan. That would have meant an extra contribution. But with these trustees' and actuaries' fees, which are not related directly to the trades, they will be a deductible expense so that they can be put into the plan as an extra contribution, or they can be paid for separately and apart from the plan.

The next item that I'd like to mention is Revenue Ruling 89-14. For some number of years both the IRS and the Department of Labor have been very concerned about plans that made loans to participants and did so at below market or above market rates. That often happened because employers wanted to treat their employees reasonably well. This ruling said that where there was an unreasonably low interest rate; the net result is plan disqualification. They said that a participant must have some security with respect to a loan to have a valid plan loan, and therefore, in most defined contribution plans, the person pledges his vested account in the plan. In order to have a valid assignment or pledge of your account and not violate the antiassignment rules, you had to have a loan

that satisfied the requirements of the code. If, in fact, the loan was made at a below-interest-rate level, then it was an improper loan and the assignment was one that violated the antialienation rules. If you violate the antialienation rules, you have plan disqualification. So, although the Department of Labor seemed quite neutered in ever being able to take an official public position on these favorable loan rules, they came out eventually with a position. The IRS has made it possible for them to disqualify a plan, and it's not something you'd ordinarily think about.

The next item is Revenue Ruling 89-68. This, I think, is terribly important to lawyers. It may be important to the large actuarial consulting firms who sometimes practice before the IRS in a quasi-legal role. Ruling 89-68 provides guidance for fees paid to the tax practitioner to prepare and submit a request for a ruling which happened to concern a nonbusiness transaction. If you have a nonbusiness transaction such as, for example, you pay your lawyer to buy a house, you cannot deduct those legal fees. Here the taxpayer was concerned whether or not a particular expense was a deductible medical care expense. The tax practitioner, maybe an accountant, lawyer or actuary, said, "I don't know. Tough question. Let's submit a ruling request to the IRS." This revenue ruling held that the cost for preparing and submitting the ruling request and the fee, the user fee, were all deductible expenses. You can tell your clients when you have to charge them substantial fees that those fees at least will be a deductible item in many cases.

Revenue Ruling 89-87 dealt with wasting trusts. This ruling held that a plan under which benefit accruals have ceased and distributions hadn't been made very promptly would remain a plan subject to all of the qualification requirements. That is, even though you've told the client that their plan is terminated, if you don't make certain that they know that they have to make distributions to everyone as quickly and as reasonably as possible, their plan may not, in fact, be terminated as far as the IRS is concerned. That has a couple of problems. First, some day when we get around to technically amending qualified plans again it means that these plans should have been amended for all changes that would be applicable just as though it was an ongoing plan. Also, minimum contributions and minimum benefit accruals would be required under the code. The revenue ruling tells us that a distribution not completed within one year following the date of the plan termination will be presumed not to have been made as soon as administratively feasible. There was 78-05B relief for the fact that this ruling did not have a retroactive effect. It was issued July 3, 1989. So, if this is the first time you're hearing about it, then you have one of these problems.

The next item has to do with bankruptcy. This is letter ruling 89-10035. Here a bankruptcy court said, "Pay me that bankrupt individual's plan interest so I can distribute it to all of or as many of the debtors as it will go around." The IRS in this private letter ruling held that would violate the qualified plan rules on antialienation. The net result would be quite interesting. I'd like to find out what the bankruptcy judge said when he was presented with a copy of this ruling by the plan's attorney saying they were not going to honor it. Nothing in this private letter ruling assured that lawyer he would not be held in contempt of court. The ruling said it was perfectly all right, since the individual had terminated employment, for the plan to make a distribution to him or her, and the court ordered that individual to turn over those assets. So there's a fine line, but the plan cannot make the distribution.

Letter Ruling 89-11007 is very interesting because some lawyer, it appears, goofed up in drafting a RABBI trust. He drafted what the IRS held to be a RABBI agreement, but it wasn't a RABBI trust. It was merely an agreement. The IRS, in their view, held that the favorable tax attributes that should have followed failed because the trustee wasn't given enough of what are normal trust powers, such as the ability to manage and invest the assets. I know that most good actuaries are very familiar with RABBI trusts and recommend them from time to time to their clients in lieu of qualified plans. The point here is that it's not something that can simply be left to inexperienced counsel or, worse yet, to an inexperienced bank until you set up an agreement.

The next item is a GCM. The General Counsel Memorandum 39785 was issued in 1989. It dealt with a company that wanted to transfer all the assets from a Voluntary Employees' Beneficiary Association (VEBA) to a 401H account. Now, if I didn't know better, I would almost begin to guess that the actuary said, "If I can control the health care plan and the pension plan, I can make sure things are done right. Perhaps I can charge more fees." But not casting any aspersions about fees, lawyers have no authority or right to do that. The IRS held in this GCM that the transfer from the VEBA to the 401H account did a couple of things. It resulted in a tainted VEBA; it resulted in a disqualified pension plan; and it resulted in instantaneous taxation to the employer of the value of the funds transferred. In any event, the reason this happened is that VEBAs specifically contain prohibitions against returning the assets to the employer under Section 501C9. The 401H accounts, by contrast, say that if you've used all the money, paid for all the benefits and if there's anything left over, give it back to the employer. That's what you must do with it.

Let me quickly mention, while we're talking about health care, that retiree medical benefits can result in disqualification of pension plans if not done correctly. We have seen the private sector and government sector plans paying health care benefits without 401H accounts. We ought not to let that happen. Often actuaries and lawyers are advising clients to look at retiree health care and redesign the program, changing the benefit structure. A year ago we looked at one local public company with 16 divisions, 14 different health care plans, and 36 different descriptions. Not all of them were consistent. Some did indicate that changes that might otherwise appear to have been made possible by one document were clearly made impossible by another document. You need to ask your clients when you get into that area to provide to you, in writing so you have a track record that you did so, every piece of communication material, every document, every plan, every summary of every plan, every highlights folder, every severance meeting, script, etc.

I just want to discuss a couple of things from health care plans. I know some of you get involved in health care, self-insured health care plan, design and drafting. All of these examples are from large public companies' self-insured health plans. None of these are from small plans. These are from plans that people paid a lot of money to have. It said benefits will not be paid for charges incurred for hospital confinement furnished by the United States, and it went on. After it was revised, it said that, except to the extent that certain in-patient and out-patient care provided through facilities and uniform services of the United States may be reimbursed to the government provided, such right of

reimbursement does not exist. The problem with the plan before and how it was repaired after was that COBRA not only gave us health care continuation, but also provided that veteran's hospitals could bill private sector plans for certain in-patient and out-patient care.

In another example, the same plan document had two descriptions of what a preexisting condition was. It said that a preexisting condition means an injury/sickness for which an employee or a dependent receives treatment, incurs expenses, or receives a diagnosis from a physician, but the very same plan had another definition that said one has to incur expenses, receive medical care or services. Which provision would control? The "receives diagnosis" will take care of the preemployment physical. The latter wouldn't. A lawsuit certainly could ensue where the plan describes the very same event or subject in two different manners.

This is some language we've come up with. I'm sure most of you by now have heard of the Supreme Court decision in *Firestone Tire & Rubber vs. Bruch*. The court said that administratively we're not going to give great deference anymore to the decision of plan administrators, and we will not hold it to an arbitrary and capricious standard anymore. If we can, we're going to *de novo* try these issues anew in the court, unless the plan says we won't. So we've added language, and I recommend this type of language be in all of your pension and welfare plans. It says that the decision of the plan holder or administrator shall be final and binding on all parties, and its decision shall not be overturned by any court unless that court finds the decision to be arbitrary and capricious. I hope not to have to test case and have this go up to the court, but it is better to try to avoid spending lots of money on legal fees for plans when we might be able to avoid this.

Another document said the plan does not cover any disability or any charge for care or service for drug addiction, drug dependency, drug abuse or drug overdose. First of all, let me mention that this was a Texas plan written before Texas mandated certain drug benefits. But it's a self-insured plan, so we say Texas can't, but in other states you may have similar problems. The problem with this is if the doctor's smart enough to get through medical school, he's smart enough to figure out that drug addiction means he doesn't get paid, and mental nervous disorder means he does. So, it's kind of foolish to have a plan that doesn't properly coordinate between drug abuse and psychiatric type care. The solutions are leave the plan as it is and litigate, exclude all mental and nervous disorders, eliminate your plan's drug abuse exclusion which, of course, means exploding costs, or do something else with the plan. You need to think about the problem.

A different plan concerns Medicare recipients. It says the following applies to the individual who's covered under the plan and is also eligible for Medicare. Aggregate payments under the plan are reduced by the aggregate benefits available under Medicare. In summary it says that covered, actively employed individuals or dependents, age 65 or older, may reject coverage under the plan. The problem with the language before was it didn't properly coordinate with Medicare. And this requires coordinating your health care plans with Medicare. Fail to coordinate properly and you've got a 25% excise tax that's applicable, which is as meaningful as COBRA penalties, if not worse. By the way, this rule used to only apply to plans with a hundred or more employees. For

those of you who have smaller health care plans and think you I don't have to worry about that, you're wrong. Congress changed the rule and said this rule now applies to all health care plans. Let me turn the discussion over to Gus Fields to talk about a couple of important Employee Stock Ownership Plan (ESOP) issues.

MR. GUS FIELDS: ESOPs are still a good thing for many employers, even though Congress has cut back significantly on the benefits that employers could get. For example, there is no longer a free ride with a tax credit ESOP under which the employer could be sure that the Treasury would bear the entire cost of the ESOP including the administrative expenses. And each year Congress seems to be cutting back a bit on the benefits that employers get from maintaining ESOPs. However, they're still a good thing for many employers, if it's desirable and convenient for them to allow employees to obtain an interest in the corporation.

I would just like to mention a couple of the cutbacks that occurred last year and also a couple of rulings that the Internal Revenue Service has issued. One of the most significant changes last year was the reduction in the 415 limits for ESOPs. As you know, in the past you got a double credit under the Section 415 limits for ESOPs. The limit was twice as high as it was for other defined contribution plans. That has been eliminated. Nevertheless, you can still ignore certain interest payments and forfeitures that are allocated to ESOP participants' accounts in determining if the plan meets the 415 limits. One of the cutbacks in the law last year placed additional restrictions on the 50% interest exclusion that qualified lenders were able to obtain on interest paid by an ESOP on a loan they made to finance the purchase of securities. In order to get that 50% benefit now, the transaction must result in the ESOP owning 50% or more of the corporation. The loan must not be for more than 15 years. There are also expanded voting rights required for the participants in the ESOP.

The Internal Revenue Service published a revenue ruling last year which basically said that a loan was eligible for the 50% interest exclusion when the interest was collected by a qualified lender, even though the loan wasn't originated by a qualified lender. For example, the ESOP and employer could go to an underwriter who agreed to market the loan or to hold the loan until it is sold to a qualified lender. Eventually they could sell it to a bank, an insurance company or a regulated investment company, and during the period that the bank or insurance company or regulated investment company received the interest they would be able to take the 50% exclusion, even though they didn't originate the loan or hadn't owned it during the entire period of its existence. Congress did consider overriding that revenue ruling. I believe the House of Representatives' bill would have required that the loan be originated by a qualified lender in order to get the 50% exclusion. The Conference Committee changed it, and Revenue Ruling 89-76 is still in effect.

Another revenue ruling that was published last year said that an employer could take a deduction for dividends paid on stock owned by an ESOP and applied to reduce an ESOP loan, even though the dividends were paid on stock that had not been obtained with that loan. The Congress didn't like that one either, and last year they changed the law to provide that, for stock acquired after the effective date, the dividend deduction would be available only if the dividends were applied to reduce a loan that was used to

acquire the stock on which the dividends were paid. This law has an effective date of August 4, 1989. It does not apply to stock acquired before August 4, if the stock was acquired and held by an ESOP before that day. Unfortunately, you can't convert a non-ESOP plan into an ESOP and avail yourself of the dividend exclusion with regard to stock that was held before August 4, 1989.

The Internal Revenue Service did issue another ruling last year which was adverse. Section 1042 allows an individual who sells securities to an ESOP under certain circumstances to get nonrecognition of his gain on that sale where he reinvests the proceeds in something else. An individual sold securities to the ESOP and did not elect, as Section 1042 requires on his return filed for that year, to not recognize the gain. The Internal Revenue Service issued a private letter ruling which stated that once the time for filing the return expired, he was not entitled to any extension of time for taking the election to recognize the gains. So, it's important that anyone who sells stock and hopes not to recognize gain on the ESOP know ahead of time, plan for it, and attach the election to the return filed for that year.

MR. ROBERT L. PAWELKO: What is Revenue Procedure 89-65? For those of you who may not be totally familiar with it, it came from 88-131. Do you remember that one? It was issued in the last minutes of 1988. Procedure 88-131 gave us all these things that extended compliance with the Tax Reform Act of 1986 (TRA), and, if you are like me and communicated to clients some of the things about 88-131, you ultimately got a little surprise. Among the things that 88-131 did was to freeze all super highly compensated employees at the end of the 1988 plan year -- most of them on December 31, 1988. Their benefits were frozen. All highly-compensated employees between the $50,000 and $75,000 limits back in 1986, were frozen on December 31, 1989. I wrote letters to all my clients and explained just how that all worked. Then we get Revenue Procedure 89-92, which is another one that expands on this. Procedure 89-92 was issued later on to clarify 89-65. I never understood 89-92. But then we got 89-65 that says, hey, time out. Everything in 88-131 just sort of drifted along.

Well, about three of my clients who had elected Alternative 2(d) (which is the easy one) on December 31, 1989 stopped accruing benefits. You just don't do anything on Alternative 2d. You could pay the benefits on the old formula for the people below the super highly-compensated level. Well, they shut off their highly-compensated level on December 31, 1989. Now, there's a lot more people who fall in the bracket between the highly compensated and the super highly compensated than there are in the super highly compensated bracket. People started yelling and screaming at a couple of these companies. They weren't getting any benefit accruals after December 31, 1989. Now, some place in 89-65, for the group of people between the old $50,000 and $75,000 limits (I think it's $56,000 and $84,000 this year), you can continue to accrue benefits on the old formula at this time, and there's a fair number of people in that group.

How do you handle benefit accruals for people who are super highly compensated and who have left, terminated or retired? I don't have answers to that. I've got a couple of clients who are paying these benefits. They've made a promise. They've got a document that has been filed or given to them, summary plan descriptions, that says that if you've got a pension plan, it's going to give you a benefit along this formula. That document is

still out there. Who cares what TRA 1986 did to it? The document is still out there. You can't pay it out of the qualified plan, maybe, but you still owe the benefit to that guy. Now, some of these people left on less than happy, acrimonious terms. With some of the things that have happened and companies that have been taken over, you had pretty ticked off executives sitting out there who have been working since December 1988 and now find out that they don't have a benefit. Now, who are they going to come to? I don't have answers to these things. I have a client that's paying it out of their pocket. We can really thank our brethren in the IRS for some of the great regulations they've given us on clarifying some of these things. It's a real problem, I think, and it's getting worse and worse as it goes on.

Is there anything special that needs to be done now? Can we continue waiting for the 401(a)(4) regulations? I have been told at least five or six times by people in the know that the 401(a)(4) regulations are due imminently. Since 1986 they're due imminently. Right now we're waiting for April 16, which is what I heard most recently. So, for 89-65 I think that there's a lot of problems with it that people aren't really facing, and that is the accrual of benefits, particularly for the super highly compensated. You'd just think that because the IRS says that you have to freeze benefits for the super highly compensated, that doesn't stop the promise that the company has made. The promise is still there. You just might not be able to pay it out of the qualified plan. I think that we need to be talking to a lot of our clients or a lot of the companies that we work with about some of these issues, particularly as this thing drags on and on, and we're now in 1990. My guess is we're going to be well into 1991 before we have any reasonable idea about what we're doing.

How about 89-52, which is the one on quarterly contributions? I guess it's a PBGC thing and they feel you need it, but it isn't hard to take a contribution and divide it by four. It isn't even hard to do the 25-50-75% phase-in. I don't know about your situation, but most of my clients have been in and out of full funding so much, and full funding is like a switch. It is just on and off. You don't gradually go into full funding and gradually come out of it. It's just . . . bang! You have a contribution of a million dollars in one year, and you have zero the next year.

Now, last year what happened to one of my clients that we're involved with is they were putting in quarterly contributions based on the 1988 requirements, and the 1989 contribution came out to be zero. Fortunately, they could recharacterize it as the 1988 contribution as long as it is paid before September 15. That worked then, and that'll work this year, and it'll work next year, but as soon as we get to the point where we actually put in a full quarterly contribution -- the first one's due on April 15 -- what's going to happen? Now you're going to be putting the money into the plan based on your prior year contribution, because no actuary gets the valuation done by April 15, at least none that I've ever worked with in any firm that I've been with. You just can't possibly get them done that fast. So, you put the money in, and now you go into full funding because you had a good stock run or whatever the case was. Now not only can't you get it back out, but you also have to pay a penalty, a 10% excise tax penalty on it.

I have a hard time comprehending where all these regulations are coming from. I can tell you right now that I don't know of a company in the country that is complying with

the law or all the laws that exist. I don't think they can. I don't think they can understand them.

Start thinking about it. Try to figure out some ways you can comply. A friend of mine suggested that if we can get a company in and out of zero contributions every other year, somehow we can always keep zero quarterlies going. That's one way to do it, I suppose, if you can get them in and out of contributions by, I suppose, changing your assumptions yearly. But what kind of games are we playing? What are we accomplishing? Who's benefiting from any of this stuff? If this is the kind of stuff that we're doing to try to get the professional corporations out of business, they're getting the big corporations out of the business of pension plans, too.

Another problem I had was that one of my clients just happened to miss making a quarterly contribution. We tried to find out what interest rate we use. It's 175% of the federal mid-term rate. You know how many mid-term rates there are? Do you know where to find it? I couldn't find it. Nobody in our office could find it. We had to call our New York office to find what rate they were talking about. It's not something that's easy. I mean we have 48 interest rates we use nowadays for calculating pension contributions and funding limits and things like that, and we've got a new one now. These are the kinds of things I guess I'd like to alert you to start thinking about. You're going to have a real problem come 1992. I'll turn it over to Emily.

MS. DAVIS: If you have any questions or any discussions on any of the rulings that we haven't discussed so far, I think we'll start that now.

MR. ROBERT SAMUEL HAWS: I have a question about the $200,000 limit you talked about before. Suppose somebody were to terminate at the end of 1990, and their pay over the last 10 years, let's say, had been $400,000 per year, and the average plan was over a five-year period. Would their average pay be computed based on the $209,200 and then four years at $200,000? Is that your understanding of how the plan would work, or would you use different limitations in the pre-1989 years?

MR. POLSDOFER: The participant retired at the end of 1990?

MR. HAWS: Yes.

MR. POLSDOFER: And you're calculating a benefit assuming you have a calendar year plan?

MR. HAWS: Right.

MR. POLSDOFER: Any portion of that benefit that was accrued beyond December 31, 1988 would have to be based on compensation in any one year that did not exceed the $200,000 cap with adjustment, whatever that would be. Using whatever that is now for 1990, that would be how that would work.

MR. HAWS: Well, for your 1989 plan year, would your cap be $200,000 or $209,000 when you're looking at the pay in 1989 if the person's making $400,000 in that year?

MR. POLSDOFER: Now, with the cap in the example that we're looking at here where he retires in 1990, then I would say that for purposes of determining his benefit at the end of nine years, when he retires, the compensation that you would take into consideration for 1989 would be the same as for 1990, not $200,000 but $200,000 with the adjustment.

MR. HAWS: And similarly then for 1988, 1987 and 1986, you would take into account the $209,000 for that portion?

MR. POLSDOFER: Now, this, of course, is based on my understanding of what the IRS is going to say. Until we see it, we probably should not believe it 100%, but if you were calculating that benefit for the person who's terminating some time during 1990 on the basis of, say a five-year average pay that went from 1990 back into 1989, 1988 and 1987, then for each of those years it's my understanding that the IRS will allow you to use compensation that's capped at the level that's in existence for 1990.

MR. HAWS: Okay. But in the absence of that guidance, I guess we would use the dollar limit in effect for each of those years until we knew for sure? I guess you could do that, right?

MR. POLSDOFER: Yes.

MR. HAWS: So, in my facts you would use $200,000 up through 1990 and $209,000 for 1990 to compute the person's final average pay. Until you had the explicit guidance you could use the $209,000 for all the years. Okay.

MR. PAWELKO: Can I add a point on this? I don't think I have an answer to this thing, but I can have an opinion on it. We have an executive who's got salary levels, let's say, averaging $400,000 a year right straight through December 31, 1989. We have a defined benefit plan. And let's just say that it was a nonintegrated defined benefit plan, to keep it easy. Are you saying, then, that we use $400,000 up to December 31, 1988 for the defined benefit plan. And let's just say that it was a nonintegrated defined benefit plan, to keep it easy. Are you saying, then, that we use $400,000 up to December 31, 1988 and then for the increments, for 1989 and 1990, we're going to use $200,000, or do we have to use for a final average $200,000?

MR. POLSDOFER: I guess the point I'm saying is we would use $200,000 historically for the final average.

MR. PAWELKO: See, I have a real problem with that because if I have another client who's got a defined contribution plan that's putting in a 5% of pay contribution, and this defined benefit plan costs 5%. I'm giving that executive a defined contribution in 1988 of $20,000, 5% of his $400,000 pay. But now, just because it happèns to be in the form of a for the defined benefit, I can't give him credit for that, and I really struggle with that. I think that maybe the best approach would be to use the $400,000 average for the accrued benefit up to December 31, 1988, and then use $200,000 as additive pieces from 1989 and 1990.

MR. HAWS: Yes, you're effectively giving them no accrual, then, in 1989 and 1990.

MR. PAWELKO: Yes, I agree. You're washing him out of a benefit.

MR. HAWS: I agree. That's why I'm posing that question. Let me ask a question on the model amendments. Let's say you had a plan sponsor right before the beginning of their 1989 year who adopted Model 3. Do some of these combinations of rules we've gotten say that they could change their mind, and now go down the 2D road? Could they rescind Model 3 and go down the 2D road such that only the super highly compensated would be denied their benefit accruals, and for everybody below the super highly compensated level it would be business as usual under the old, improperly integrated formula?

MR. PAWELKO: Yes. That's one of the neat things about 89-65. You can do whatever you want as far as having adopted Model 2 or Model 3 or anything like that. So, yes.

MR. ROBERT M. DUGAN*: On the 10-year phase-in of the dollar limit under 415, based on user participation, did I understand you correctly that in a plan termination situation that you can still give everybody up to 1/10th of the dollar limit even though there are no further years of participation beyond the plan termination date when you're reallocating assets in a plan termination situation?

MR. POLSDOFER: No, I don't think that's exactly what I was saying. The guarantee of always getting .1 really applies to someone who has less than a year of participation, and he's always entitled to .1. But upon plan termination, although I'm not 100% sure this is the case, I would assume that if you terminated the plan but did not distribute assets, you held the assets in the plan, and then just allowed people to participate in the plan to the extent of their frozen benefits. Frozen, except that I think they could grow into the 10-year phase-in so that if, for example, you've allocated excess assets and created a new benefit structure in the plan in the year in which it terminates, then for that particular year the person's fraction would be .1, and then the next year it would be .2 and the next year .3, and he could grow into that excess. I don't know that it's clear in that notice, but I think that the person could probably get .1 for the year of plan termination even though that was not a full year; (.1 as to that new benefit structure).

MR. DUGAN: That's my situation -- .1 would be plenty, but they only want to give it to the people who are there on the plan termination date. They want to make it effective on that date.

MR. POLSDOFER: Yes. Now, unfortunately, that's just not real clear cut, it seems to me, in 89-45, but my interpretation would be that you could give those people at least .1.

MR DUGAN: And we'll find out when we get a determination letter, right?

* Mr. Robert M. Dugan, not a member of the sponsoring organizations, is President of RM Dugan & Associates in Inverness, Illinois.

MR. POLSDOFER: Hopefully.

MR. JERRY D. ALLEN: Just another question about the 10-year phase-in rule. I think the Blue Book on Tax Reform dealt with this issue, and it gave some examples. Retiree increases is one of the examples. And then it mentioned that this 10-year phase-in could be ignored if it did not predominantly benefit highly compensated employees. From informal discussions with the IRS, by not predominantly benefiting highly compensated employees this means no highly compensated employee. Is that correct?

MR. POLSDOFER: I would say so, yes.

MR. ALLEN: I'm not sure about the Blue Book, but I remember some language in it about not predominantly benefiting highly compensated employees.

MR. POLSDOFER: Yes. There's a statement in 89-45 which I have right here, and it's either just repeating what was in the Blue Book or it's virtually the same thing, but it says, "future regulations under Section 415 may except," (exempt I think they mean) "certain changes increasing benefits which are not primarily for the benefit of highly compensated employees from the application of the 10-year phase-in." What not primarily for the benefit of highly compensated employees means is not clear. Certainly if it didn't benefit any highly compensated employees, that would cut it, but at this point, even if it is not affecting any highly compensated employees. We still don't have that exemption. The IRS has said that they're thinking about it and that they will probably grant an exemption some time in the future, but right now there is no exemption. The best guess would be that if they do give such an exemption, it would certainly be for nonhighly compensated, and maybe they would allow some highly compensated to fall under that exemption, but it's really guesswork at this point. The impression that I got was the drafters of this provision were concerned that they might cause more trouble than they intended to, and they really hadn't thought through what kinds of exceptions there might be. They wanted to leave the Internal Revenue Service with some flexibility to deal with them as they arose, and I believe that was the reason for this provision.

FROM THE FLOOR: Regarding the 10-year phase-in again. I thought I remembered that the original law had some wording in there, right in the law itself, about exempting career pay plans that are updated periodically, and that was in the statute. I didn't read the Blue Book, but I think the statute said that certain types of changes -- and one that was specifically mentioned was, I think, past service updates, as we would call them -- would be exempted.

MR. POLSDOFER: Yes. I could be wrong, but I don't recall that there's anything in the statute that exempts career pay plans. However, it's possible.

FROM THE FLOOR: Well, these were not career pay plans that were updated for a new formula, but I guess updated to reflect inflation.

MR. POLSDOFER: And there's certainly not anything in Notice 89-45, at least I don't think there is. I don't recall seeing that in there.

FROM THE FLOOR: Was that part of the thinking in terms of certain changes that didn't primarily affect highly compensated?

MR. POLSDOFER: Now, I've not heard anything on that, but it would make sense that if they are going to grant exemptions, that might be a reasonable one.

FROM THE FLOOR: Well, yes, I would think so, too. I mean if you're giving a past service update, and you happen to be giving it to highly compensated as well as everybody else, which is the way they usually work, then I could see the language being stretched to cover that kind of an exemption. The exemption can be stretched to cover that type of an amendment since it's not primarily designed, I think, for the highly compensated, but just the general improvement in benefit. But you haven't heard anything or seen anything?

MR. POLSDOFER: No, I have not.

MR. LAWSON: I'd like to add a remark from a lawyer's side with respect to the quarterly plan contribution notice and the law. Many of you will experience the unfortunate situation of having a client sold. It is nice when your clients buy companies, but occasionally you will find that, through no fault of your own, a client of yours becomes a target and becomes acquired. There is something in these rules that I think you need to know because the lawyers will not, when they draft the sales representations, have any idea to ask the question of the actuary. So you're going to have to bring this to their attention if this is relevant. If you miss a large enough payment liability in the quarterly contribution requirements, and you've got to exceed a million dollars, there can be a lien. There will be a lien in favor of the plan against all the assets of the company, and the danger in this is not that if you have such a lien that necessarily it can't be cured, but that one of the representations likely to be made by a seller is that his assets are free and unencumbered from any liens.

Even though you may have already cured the problem in terms of the contribution, if there is an uncured lien, you give someone a fingertip ledge, if you will, to make a claim that a major representation in a sales agreement has been breached which could trigger liabilities that may dwarf the million dollar or more underfunding of a contribution. So, it's not something that corporate lawyers who don't let ERISA people anywhere near acquisitions and sales until after the deal's done typically think about. You have to inform the people that you're working with that there are a variety of problems that can occur in purchasing and selling companies. If you represent the buyer, this is something that you can do to show how smart you are; tell the buyer and his counsel to ask the specific questions with respect to liens arising under the quarterly contribution requirements.

MR. FRANCIS X. REAGAN: I was just wondering, with respect to 89-52 and the quarterly contributions, there was a question about new plans. In the event of a spin-off, the question was, Are quarterly requirements needed for new plans? They said for the first plan year the plan is covered under Section 412. I was wondering if spin-offs apply to that because, like you said . . . by April 15 you really can't find out too quickly. Did you have any opinions on that?

MR. LAWSON: I don't think there's an answer to that question that anybody can go back and point their finger at, but my guess is that a spin-off is part of an old plan. It's not a new plan at all. And it owes quarterly contributions from that old plan status.

MR. REAGAN: I didn't know if perhaps as a lawyer you might find some of your colleagues taking an aggressive stance on that and others being more conservative.

MR. LAWSON: Lawyers who take aggressive stands in an area where you can seek advice, if nothing else, at least informally over the phone from some very talented, bright people who want to help you in Washington, are quite foolish. I certainly would not recommend that. If the liabilities could get into a problem area, I would not.

Let me also mention one thing I forgot because of time. Gus was mentioning ESOPs, and I'll share with you a concern of mine that caused Gus and I to reject representing a financial institution recently as an ESOP client. The financial institution was a regulated financial institution. Those organizations are subject to very strict capitalization requirements, and many of them have letter agreements today with the federal government regarding what they can and cannot do. It's mostly what they cannot do with respect to their capitalization. They think about occasionally turning to an ESOP as a financing vehicle to restructure their debt. A year ago I would have had little hesitation to have participated in a debt restructuring of a major financial institution. Then a law was enacted which regulates federally insured institutions. Basically it makes all people, like lawyers, actuaries and accountants who participate in events which impair the capital of a regulated institution, liable, just like the directors and officers could be liable for that capital impairment. So, I would strongly caution any of you who get into the ESOP area to use caution with respect to a regulated institution.

MR. LAWSON: The other thing you need to be very cognizant of in the same regard is that there are major securities law problems that don't often come up and are not often addressed in sessions with actuaries, yet you are the lead, the point people, in much of the employee benefit plans restructuring. Let me just share the concept of violating or participating in the violation of the securities law. For example, you have a wonderful communications department, and you are going to sell a 401K leveraged ESOP and convert a profit sharing plan into this leveraged ESOP. You're going to allow employees to vote on it because we believe employee participation in these kinds of decisions makes a great deal of sense. The moment that an employee has the right to make that decision, he has a sense of security, and if your communications people have done a less-than-perfect job of complying with securities law requirements, which they're normally not used to having to worry about, you may have turned yourselves into a secondary creditor. That's a scary term. That means you've got all the liabilities under the securities law, all the fraud liabilities, all the go-to-jail liability potential.

MR. PAWELKO: Gary, can I ask a question on this? As an actuary for a savings and loan or for a bank or something like that, does that mean that if I calculate the liabilities for a pension plan and help get an annuity contract with an insurance company that suddenly goes under, and the liabilities come back to the plan, and it's now impaired even more than it was, does that mean I've got a problem?

MR. LAWSON: Well, it's a terribly interesting question. I don't know. I certainly think that it is something to be carefully considered and studied. The federal government and the financial institutions have no way to bail themselves out. There have been several very successful lawsuits by the federal government primarily against law firms in the multimillion dollar area. There are several insurance malpractice carriers for law practitioners that are on the verge of going bankrupt because they had turned over all of their assets to the federal government and the banking industry. So, I would proceed with great care and caution and ask that you have an in-house session if you do any work with regulated institutions.

MS. DAVIS: I wanted to make a comment on the earlier question about the spin-off and the quarterly contributions. We had a similar situation, and we took a very conservative approach. One of the plans that was spun off was terminating and the other plan was continuing. For the continuing plan, we looked back at the last year's total contribution to determine this year's quarterly contribution. We actually used the old combined plan contribution to determine that amount even though on some reasonable basis you'd think you could go back and try to allocate the portion of the previous year contribution that was attributable to the plan that was continuing, but there are no guidelines on how to do that. So, we took a very conservative approach on that basis. It's easy to do during this phase-in period. It gets more significant as we get on down the road.

MR DONALD S. GRUBBS, JR.: Much of what we have discussed at this session and many of the other sessions relate to the subject of complexity in the regulations and the laws. I would like to mention the hearing that occurred two weeks ago in a subcommittee of the Senate Finance Committee chaired by Senator Pryor addressing this issue of complexity. Senator Pryor is very concerned about this and is expected to introduce a bill. You may disagree with some of the details, but I think most of us who work in a practical way with it still will be able to find it very helpful. To my knowledge that bill has not yet been introduced, but I've been out of touch with things for a couple days, so I could be behind. For those who are concerned with this issue, I would suggest that you might want to write to Senator Pryor to encourage him, to make him know you're concerned about the issue of complexity, to suggest any specific proposals that you have that could simplify the law, and also to write Senator Heinz, the ranking Republican on that committee, who is also quite concerned about that issue. Once such a bill is introduced, take a good look at it. Make your suggestions on it. If you like the bill, you may want to speak to your own senators about cosponsoring the bill and speak to members of the House about introducing a companion bill in the House.

MR. PAWELKO: Before we take the next question let me add one comment. I just discovered the other day through a client of ours whose supercomputer writes the answers to the letters that we all write to our congressmen, and it was really quite scary to find out that there's a checklist. I hope I'm not offending anybody here, but the congressman's staff looks at the letter and picks from paragraphs and then sends it into this computer company. They put together a letter, and it is signed by the congressman, automatically, in their handwriting. Not every letter is handled this way but many are. What I would strongly commend to those of you who don't know it, congressmen don't know much about the law that they have written or sponsored. The exceptions, of course, exist, and Heinz is certainly one of them. Get in touch with staff people. It is

the staff person for the congressman or the committees that are knowledgeable in this area, and take any and every opportunity to educate and become familiar with them. They are, by and large, human beings, but there are a few exceptions. The staff are the people that you need to get in touch with. You reach your congressman with your checkbook. You reach the staff intellectually. And that's a very important distinction.

MR. TIMOTHY J. ADAMS: I just have a brief question regarding the 10-year phase-in. If the 415 dollar limit goes up, say to $100,000, is the new phase-in limit equal to 10% times the lapsed years times the new limit, or is that increase phased in, too?

MR. POLSDOFER: The phase-in at any point is a fraction, and it's .1, .2, .3 of the current dollar limit. So, it would keep going up, and that would affect, in a sense, the prior year.