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LATE BREAKING DEVELOPMENTS FOR PENSIONS IN THE UNITED STATES, CANADA AND INTERNATIONALLY

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o Topics will be based on current events

MR. PATRICK LANDRY: I think American actuaries might be surprised and interested in the recent developments in Canada. Having lived in both countries, I can say that there are many similarities between Canada and the U.S. However, as far as pensions are concerned in Canada (and specifically in the Province of Ontario), Ontario introduced pension legislation almost a decade prior to the Employee Retirement Income Security Act of 1974 (ERISA), and what is occurring in Canada may be a preview of what is to come in the United States and maybe even internationally.

MR. WILLIAM B. SOLOMON:

> "There were strange things done under the Ontario sun
> By the men who make our laws,
> The Queen's Park Trail spew their public tales
> Of chapter, verse and clause.
> The Northern Lights have seen queer sights
> But the queerest they ever did see,
> Was that day last month when Elston's bunch
> Created indexed pensions for me!"

Following the enactment of the Pensions Benefit Act, 1987 in Ontario, a number of loose ends required tidying up. The most significant of these was the issue of inflation protection of retirement income and the separate, but related, matter of surplus refund. A special provincially appointed task force (known as the Friedland Task Force) reported to the provincial legislature in February 1988. Approximately 12 months later, the government issued a detailed report entitled Building on Reform: Choices for Tomorrow's Pensions, outlining its approach to the controversial issue of inflation protection. Throughout this time period, there has been, and continues to be, a government-imposed moratorium on the refund of pension plan surplus from ongoing plans.

I would like to touch on a number of the key recommendations of this report, as well as the implications that enactment of the proposed legislation may have on the approach to pension plans in Canada in general, in Ontario in particular, and as has been pointed out to me by Patrick, possibly in the United States as well.

Perhaps a brief word on the importance of the Ontario proposals in the overall framework of Canadian pension legislation is appropriate. In Canada, pension plans require joint registration: with Revenue Canada for tax relief purposes and at the provincial level if there happens to be provincial legislation. Of approximately 21,000 pension plans registered in Canada, over 50%, or about 11,000, are registered in Ontario. Ontario members represent approximately 40% of the total membership of all pension plans in Canada. Consequently, changes to pension legislation in Ontario tend to have implications that go beyond the provincial borders. (By contrast, if Prince Edward Island changed its pension legislation, it would not make a big impact since it has approximately, 0.5% of the population of the country.)

Although Ontario was the first jurisdiction in Canada formally to implement pension legislation in 1965, the 1987 Act was the first major change to the Act in over 20 years. Other provinces,

notably Saskatchewan and Manitoba, had made major revisions to their pension legislation ahead of Ontario, but Ontario's proposed revisions will establish a new benchmark against which other pension legislation will be judged.

The principles of pension reform have been stated as:

- the protection of pension benefits within a sound economic and responsible fiscal framework;
- the provision of an effective administrative framework;
- the provision of equitable, modern and clear employment pension standards, which reflect the needs of a changing society and economy;
- the allowance of sufficient time for plan sponsors, plan members and bargaining agents to adjust to pension reform requirements; and
- the fostering and expansion of the voluntary employment pension plan system.

Coverage under voluntary employment pension plans, in Ontario and the rest of Canada, has remained at a fairly modest level throughout most of the past decade. Data from Statistics Canada indicate that, in 1986, only about 46% of employed workers in Canada, and the same percentage in Ontario, were members of a registered pension plan. As another measure, only about 37% of the total labor force were covered by a formal pension plan.

The proposed measures in Ontario, in my opinion, will do little to increase this coverage percentage. In the absence of legislation requiring mandatory pensions (which was, in fact, discussed in Ontario during the 1960s), it is my view that employers will continue to seek alternatives to the registered pension plan in order to provide retirement income to their employees.

Since 1970, membership in pension plans with more than 500 members has remained fairly steady, at about 84% of the total pension plan membership. But job creation over that period has, in fact, been primarily among smaller businesses. This would suggest that new, smaller companies are not implementing pension plans to provide retirement income for their employees. This new legislation is only one example of why they would not do so.

The principal recommendations of the Friedland Task Force have been adopted. As a general rule, pension plans should be required to provide, on an annual basis, an increase in the level of pensions in payment of 75% of the increase in the Consumer Price Index (CPI) for the previous year, minus 1%, subject to an annual maximum level of inflation of 8%. This would result in a maximum annual increase in pensions of 5%. This annual increase provision would apply only to members of defined benefit pension plans, which currently represent about 80% of plan members in Ontario. (Legislation like this will, no doubt, assist in reducing that percentage!)

Indexation would also be required of benefits granted to persons with vested deferred entitlements.

Although the proposed legislation will make indexation compulsory on a prospective basis only, i.e., for benefits earned after the effective date of the legislation, voluntary compliance on a retroactive basis, for both current pensioners and benefits accrued prior to the legislation date, will be "encouraged." In order to achieve the desired result, the province has taken a carrot-and-stick approach to retroactive indexation. Briefly, the province is offering employers access to a dollar of surplus for each dollar they "spend" on funding retroactive inflation protection up to the level of 75% of CPI, minus 2%. Presumably, if the pension plan currently has no surplus available, there would be no incentive to grant retroactive indexation of any kind.

However, if a plan were to wind-up (which is an increasingly common occurrence now in Ontario), sponsors will not be entitled to withdraw surplus until each member has been provided with the greater of formal retroactivity to the level of 75% of CPI, minus 1%, or until the employer has paid for at least 50% of the value of the employee's pension entitlements.

"Contribution holidays," meaning the employer meets the funding requirement for the next plan year out of the surplus that is available, will still be permitted.

Other provisions in the proposed legislation deal with matters arising from the requirement to split pension credits arising on marriage breakdown. In addition, there are proposed changes to

improve the administration of plans. I will only touch very briefly on these matters because I think they are more of an esoteric nature than of an overall design nature. There is legislation in Ontario, as well as other provinces, which requires that family assets include the value of pension benefits and the splitting of these assets is giving rise to a number of complex issues, which the province is now addressing. There are sections in the legislation dealing with the enforcement process. As this is currently only draft legislation that has been put out to invite comment from practitioners and plan sponsors, we will wait to see what the final legislation has to offer.

Ontario is the only province in Canada that currently has a Pension Benefits Guarantee Fund (PBGF). The operation of this fund is significantly different from the Pension Benefits Guaranty Corporation (PBGC), which operates in the United States. One recent failure has placed the PBGF in a significant deficit position. At present, the funding of the PBGF is by means of an assessment against pension plans that are in a deficit position. While no draft legislation has been put forward to restructure the PBGF, a few options are being discussed:

- to reduce or limit payments made by the PBGF on claims, and/or to increase the premiums;
- to eliminate the PBGF entirely; and
- to do what is simply called in the document "other possible measures." (It appears that the province is open to suggestions.)

Proposed amendments to the Ontario Pensions Benefits Act, 1987 include a new Section 55 entitled *Adjustment For Inflation*. The section is 34 pages long and covers the calculation of inflation adjustments and the availability of surplus from ongoing plans and on plan wind-up.

The latest proposals and draft legislation introduced in Ontario call into focus the issue of mandating inflation protection for pension plans, which were not (unless derived through the collective bargaining process) mandatory plans in the first place. Although the concept of mandated pension plans in the private sector was considered in Ontario during the early 1960s, the introduction of the (indexed) Canada Pension Plan in 1966 caused Ontario to withdraw its proposal.

Over the past quarter century, since the Pension Benefits Act was proclaimed in Ontario, a number of advances in plan design (such as, final average earnings benefits, earlier vesting, and spousal benefits) have been accepted (in some cases, reluctantly) by plan sponsors. I would suggest to you that mandatory inflation protection will not be embraced as readily!

While indexing will apply to defined benefit pension plans prospectively on a compulsory basis, and retrospectively on an "encouraged" basis, no such burden is being placed on defined contribution (money purchase) plans or on Group Registered Retirement Savings Plans. (A "Group RRSP" is a plan whereby employees are encouraged to put tax deductible amounts into a savings vehicle, which is sponsored by their employer.) The trend to such plans has been evident over the past few years. The proposed legislation will hasten and encourage this growing trend.

What was the matter with the existing system of providing ad hoc increases to pensions in payment at times and in amounts determined by the plan sponsor? A recent survey by Actrex Partners, as well as similar surveys compiled by other consulting firms, confirms that ad hoc increases have enjoyed considerable acceptance. The proposed legislation will, in fact, discourage the continuation of such informal practices.

Let us look now at the additional cost of inflation protection. When the first phase of pension reform was introduced effective January 1, 1987 in Ontario, the added cost to pension plans was not viewed as significant. Many of the changes, such as two-year vesting and certain added preretirement death benefits, had some impact on employer funding requirements, but most of the changes were more cosmetic than substantive.

Not so with inflation protection. It has been suggested that, assuming no other changes are made in plan provisions, the additional funding requirement resulting from the current proposals can eventually add another 2.5-3% of payroll to the plan sponsor's pension costs. This represents the full contribution rate that is currently being made under many existing money purchase plans.

While larger plan sponsors may be better able to absorb these added costs, by passing them on as price increases in their goods and services, many small and medium-sized plan sponsors will face considerable financial hardship in coping with the added cost of inflation protection.

What has been the reaction, to date, to these proposals? As with any compromise solution, neither party is entirely satisfied.

The Ontario proposals have been criticized by labor as doing nothing for existing pensioners, nor for benefits earned prior to the date of enactment (although, as I mentioned earlier, there are some incentives being proposed in return for granting retroactive inflation protection). Plan sponsors and many consultants have criticized the proposals as being excessive and expensive, adding further to the cost and administrative complexity of what, in many cases, are voluntary programs.

What are likely to be the implications of these proposals in the future? Looking first at those employers who currently do not provide a pension plan for their employees, there is nothing in the proposed legislation that would encourage them to do so. In fact, quite to the contrary, the reform proposals will discourage employers from establishing pension plans in general, and defined benefit plans in particular. The Group RRSP approach is more likely to find favor, if any form of retirement arrangement is to be established for employees.

For those many small to medium-sized plan sponsors, whose plans make up the majority of registered pension plans by number, some rethinking and restructuring of pension plans will continue to occur. Some will wind-up their plans entirely, choosing rather to go to the Group RRSP approach. Others (and our recent survey results would confirm this) will restructure their plans to be money purchase rather than defined benefit, thereby avoiding indexation, at least for the present. Still others may reduce the level of future accrual of benefits so as to adjust for the added cost of inflation protection in the overall benefit structure.

Larger private sector plans and government plans may do nothing, and simply absorb the added cost resulting from prospective indexation. While cost sharing with employees is possible, most large plans, in the private sector at least, are noncontributory, and in my opinion, it is unlikely that employee contributions would be introduced again in future simply to pay for the added cost of indexed benefits. I would suggest that these plans will comply with the minimum legislative requirements and provide partially indexed pensions in future.

There will be other implications as well, affecting the capital markets. In the absence of indexed securities (which was a recommendation of the Friedland Task Force) but was not adopted by the province) and with the requirement that there be annual adjustments to pensions in payment, a more structured and formalized approach to the investing of assets in respect of retirees is likely. Plan sponsors will identify a portion of the pension fund that is required to provide benefits in payment, and they may invest those assets so as to ensure an adequate income stream in future.

Combine this with a general aging of present plan membership, and few (if any) new pension plans, and we are very likely to see a shift in future asset mix of pension plans toward higher yielding fixed-income securities as a means of minimizing the investment risk of the pension plan.

As typically happens, any time there is a legislative minimum, it will very quickly become the maximum. That is, while plan sponsors may, in the past, have provided ad hoc increases at levels that would have been in excess of the proposed minimum requirement (75% of CPI, minus 1%, to a maximum of 5%), it is doubtful if any increases will exceed this requirement in future.

Perhaps now would be a good time to revisit the principles with which I began my talk and consider the possibility of success of each:

o Pensions should be protected within a sound economic and responsible fiscal framework. While the first part of this principle is likely to occur, the latter part may not be. I have suggested that the full added cost of inflation protection could be as much as an additional 3% of payroll. Many plan sponsors, especially smaller ones, will either be unwilling or unable to accept this added cost.

- o An administrative framework should be effective. While the actual calculation of annual indexing amounts should not present any difficulties, employers may find that money purchase plans are a preferable alternative.

- o Equitable, modern, and clear employment pension standards should reflect the needs of a changing society and economy. Well, time will have to be the judge on that one.

- o There should be sufficient coverage. I can find nothing in this document that will lead employers either to create or expand existing coverage. Rather, the opposite is more likely to occur. Perhaps I will be invited back to address a future gathering of actuaries to discuss the reasons for the collapse of the private pension system in Canada.

MR. A. RICHARD LABOMBARDE: I think a fair number of people in Washington are keeping their eyes on what is going on in Canada, and I would strongly encourage the U.S. actuaries not to ignore it before it is too late.

Right now, Congress is set to take at least a tentative first step in the direction we have just been discussing; a first step in the sense that Congress is just looking at the situation in which a pension plan terminates with surplus assets. Congress is saying, "We will not address the ongoing situation yet, but at least in the event of plan termination, there ought to be some retroactive protection with respect to inflation increases." What I am talking about is a bill which Senator Howard Metzenbaum introduced, dealing with pension plan asset reversions.

Now, those of you who have watched the Washington scene for a fair number of years know Senator Metzenbaum has been introducing asset reversion bills for a decade now, if not longer. However, this bill has momentum. In my opinion, I would give this bill better that 50/50 odds of being passed, very possibly this year.

Senator Metzenbaum got a fair amount of momentum in 1988. We were lucky to get off with just a 15% excise tax instead of the 60% that was originally sought. He got a fair amount of sympathy in the Tax Committees during that time, and it is no accident that the IRS put a hold on its determination letters until May 1, 1989. The IRS was in discussion with Senator Metzenbaum, and the hold was specifically to give him time to get rolling on this.

There are some major new features in this bill, S-685. (Its companion bill is HR-1661.) The allocation of surplus upon termination of a defined benefit pension plan in this bill references the nature of the implied commitments. There is a tie-in to the theoretical, conceptual basis behind the benefit commitments that are there. There is also a tie-in to the type of the replacement plan; in none of the bills that I have seen previously has there been quite this tilt to it. These issues are starting to be taken quite seriously. There are a fair number of congressmen who had not supported reversion legislation before, who are starting to take a second look at this, and I think it does have a fair amount of momentum.

There are a couple of missing links. There is no reference to resolving any of the questions arising from the Blessitt decision. Some of you may feel that is fine. The Blessitt decision was reversed, and that is all we need to see on it. However, there is a case currently before the Supreme Court that deals with similar issues. In the absence of anything from Congress, I think the ambiguity in priority category six would remain, and sooner or later we would see a Blessitt decision come back. The fact that there is nothing of that type in this bill surprises me, possibly pleasantly, except it is hard to be sure. There are things that Senator Metzenbaum said, in introducing this, that almost sounded as though he had resigned himself to the stance of the Court when it reversed the Blessitt decision.

There is no tie-in that I can see to any change in the full-funding limit. I think we can all anticipate that, sooner or later, there is a fair chance that we would get some change in the full-funding limit if this bill continued to gather steam. There is discussion under way with respect to the full-funding limit, and if you get a tie-in there, this bill may be passed just because there are a number of things building that way.

I have a couple of points, then, as to what this bill is talking about. First, in order to attempt to revert any assets to the employer, an employer must terminate the pension plan and vest all benefits earned up to the date of termination. This is the same as current law, but the reason I

mention it is that there is nothing along the lines of the administration's proposal two years ago that, as long as you just annuitize the benefits, you can withdraw surplus money.

If you were at the Enrolled Actuaries meeting a year and a half ago, you will remember there are some outstanding questions regarding vesting of employees with breaks in service. To my knowledge, the IRS has not produced any formal guidelines on this. It is another one of those areas where we are still waiting for guidance -- a future late-breaking development, if you will.

There is a requirement in the bill for a certain degree of controlled group liability. The essence of this requirement is that before there can be any reversion of assets, every defined benefit plan within the controlled group must be 100% funded with respect to benefit liabilities. There is no provision in the bill with respect to transfers between the funds in order to achieve that, but I imagine that either such a provision might be introduced, or there will be a fair amount of attention drawn to the controlled group question as this progresses.

As to the reversion itself (or, rather, the allocation of the surplus assets upon the termination of a plan), we have three situations:

- The employer establishes a complete replacement plan.
- There is a substantial replacement plan, but it is not necessarily the same plan, or as good a plan, as what was previously in place, or is a defined contribution plan in place of the defined plan.
- The employer does not establish a new plan at all.

If the employer establishes a complete replacement plan, i.e., an identical defined benefit plan, then the plan must retain a cushion of 125% of projected benefit liabilities in the new plan to protect the promised benefits of active workers and to protect against a stock market downturn. This is 125% of projected benefit obligation (PBO), not of current liability or accrued benefit obligation (ABO), as some of the earlier proposals had suggested. The employer would also have to provide a one-time increase to retirees to the extent that their benefits have not been adjusted for inflation in the past. This is retroactive to the point of each employee's retirement. It is not 75% of CPI, minus 1%, with a limit (as proposed in Ontario). It is 100% of CPI, with no maximum. The only credit the employer gets is if there have been cost-of-living adjustment (COLA) increases in the past. If the employer has given less than full COLAs in the past, then there will be a one-time increase to retirees. This would also apply to terminated vested members, if memory serves me correctly. Then the employer would be permitted to recoup any remaining assets, if in accordance with the terms of the plan; remembering, of course, there were some changes in the Omnibus Budget Reconciliation Act, 1987 (OBRA 87) and remembering also that there is a 15% excise tax. (The 15% excise tax has not been addressed in this bill at all, to this point. Congressional staff have considered this question. It is my understanding that the current stance is that the 15% would remain, and it would apply against the full surplus, not just against the remaining surplus.)

What happens if the employer establishes a substantial replacement plan, i.e., a less generous defined benefit plan, or a defined contribution plan? A substantial replacement plan is a defined benefit plan that is nonintegrated, with an accrual of at least 2% of final average earnings per year, or a defined contribution plan with contributions of 3% of salary per year. These are the minimum standards, or else the employer is considered to have a sham plan as the follow-up plan, and that throws you into the third circumstance. If you are in the second circumstance, the employer must transfer a cushion of 135% of the projected benefit liabilities into the new plan. If there is a defined contribution replacement plan, this cushion must be allocated to the individual employees' accounts. Again, there must be a one-time increase to retirees, if they have not received full inflation adjustments. Beyond that, the employer would be permitted to recoup any remaining assets, subject to payment of the excise tax and any income taxes that are otherwise payable with respect to this.

What happens if the employer does not establish any new plan? Essentially, the employer gets nothing in that case. The same requirements apply with respect to providing cushions to the accounts of individual employees, then to the retirees. If there is anything left over, there is a proration among all employees. The employer gets nothing in that case.

I have referred to PBO here. PBO is to be determined using the PBGC interest rates and salary increases of 5%. I would anticipate that salary increases will be one of the intriguing things that will generate a fair amount of discussion on this bill; if you have a nonsalary-related plan, then you are still going to be using the 5%. You use the 5% with respect to expected future benefit increases. Even if it is an hourly nonpay-related plan, you anticipate 5% increases, in order to measure projected benefit liabilities for the purpose of determining the cushion that I have described.

Since we are discussing PBO, let me make one side reference to exactly what this is going to mean in accounting terms -- because if this bill passes as is, I think there is a legitimate question in terms of what is shown on the balance sheet and for costs. As I see it, I do not think this legislation would change the costs or the liabilities, any time at all. I do not think the PBO would increase. I do not think that anything would change, except for the following. I do not think you would be able to show either any or certainly not the full amount of any prepaid pension costs that accumulate if you are overfunded with respect to PBO, because, in that circumstance, any of those amounts in excess of PBO essentially would have to go to the credit of the employees if the plan terminated. And if you read Financial Accounting Standards Board Statement 87 (FAS 87), part of the justification for showing the prepaid pension costs as an asset on the balance sheet is that the employer could always terminate the plan and receive the amount as a reversion of assets. Since that would now be limited, I think that it stands to reason that the accountants would probably limit the assets on the balance sheet. I really do not anticipate that the liabilities themselves would increase, because this is a contingent liability. If you had a situation where you knew a pension plan termination was imminent, an accountant might ask you to show some kind of contingency based on that, but otherwise I would see no immediate change.

The effective date of this is April 4, 1989. This is not April 4 with respect to the termination date of filing of notices. Any final distribution of assets after April 4 would be affected by this. If you have a pension plan termination already in process and it has not hit final termination, take a close look at this bill. You may differ from me in terms of what its chances are, but I think you should be warned that it does have a fair amount of momentum behind it.

I will turn now to some other recent developments. Some of them are at least two weeks old, so in the U.S. they do not exactly qualify as "late-breaking" any more.

IRS Notice 89-45 deals with a ten-year participation phase-in under Section 415 of the Internal Revenue Code for defined benefit plans. You may remember that in 1987, after tax reform, Notice 87-21 dodged the issue with respect to tax reform requirements; the phase-in would apply not only with respect to the total benefit but also with respect to new amendments. Notice 87-21 said that until the IRS comes out with further guidance on this issue, that particular requirement of tax reform would not be enforced. This is that later guidance that was referred to: Notice 89-45, issued in late March. The gist of it is that the ten-year participation phase-in will apply to any benefit structure adopted and effective on or after May 17, 1989.

Given that we are in such an uproar with a lot of other things, questions unanswered from integration to 410(b) to 401(a)(4) on down, I do not see many employers quickly trying to get their benefit structures in place before May 17. However, any employer who is going to pass a substantial amendment should seriously consider getting this through before May 17 to avoid the Section 415 phase-in rule.

Each change in benefit structure would be subject to a ten-year phase-in, and where there are multiple changes in the benefit structure, each one of them would be subject to a ten-year phase-in. (This will be similar to the PBGC's phase-ins of guaranteed benefits -- if you have ever done those calculations, you know this could be complicated. I think once we have all the Lotus spreadsheets in place, it will seem simpler. It will not be all that bad, but it could be very messy.) You will have to look back at the last ten years. If there have been any benefit increases, you will have to calculate what the benefit would have been if each one of those benefit structures had not gone into place, and the facts had remained the same with respect to salary and service. So, it is conceivable that, if you had a benefit increase every single year, ten years from now you could get to a point where you would perform ten different benefit calculations under ten different formulae, for the purpose of applying these phase-ins.

When you are doing multiple changes, the benefit attributable to a particular change is supposed to include the benefits attributable to that change and all subsequent changes. You will take today's benefit with all changes, and compare it with the benefit that would have been in place, if that particular change under consideration had not gone into effect. For example, suppose there have been two particular changes, one in 1989 and one in 1990, and you are looking at the figures in 1991. When you are looking at 1991 at the first change (the 1989 change), you will compare what the benefit is after the 1989 change and the 1990 change with what the benefit formula provided before the 1989 change. Thus, there is an add-on effect involved.

This IRS ruling also includes a reiteration of 85-131, and the methodology part of the Mirza decision in August 1988, that dealt with unreasonable actuarial assumptions. There was a part that also dealt with unreasonable methodology. That part effectively says that if a benefit accrual exceeds 1/10 of the applicable 415 limit in that year and if the plan uses the unit credit funding method, then there is a limitation of the normal cost to the 1/10 portion. If the employee has enough past participation or service to earn a further benefit beyond that, that is fine as long as it is within the limitations in Notice 89-45. However, any additional amount has to be in the past service cost amortization.

As I have mentioned, there are going to be some problems with administration of this and with calculation of all of these past benefits. You may have some problems communicating to employees exactly what their benefits are. There are definitely some plan design considerations. We already have at least one employer who is implementing a plan change before May 17. In the long range, I think plan sponsors would do well to try to bundle their changes as much as possible in this quickly changing environment.

Notice 89-45 does not specifically refer to what happens if you have a termination of a plan and you want to amend the plan to give all the excess to the employees, particularly if bill S-685 sponsored by Senator Metzenbaum is passed. There are some employers who may want to amend their plan first so that they can implement the allocation that they want, not whatever allocation would be in the bill. Notice 89-45 does not specifically refer to such a situation. I take it from the way that it is expressed that the maximum increase, which would be given to any particular employee because of termination of the plan or amendment of the plan in conjunction with termination, would be 1/10 of the limit. That is, in 1989, $9,806.40 in annual retirement benefit would be the maximum that anyone's benefit could increase, if the employer were to terminate the plan and give the excess to the employees.

There have been several interesting rulings recently, relating to 401(h). Although we are concentrating primarily on pensions in this discussion, pension actuaries in the U.S. do turn their attention, from time to time, to 401(h). Several questions have been resolved recently that I think some of us have known about for the past year or so on a verbal basis from the IRS, but we now have something in writing. I would encourage you to take a look at the private letter ruling and the general counsel memorandum that have been issued.

The essence of these two rulings is that the subordinates test for 401(h) is distinct from the deductible limitation. The subordinates test itself does not limit the deductibility of the contributions. The fact is made plain in these two rulings; and specifically with reference to doing the subordinates test, it is pointed out that you may use the normal costs under the projected unit credit method, in lieu of looking at the actual contributions in order to do that subordinates test. So not only is the IRS dislinking deductibility on contributions with the subordiantes test, but it is clearly stating that the subordinates test does not have to loot at contributions in the way that seemed to be implied in the regulations.

What do you do for deductions? Refer back to regulation 1.404(d)/3(f). There is no application under 401(h) deductible contributions of the full-funding limit. You can hit the full-funding limit on the pension side, and still make a contribution on the 401(h) side. Neither of these rulings refers to current liability in that regard. I would imagine that, to be consistent with this, when we find out something on current liability, 401(h) benefits are probably not going to be included.

The general counsel memorandum does say that, essentially, you cannot make a transfer from either a 401(a) or Voluntary Employees Beneficiary Association (VEBA). It does not specifically say you cannot do it, but with the VEBA you have a 100% excise tax on disqualified benefits.

And on the 401(a) side, if you make a transfer, you have disqualification of the plan -- that is made clear in the general counsel memorandum.

Finally, what do we have forthcoming? In Mid-April 1989, apparently just in time for us all to get our quarterly contributions in on time, we will finally get guidance from the IRS on exactly how we are supposed to be doing that. We will see an integration notice sometime in May. This should loosen things up for us on career average plans. It will not give us what we need on the Primary Insurance Amount (PIA) offset plans; we have to wait for the 401(a)(4) regulations. Those, we are hearing, are going to be coming in late summer. I would place my bets on late fall, at the rate that things are going. Regulations on section 410(b) might be out within the next week or so. Guidance on current liability should be published in May. That will tell us things in terms of what is in the current liability and what the rates are.

I want to take a moment, at least, to register my amazement with the ruling that came out on the current liability interest rates for the last four months of 1988. Perhaps it is a little trivial to talk about being limited to 8% when we could have used 7.96% under the corridor. Any of you doing 1989 valuations already, take a look at that notice because, at the very least, I think we are going to see a floor of 8% for 1989. My biggest fear, since interest rates have gone up significantly since then, is that we may have a floor of 8.25% or 8.5% staring at us. So although the corridor is well below 8% now, do not just go with the corridor lower bound, and be careful if you go with 8%; you might have to use something higher once we get further guidance from the IRS.

We are likely to see some budget legislation in Congress this year. There is talk of dropping the 415 limits to the wage base of Social Security (currently at $48,000). We would reduce the Section 401(k) contribution from the $7,600 (whatever it is right now) down to $4,000. But, most significantly, people in Washington are talking far more seriously about direct taxation of the pension funds themselves. There is a proposal from the Congressional Budget Office for a taxation of 5% of the realized income on defined benefit plans, defined contribution plans, or IRAs. There are also significant proposals in Washington that would tax high turnover in pension funds, so that if a plan had turnover of the investments faster than, for example, one year, there would be an excise tax. This has been discussed for years, but I would say some time within the next four years, there is bound to be something far more serious on taxation of funds.

In closing, I want to talk about a late-breaking development that I will ask as a Trivial Pursuit question. How many in the audience have heard of FAS Statement 102? FAS Statement 102 effectively says that when you are doing FAS Statement 35 calculations -- (remember, those were not superseded by FAS 87) -- you do not have to do the cash-flow analysis that accountants normally call for with other enterprises. I guess it is nice to know that we do not have to do something, which we did not think we had to do anyway.

MR. THOMAS A. ROWLEY: I have narrowed down my comments to four particular countries (Australia, New Zealand, Spain, and the U.K.) and two topics which have multinational implications (accounting and taxation). The countries were picked not so much for their importance to North American industry but rather because they are good examples of how some countries have approached the problem of benefits in general, and pensions in particular, in ways that are radically different from the U.S. and Canada. Also, to make the list, they must have gone through some important upheaval within the last year or so.

Let us start with Australia. The first and most obvious characteristic, which distinguishes Australia from the United States and Canada, is the prevalence of retirement benefits in the form of defined benefit lump sums. We have heard Bill and Richard both talking about indexation. That whole issue is of tremendous importance in every country where pensions are found -- but not in Australia. The Australians have a rather neat solution. You pay lump sums and indexation is seldom discussed.

Social Security is a problem. It is means tested. For every $2 of income you have, your Social Security pension is reduced by $1. Because it is means tested, it cannot effectively be taken into account in the benefit formula, so there is essentially no integration with Social Security in Australia.

In the middle of 1988, Australia turned the whole tax basis of superannuation plans upside down. Many countries have talked about cutting the tax advantages enjoyed by qualified retirement

plans. Australia did not talk about it very much, but the government actually did quite a lot. Specifically, it did four things:

- o Maximum approvable benefits were cut back. (Many countries have done that.) Over a period of time, the maximum lump sum will be reduced from somewhere between three and seven times salary, depending on income level.

- o Investment income is now subject to a 15% tax. The previously tax-exempt status has been removed. It is possible to obtain certain tax credits for investments in common stock, but unless a company is prepared to invest more heavily in such stocks than prudence indicates, the company will not be able to reduce taxes much below about 10%.

- o The superannuation fund will now be charged a 15% contribution tax on any contribution paid by the company.

- o To compensate for the contribution tax, the benefits themselves will be taxed on a more favorable basis.

In an extraordinary message, even for a politician, the Australian Treasurer appeared to present this as essentially a tax-and-revenue-neutral picture. There is certainly some truth in the fact that companies could offset the 15% contribution tax by cutting back the benefit levels. However, companies have thus far been somewhat reluctant to grasp that particular nettle.

Finally, a year or two ago Australia introduced a fringe-benefit tax, whereby anything that is outside the tax-qualified superannuation area is subject to a tax comparable to the tax on imputed income that occurs in the U.S. and Canada. However, instead of the benefits being taxed in the hands of the individual, the company is required to pay a heavy fringe-benefit tax upfront. It almost certainly cuts out the attractiveness of many benefits, while increasing the collectibility of taxes on the benefits which persist.

Turning now to New Zealand, I should begin by saying that the relationship between Australia and New Zealand is not unlike the relationship between the U.S. and Canada, in the sense that most people outside of the countries are aware of the similarities, whereas people within the countries are very much more aware of the differences. Ask an Australian, "Does Australia have much in common with New Zealand?" He would probably say, "No."

About six months ahead of Australia, New Zealand announced some major tax reforms, including the following:

- o A tax on the investment income of previously tax-exempt pension funds.
- o A tax on company contributions made to pension funds.
- o A move to cut the taxes on the benefits themselves, so that companies could essentially make these changes neutral, provided they were prepared to cut benefits in recognition of their new tax-free status.

There are significant differences between the details of the packages in Australia and New Zealand, but in comparison with the rest of the world, I think the similarities are overwhelming.

It does not stop there. A few years earlier both countries, at about the same time and for much the same reasons, introduced the fringe-benefit tax concept in which things like automobiles, club memberships, etc. are subject to a heavy tax payable by the company.

Finally, I have quick comment on Social Security in New Zealand. Again, like Australia, there is a form of means testing in the sense that there is a tax surcharge on any other income above a certain level. However, even before the imposition of this surcharge, Social Security, although quite high by normal standards, was typically ignored in the design of company pension plans. Integration did not occur for an interesting reason. Social Security in New Zealand is funded entirely out of general taxation, rather than by identified employee and company contributions. Consequently, the individual employee does not see Social Security as having anything to do with his employer. Any attempt overtly to reduce the company pension plan benefit because of Social Security is therefore viewed with considerable resentment. One of the problems some of the

foreign multinationals have in New Zealand is that they tend to try to impose integration on the local marketplace and have a lot of problems with it.

Crossing the world to Spain, we have an interesting situation, I think, of evolution going wrong. Social Security began in Spain, as it does in many poor and politically volatile countries, as an ambitious program to be paid for by future contributors. The concept was that everybody would retire with 100% continuation of income. As reality took over, "income" took on a peculiarly Spanish definition. There would be 12 job categories. Everyone was assigned to a job category, and the Spanish government assigned a hypothetical salary to each job category. This enabled the Spanish treasury to cut the benefits by deliberately allowing the hypothetical salaries to shrink in comparison with reality, while still presenting the facade of giving 100% income replacement. It is difficult to generalize, but it is now very common to find the actual salary more than double what the hypothetical salary is for Social Security. And even at this diminished level, the Spanish economy does not seem able to support the Social Security system.

To fill the vacuum, the role of the private sector has been gradually increasing in importance over the last decade or so. Until recently, these company plans rested on a very shaky foundation, relative to tax legislation and labor law (e.g., the ability to require employees to retire). About a year ago, the Spanish government introduced legislation to provide a proper basis for the expansion and development of company-sponsored plans. A year later, at the end of 1988, Spain finally produced the key regulations and gave companies a period in which to register their plans. It did not happen. When the fanfare had died down and companies started to read the regulations, they found too many problems. In particular, employee representation on Pension Fund Committees, and the power of these committees, extended far beyond what most companies were prepared to accept. Precise statistics are still somewhat vague, but a reasonable estimate is that fewer than 3% of company plans in Spain have elected to qualify for tax purposes.

Finally, on the discussion of specific countries, let us take a quick look at the United Kingdom, which represents the largest employee benefit marketplace outside of the United States. It has been said that politics makes strange bedfellows, and this has been extraordinarily true in the U.K. in the last 10 years. Proponents of the left wing have been heading as far left as they could go, while equally strident proponents of the right have been going as far right as possible. Somewhat to their surprise, they have started to meet each other on some issues. For example, in the employee benefits area consider the question, "What should I do for my fellow worker?" At the extreme left, the answer is nothing, because the State will take care of everything. At the extreme right, the answer is nothing, because the individual must stand on his own two feet. Both extremes agree that there is no requirement for private sector pension plans.

One reason for this peculiar situation is a very fundamental difference in the U.K. from the United States -- the ability to discriminate in favor of the higher paid. It is not a part of the tax framework in the U.K. that tax breaks should be applied evenhandedly across the range of salaries. (As an aside, those of you involved in employee benefits in the U.S. might take a moment to contemplate how much of the benefits legislation flows from the fact that Congress does not want tax concessions to favor the higher paid. Were this not the case, there would be a radically different form of benefit consulting, with a massively reduced role for lawyers and Internal Revenue Code experts.)

One of the results of having this permitted discrimination in the U.K., as in Canada, is that these practices encourage what has been called the "politics of envy." All systems evolve, but with regular changes in government from left to right and back again, with parties politically driven to dismantle the efforts of the previous administration, the evolution comes in fits and starts.

One of the more significant aspects of Margaret Thatcher's administration is that there has now been almost ten years of continuity. Until last month this has produced a very stable benefits environment, with only a little bit of tinkering. There was some tendency to move away from the traditional, paternalistic approach of the past. Now employees have the right to build up their own individual pension outside of the company plan if they wish, on a tax-advantaged basis.

To everyone's surprise, the 1989 Budget last month introduced a ceiling on tax-qualified pensions, by limiting pensionable earnings to 60,000 pounds. Up to that level there has been some relaxation in the rules, and above that level (although you cannot have a tax qualified pension) there has been some relaxation in the treatment of deferred compensation arrangements. Nevertheless, the

introduction of such a limitation will have very little impact on the British economy (not that it needs much help at the moment), but it will be potentially disadvantageous to a small percentage of very highly paid individuals. This was not at all the kind of thing that Margaret Thatcher was expected to do and mainly just confirms the fact that politicians are unpredictable.

Finally, I would like to talk very briefly about multinationals, and how they are running their businesses these days -- specifically, Globalization versus Autonomy. Globalization, in its purest sense, means running your worldwide company as a single entity. For example, all the manufacturing is done in Taiwan, all the engineering is done in Germany, all the marketing is run out of Italy. In other words, the company does things where it thinks they could be best done. Autonomy means each country is a microcosm of the parent company; in Italy, whether the people there can manufacture well nor not, they will have control over their manufacturing, distribution, marketing, and so on. What is interesting is that if you survey companies, asking whether they think they will be run on a more global basis in the future, they all say yes. You can then ask them whether they think autonomy will be more important in the future. They all say, yes, again.

In fact, those two characteristics increasingly seem to be at odds with each other. To build the global company, you have to sacrifice local autonomy, and we are just beginning to see some recognition of that as companies begin to back off from autonomy.

We have found that the management of a multinational is a combination of three factors: control, compliance, and information. The control the company exercises ranges from dictatorship at one end of the spectrum to total autonomy at the other. Depending upon where on that spectrum the company lies, the information flow between parent and subsidiary will vary. If the company is very dictatorial, there is a lot of flow from subsidiaries requesting corporate approvals. If it is very autonomous, all the parent will ask for is routine information about results and performance.

Outside of that framework is the compliance issue. Until recently, this has been fairly minimal -- typically, a few standard requests for financial input for consolidated statements. However, in the last several years, the accounting professions in the U.S. and Canada have introduced strict accounting standards (FAS 87 and the Canadian Institute of Chartered Accountants (CICA) Section 3460), which extend to all foreign plans. Also, the U.S. Section 404(a) of the Internal Revenue Code governs the deductibility of foreign pension expenses for U.S. tax purposes, and we have been awaiting final regulations for some years now.

This will cause significant activity for the parent firms and their subsidiaries. As a result of this compliance activity, multinationals are becoming more heavily involved in their foreign benefit plans -- and getting some unpleasant surprises! As globalization takes over from autonomy, this trend will accelerate. Perhaps that is one of the reasons the Society is now offering an elective Fellowship course on international pensions. I think this is going to become more of our daily work in the future.

MR. LANDRY: *Bill, you emphasized that the new Ontario legislation is a draft proposal. Could you give us your views on the probability that it will actually become law?*

MR. SOLOMON: Patrick, it will become law. It is only a matter of timing. The Province is now going through a consultative process with the practitioners and plan sponsors. The day has passed when conceptually you could argue about whether or not inflation protection will become part of the law. It will become part of the law; what the Province is looking for now is assistance, from consultants and others, as to some of the practical limitations of what they are proposing. After this legislation is passed, possibly later this year, that is the last we will see of pension reform in Ontario for a number of years.

MR. RICHARD L. MOODY: *Tom, I understand that recently, within the last year or so, the U.K. has instituted its own set of accounting standards for pension plans. I understand the European Economic Community (EEC) might also be instituting similar standards. How many more of these in different areas are we apt to see?*

MR. ROWLEY: The U.K. has instituted SSAP 24. This has quite a lot in common with the FASB and CICA rules, in the sense that it is specific and fairly sophisticated. I think we will find that most of the other jurisdictions are many, many years behind. I think other European countries trying to develop accounting rules still have the tendency to say, "Try to get this information, and

if you can, well, that would be good." As far as the European Economic Community (EEC) is concerned, I do not think that EEC standards are going to have a major impact. The EEC might, I suppose, take advantage of what the British have done and try to make that apply across the board, but that I think is a little unlikely.

FROM THE FLOOR: Bill, is there any possibility that inflation protection will cause a trend toward lump-sum benefits in Ontario?

MR. SOLOMON: The old legislation in Ontario permitted (if a plan so provided) a 25% commutation of the value of the benefit. I believe that was dropped in the current legislation, and lumpsum payments are not permissible as a form of settlement. In terms of plan design, however, there has been a trend to money-purchase plans, and that trend will continue. On termination of employment with money-purchase plans, the individual can transfer the lump sum that has been accumulated to a personal RRSP and has some control over the lump sum. But, under the current Act, eventually the lump sum must be annuitized. So, I think the simple answer is no lump-sum payments out of these plans.

MS. ANNA M. RAPPAPORT: Tom, we see in several countries a great deal more legislation. We see goals that are stated as increasing coverage, and at the same time the net effect is declining or fairly stable coverage. There are particular problems with small businesses that are growing, in North America, on both sides of the border. We also see populations in many countries with significantly more older people. I have several questions in that regard. Do we think we are going to have a real push for mandatory coverage to increase coverage; do we think retirement ages might increase; or are we going to end up with just more individual responsibility? How do we see some of these things playing out together?

MR. ROWLEY: The only practical solution that I can see at the moment will be for more individual solutions to this. This is certainly happening in the U.K. I think it will also happen in Canada, with its move toward a much broader ability to use RRSPs. Having been involved in some small businesses and knowing the pressures they are under, it is very hard to imagine a legislative solution being the answer. I think what you will see is a choice between a massive social security program (which I think is declining as a risk, because it just does not work), or a lot more options for the individual to get a tax break toward building up his own solutions.

MR. SOLOMON: I have several comments on that. The Canadian economy is currently one of the few economies in the world to which the U.S. can point with pride and say, "We are better than they are." It is unlikely that Canada would address the issue through legislating expansion of government programs -- the Canada Pension Plan or Old Age Security. The issue of coverage has been addressed; you have seen the solution that was proposed. As a result, I think that in Canada the individual will be left more to his own devices through the use of an RRSP, rather than looking to an expansion of the private pension system.

MR. CHARLES IAN GENNO: Bill, what has the response been, among your clients, to the proposed tax legislation in Canada, which will significantly alter individuals' eligibility to contribute to RRSPs, depending on the design of the employer's pension plan?

MR. SOLOMON: Part of me says wait until April 27 when the federal budget comes out, and see if the government still proceeds with it. Most employers are reluctantly accepting the proposed legislation, and going ahead in anticipation of having to comply with the calculations of Pension Adjustments, Pension Adjustment Reversals, Past Service Pension Adjustments etc.

But the one trend that I have seen is that most plans are now becoming entirely noncontributory. There is a trend away from the required employee contributions that a lot of private sector plans still had and that will (to a certain extent) help simplify some of the calculations, particularly if you tie that in with the 50% financing rule in Ontario. As I stated during my remarks, and as confirmed by our recent surveys, there is a trend towards asset accumulation plans and away from the defined benefit plans. I believe this trend will continue.