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MESSAGE FROM THE IRS

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Representatives from the IRS will present views on recent regulatory issues and pronouncements. There will be a follow-up discussion in the session "Audience Dialogue with the IRS."

MR. ETHAN E. KRA: With me from the Internal Revenue Service are Marty Slate, Director, Employee Plans, Technical and Actuarial Division, and Jim Holland, Chief of the Pension Actuarial Branch. They handle the ERISA work at the IRS, other than the field representatives.

MR. MARTIN SLATE: I will update you on our tax reform regulations, and then I will review some program matters. Our upcoming determination letter program is, of course, tied in with the regulations. In this connection there is a new program for settling qualification violations by means of closing agreements.

We have just completed the hearings on the proposed separate-line-of-business (SLOB) regulations. The SLOB rules enable an employer to divide his work force appropriately into separate lines of business for coverage and discrimination purposes. The hearings were highly constructive. Our major difficulty in drafting the proposed regulations was that we were starting cold without many data and without much precedent. At the hearing, folks brought forth solid data and pertinent real-life situations. Prior to a detailed review, I can only give you some initial reactions.

The basic framework of the regulations appears workable for most people. This framework is built around the employer asking himself three questions to determine whether a work unit is a qualified, separate line of business. First, is the unit a line of business? Second, is it a separate line of business? Here the unit must meet various separateness standards, such as having separate financial accountability, separate work force, separate management and separate assets. Third, is the unit a qualified, separate line of business? To be qualified the unit must have 50 employees and meet a design-based safe harbor such as the 50/200 corridor. Alternatively, the plan can receive a determination letter from the IRS. However, determination letters can be sought only in certain circumstances: only where a line of business provides no more than a certain minimum benefit to the rank and file or no more than a certain maximum benefit to the highly compensated.

Probably the item most discussed at the hearings was the separateness standards that come within the second prong of the test. Separate management and separate asse[illegible] could not be met particularly by companies with headquarters operations havi[illegible]onnel and assets that span the whole company. In the final regulations

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we will be looking very closely at possible modifications of the separate management and separate asset tests and also the separate labor force test.

There were many comments on the third prong of the test, the features needed for a qualified separate line of business. We will review several suggestions for additional safe harbors. Many commented that for those lines that don't meet the safe harbors, the gateway to the determination letter process, the minimum/maximum benefits test, is too narrow and that sympathetic situations might find themselves being shut out of the process simply because they can't get into the gateway. We're reluctant to open up the determination letter process all the way, but there were several good ideas as to how we might make the gate wider for plans that need to use the process. One suggestion that we liked was that a company could ask for a letter if it meets the criteria under FASB 14 for reporting separately but has chosen not to report.

Another major topic area involved the rules on allocation of employees, specifically how we allocate shared employees among the different units they serve. Comments focussed on the data gathering and recordkeeping that employers will need to run the pertinent tests. For professional employees, lawyers, finance types and so forth, who serve multiple lines of business, the required information on the time spent working for the various lines is not available or perhaps infeasible to calculate. Our intent is to enable employers to utilize data already available to them as much as possible.

The next consuming order of business is to finalize the nondiscrimination package. This is the whole complex of rules including 401(a)(4), 410(b), 401(l), etc. You should have the package in summer 1991. The message on Section 401(a)(4), is that the basic thrust and structure of the proposed package that was issued in 1990 will remain very much intact. It will include the same safe harbors, an objective general test, and the various flexibility features like restructuring. There will be little change in the basic other rules such as on optional benefits or on past service credit. When we decided to defer the effective date of the regulations until 1992, it was absolutely not a signal of a major overhaul. Our intent was to come out with a final package in summer 1991, a fine-tuning of the proposed one. We did not ask people to redesign their plans on a hurried basis.

You can expect to see some material changes in structure. In the time frame for testing discrimination, we were concentrating on the substantive rules when we did the proposed package, we did not focus on the end-of-the-year situation or what happens when an employer comes to the end of the year and finds out that he has unwittingly not quite met the rules. Comments on the proposed rules told us that this is a real possibility, since some employers might not be able to collect the necessary data and run the necessary tests until after the end of the year being tested. Under the existing rules, if the plan fails the tests at year-end, the time period for corrective amendments might well be closed. Final rules will make allowances for this situation by providing a correction period after the close of the testing year at issue. Therefore, an employer will have a few months to correct minor deviations in coverage or benefit delivery. This is an operational analog to the Section 401(b) remedial amendment period which gives an employer time to straighten out form problems. Section 411(d)(6) would restrict an employer from taking away benefits that have already accrued by the time the employer takes corrective action. So, there would still be an incentive to comply during the operative year.

Also a lot of work involves restructuring. For example, in the 401(k) area we're leaning toward not allowing restructuring. From a policy perspective the availability of any kind of restructuring in the 401(k) area can be a disincentive to enhancing rank-and-file participation. Also, we question restructuring where averaging of plan benefits is permitted, as it is in the 401(k) situation. Any tightening would very likely be done only on a prospective basis. Also on restructuring we want ways to test the so-called most valuable benefit. We're trying to develop systems that work for defined benefit plans that test normal and most valuable accrual rates, not systems that are overly complex and can only be undertaken by the largest employers. This is proving to be one of our most challenging tasks. So, correction and restructuring are the major areas of change.

There will be some rifle shots in other areas. For instance, we want to give guidance on cash balance plans, nondiscrimination guidance in particular. We'll address some of the fundamental questions that these plans raise outside the 401(a)(4) context: questions of compliance with the accrual rules, with the age discrimination rules, with the interest rate requirements of Section 417(e), etc. We are trying to put together a safe harbor for these plans. If we do this, it will work much like the target benefit safe harbor. In other words there would be limits on the interest rate or rates applied to hypothetical cash balances in contributions in order to determine accrued benefits. If the cash balance plan utilizes this safe harbor, it will be deemed to meet the various rules. Also we're considering allowing employers to test contributions or benefits against the rate of pay, be it hourly, weekly or whatever a reasonable pay period may be. Obviously, a plan can use the rate of pay for determining an allocation or accrual rate, but testing for discrimination is a different issue because you want to test on the basis of actual compensation, and using a rate of pay may not always produce comparable results. Also, in considering the rate-of-pay issue we have to consider how the concept ties into the existing safe harbors. We will probably provide a mechanism that allows for the use of the rate-of-pay concept. There would, of course, be controls to prevent distortion or prohibited discrimination. Also, there should be a mechanism for a defined benefit plan to provide benefit accruals even though a participant is on leave of absence, such as on duty in the Persian Gulf.

We'll review the use of Social Security supplements to test for the most valuable benefits and how to test whether window benefits are nondiscriminatory, including what window benefits can be in a safe harbor plan. Window arrangements have come into a special focus in these economic times. A test for nondiscrimination on the basis of effective availability may be better than actual utilization of the window benefit. So, if the window benefits are offered to a nondiscriminatory group, election of the window benefits by mostly the highly compensated will not necessarily result in discrimination. In recent weeks window benefit design arrangements have called our attention to the fact that the phase-in requirements of Section 415(b)(5), and particularly Rev. Rule 89-45, may be affecting the scope of such arrangements. I can give you no reassurance on this question. To the extent there may be a modification to 89-45, and right now there's no such modification on the drawing boards, it will not be in the context of the Section 401(a)(4) package.

Do not expect a change to Primary Insurance Amount (PIA) offset plans. We're not likely to provide a safe harbor for PIA offset plans. Many PIA offset plans do pass the general test, but when we look at these plans we see that they pass on the basis

of demographics and design. We simply have not come up with a workable design-based safe harbor. At about the same time as the nondiscrimination package is issued, we'll be coming out with the final 401(k) rules. This is not a high impact item because the proposed rules of 1988 seem, for the most part, to have worked out. One area of interest has been the treatment of Section 401(k) partnership plans. Look for the final regulations to retain the position that an arrangement that directly or indirectly permits individual partners to vary the amount of contributions on their behalf is a Cash or Deferred Arrangement (CODA). However, consideration is being given to clarifying that a partner need not make the cash or deferred election before being entitled to receive a draw of partnership income. Rather, the election can be deferred until the end of the partnership year. Also, we will be providing direction on Employee Salary Deferrals Matched (ESDM) 401(k) Through Employee Stock Ownership Plans (ESOPs). We stopped entertaining ruling requests on these cases in January 1991 because it was not clear whether these two kinds of arrangements, 401(k) plans and ESOPs could be linked together. The Section 401(k) regulations will articulate our position on this. Also minor tinkering with the rules should make them more administrable. One example is the way in which earnings on excess deferrals are allocated. The proposed rules delineate an exclusive method. Final rules will allow plans to choose other reasonable methods of allocation. Similarly, we will be smoothing out the safe harbor rules with respect to hardships.

The changes that we are contemplating mostly have to do with larger plans or unique kinds of plans. At this point the guidance is virtually complete for the smaller, more mainstream plans.

My next topic is our determination letter program. This program has been open since May 1990 to defined contribution plans that meet the ratio percentage test for rulings in the 1989 effective tax reform provisions. With the safe harbors and many of the other basic nondiscrimination rules settled, we plan to expand the program. In early July 1991, before the final discrimination regulations are issued, the program will include defined benefit and target benefit plans that meet the design-based safe harbors. The program also includes defined contribution plans that meet the design-based harbors for defined contribution plans. To be eligible for the program a plan could not utilize the average benefits test, the line-of-business test or rely on another plan to satisfy the coverage in discrimination rules, nor may it use the rules on restructuring or imputing permitted disparity. These stand-alone, safe harbor plans include many individually designed plans and the large numbers of nonstandardized plans emanating from our master and prototype and regional prototype programs. Plans will be expected to meet the safe harbor rules for the 1991 plan year. They may amend retroactively back to 1989 or 1990, in which case we will give them a determination letter for these years. If not, the sponsor will operate in accordance with good faith compliance for 1989 and 1990. In these circumstances our determination letter will not cover questions relating to these years.

Although we will not rule on good faith compliance, most plan sponsors should have no trouble meeting the good faith standards since we would only be concerned with clear violations of the new statutory rules. The idea of the July opening for determination letters is to give adopters of prototype plans and of individually designed safe harbor plans the opportunity to move ahead. Again, the program will involve only rules that are not expected to change. So, you shouldn't have to concern yourself

about receiving a letter and then having to refresh it once the final regulations are out. We are not unrealistic enough to think that every safe harbor plan in the country is going to be coming in. Still, there are employers who want to get all this behind them. There are those who have been living with the benefit suspension of Notice 88-131 for much too long, and we hope they will find this partial program opening helpful. Many plans, particularly the larger, more sophisticated defined benefit plans, will have to await the final rules effective 1992.

With the basic organization and thrust of the regulations set, we must now structure the determination letter program that we will have once the final rules are out: what the scope of a determination letter will be; and, correspondingly, what kind of information we will ask you to furnish and what kind of reliance our determination letter will provide. This is a real question for plans that don't rely on the major safe harbor tests to meet the discrimination rules. Simply by eyeballing a plan we can easily provide a letter as to whether a draft plan design meets one of the major safe harbors. The situation becomes more complicated, though, when a plan does not meet a safe harbor rule on its face and benefits have to be tested through a demographic analysis. This would include, for instance, plans whose accrual patterns do not fall within the safe harbors and, on the coverage side, plans that must rely on the average benefits test. Taxpayers and the IRS cannot ascertain compliance in these circumstances simply by eyeballing a plan formula. A demographic employee analysis is needed. The issue is how much we can ask you to submit and how much our field specialists can review. We all want and you all want the IRS to be able to issue a letter covering as much as possible, particularly since a letter carries reliance with it. But, on the other hand, there are limits to the amount of new analysis that you may wish to undertake at the determination letter stage, and our review capacity is finite.

On certain core issues we will expect to request and automatically undertake a review. This would include all form requirements and nonform requirements of the type that have historically been considered part of the determination letter process, such as, coverage, minimum participation, and the definition of compensation. On these nonform items, we would ask an employer to complete a formatted worksheet where needed. On noncore issues, a determination letter would be optional. The employer will decide whether to ask for a letter on particular issues and, therefore, expand the scope of reliance. Some of the more sophisticated discrimination issues are restructuring, the availability of optional benefits, and other aspects involving demographics. If an employer wants a determination letter on a particular issue, again, the preferred approach will be to provide us with a completed, formatted worksheet summarizing employee data and demonstrating that the rule is met. This formatted worksheet will enable employers to channel their data gathering and analysis. Also, and this is important, the format will define the scope of reliance.

Some will choose not to seek out letters on these noncore provisions because they feel comfortable that their plans meet the rules and/or because they don't want to undertake data collection and analysis as part of the determination letter process. Others will want certainty and seek determination letters on the noncore provisions. The scope of the determination letter and reliance will be tailored to the amount of analysis an employer chooses to provide. A determination letter on an operational matter provides reliance only so long as the same testing methodology that was used in the determination letter demonstration continues to show that the rule is met.

That's an important point to note. Discrimination is a year-to-year concept. When the IRS approves your plan for a particular year with respect to such nonform matters as restructuring or average benefits, we are blessing your methodology and the pertinent numbers for that year only. For future years, reliance carries only to the testing methodology.

Our determination letter program is an important one for you. Our thoughts on this program are by no means final. We welcome your input.

We have been asked whether determination letters will be issued with respect to transfers of excess pension assets to 401(h) accounts maintained under such plans. These transfers were authorized by the Omnibus Budget Reconciliation Act (OBRA) 1990 and the creation of new Code Section 420. Employers that wish to make these asset transfers are likely to want to amend their plans to meet the applicable requirements under Section 420. We will be opening our program to pass on these amendments as part of our announcement. Upon opening up the program, we will be providing guidance as to the provisions that will be required in order for an amendment to pass muster under the program. The Rev. Proc. defining those procedures is expected within a few weeks. If you have a live problem before then, simply get a hold of us in Washington. Frankly, the quantity of such transfers is manageable -- to the point where we can handle them on a one-on-one basis until a program does open up.

In our examination program, our audit efforts have stepped up over the last two years. A major focus is now on employers who, in our view, are using unlawful funding methods and unreasonable assumptions, such as unreasonably low interest rates or retirement ages, to claim excessive deductions for contributions to their defined benefit plans. Our field offices have now completed examining over 4,000 returns. Our target figure is 12,000, which we should meet in the next year. This 12,000 figure has been adjusted downwards from our previous estimates of 18,000. Many of our examinations encompass several plan years of individual taxpayers, perhaps 1986 but generally 1987 and 1988, each of which is included in the 12,000 figure. The number is further affected by the fact that almost 30% of the cases that we are examining, we're completing without finding a violation. We expect findings against 3,500-3,700 taxpayers.

We have already contacted over 85% of the taxpayers whom we plan to examine. In truly abusive situations there will be annual deductions well in excess of $150,000 and disallowances well in excess of $100,000. Between 35 and 40% of the cases involve practices that go beyond the use of questionable assumptions. There are many cases using funding methods that result in severe front-loading, cases with Section 415 issues, etc. In fact, in many of these cases, the interest rate or ages should have little or no role in adjusting the allowable deduction. Use of an improper funding method often results in the plan exceeding the full-funding limit. Once this occurs, no further deduction is permitted in the year at issue. To help with the program we have brought on seasoned actuaries in the field offices to work with our revenue agents. We prefer to resolve many cases at the field office level because we see the audit process as a way for taxpayers to put their facts on the table and because we are talking facts and circumstances. This allows cases to be developed, and an up-front resolution can be explored. At the litigation level, Judge Clapp has

assumed jurisdiction over all the cases in the tax court. He has scheduled trials for January and February 1992 involving two, major law firms, one out of New York, one out of Houston, and nine smaller entities out of Phoenix. Hopefully, these cases will address the issues in a logical sequence.

The actuarial program is one part of our examination effort. A pilot examination program just finished on plans that terminated without seeking a determination letter. Our task is determining compliance with such matters as the Section 415 limits, taxes paid on distributions and reversions, and whether the plans had been previously amended to comply with the TEFRA/DEFRA and the Retirement Equity Act (REA) laws. We hope our profile will enable a broader examination program in that area. Another pilot program will review plans with substantial amounts of employer assets to check for possible prohibited transactions. Both of these pilot programs include defined contribution plans and defined benefit plans of all sizes. We're moving towards a more balanced examination program, focusing on big plans and benefit delivery, perhaps, just as much as discreet violations in the small plan universe.

As part of the broader program, based on the actuarial audit program, you can expect actuarial issues to be part of the package. Congress has been interested in underfunding. Our auditors and actuaries will scrutinize underfunded plans, changes in funding methods, and certain multiemployer plans. In the latter, there has not been much audit activity.

Now, a more cheery note. Plans that were not amended for TEFRA, DEFRA and REA are a concern in any case, and especially in light of 1990's tax court ruling in *Basch* vs. *Commissioner*. *Basch* holds that plans must be amended for new law changes even if these changes don't have an immediate operational effect on the plan. *Basch* was the first in a series of tax court cases involving nonamenders. Can we resolve these cases short of disqualification and all its ramifications? Section 7805(b) authorizes the IRS to grant retroactive relief from sanctions if the particular violation in question was undertaken in reliance on IRS action. In Section 7805(b) cases, where the requirements for retroactive relief are not met but where the evidence is mixed and the IRS may face litigation risks and where there are other equities such as a good number of rank and file, we will consider entering into a closing agreement with the taxpayer. The agreement will provide for the taxpayer to take corrective action and to pay a substantial amount of money to the Treasury in return for our forebearing from disqualifying the taxpayer's plan.

On the basis of our national office experience, the field offices are authorized to experiment with closing agreements on certain qualification issues. Key district offices consider closing agreements as an alternative to revocation of a plan's qualified status. Certain focus areas for the program include operational violations in the top-heavy and integration areas, partial termination and failures to amend. Such agreements will only be available when the equities so dictate and we will require a full correction and money payment that will assure deterrence. We will certainly not consider closing agreements when violations are deliberate or continuing or when they have resulted in significant unlawful advantages to highly compensated employees. Our hope is that this experiment proves successful. Speaking as a tax administrator, as our audit program steps up, we will be best served if an intermediate sanction is developed and is available in appropriate cases involving qualification violations.

Also our field offices now have the authority simply to require a correction in cases involving operational violations of the qualification rules that are insubstantial or *de minimus*, such as an isolated or individualized good faith mistake. An example is a plan administrator incorrectly applying the vesting percentage of a plan participant upon separation, resulting in a single sum distribution lower than it properly should be under the plan terms.

But the plan must have a history of compliance. The plan sponsor must have established practices and procedures to assure compliance with Section 401(a). Once the violation was discovered, the taxpayer must have made an immediate and complete correction so that no participant suffers substantial detriment. More detail on the closing agreement or *de minimus* program is in the April 17, 1991 CCH Pension Plan Guide (#843).

Finally, there are three recent developments. Our national office is opening up a master and prototype program for Simplified Employee Pensions (SEPs) with salary reduction features or Salary Reduction (SR) SEPs. If you are a prototype sponsor or your work is with small employers, you may want to look into this new program. SAR SEPs are, of course, available only to employers with 25 or fewer employees, but they represent an alternative to 401(k) plans because of their simplicity without fiduciary filing or other administrative requirements.

The second matter will be of interest to smaller employers. The Federal Court of Appeals case in St. Louis called *Sergeant* vs. *Commissioner* involved the pension plans of two hockey players with the now famous Minnesota North Stars of the National Hockey League. Each player created a personal service corporation and entered into an employment contract with that corporation. Each player's personal service corporation then contracted with the North Stars to provide the hockey player services to the team. Each personal service corporation established a pension plan. These plans are more generous than the plans available to the players through the hockey league. The IRS thought that each hockey player was in reality an employee of the North Stars rather than an employee of the personal service corporation. Therefore, we determined that the amounts paid by the North Stars to each personal service corporation to be salary and subject to employment tax. Also, because the hockey players were employees of the North Stars and not employees of the personal service corporation, we disallowed deductions claimed by the personal service corporations for contributions to the pension plans. The tax court agreed with the IRS. The majority held that the very nature of the hockey profession suggests a control of the players by the North Stars rather than by the personal service corporation. However, the appeals court focused less on the issue of control and more on the legal, contractual obligations between each player and his personal service corporation. On this basis the court found that both hockey players were employed by their respective personal service corporations. Accordingly, the 8th Circuit upheld the deductions claimed by each personal service corporation for contributions to their pension plans. We are obviously disappointed with this outcome. Our preliminary reaction is that the court was too concerned with the form of the employment contracts between the players and their personal service corporations and gave too little weight to the realities of the situation, control and so forth. We don't plan to give up on this issue. We will litigate in areas covered by other courts of appeals. Be

cautious about setting up plans based solely on the formal employment contract relationship and regardless of the factual content simply because of this decision.

The final item concerns insurance contract plans used for retirement, or so-called Section 412(i) plans. Section 412(i) arrangements are lawful under the Code, and I don't mean to suggest otherwise. I simply alert you to our concern of improper plan administration or incorrect interpretation of the law. One circumstance involves conversion. In other words, what happens when an employer converts from a trustee defined benefit plan to a Section 412(i) plan? Conversion can take place while a plan is ongoing or in the final year of a plan's existence. We are focusing on ongoing and particularly, termination conversions. Is any one-time payment made upon conversion being deducted in a way inconsistent with the rules of Section 404 which may require that such deductions be spread over several years? Section 415 problems may result from these arrangements. Low interest rate, used to price the annuities, and potential lump-sum distributions under the contracts, may lead to Section 415 violations. We welcome your input.

MR. KRA: You mentioned that the IRS is looking at the changes in funding methods and to what extent those rules or permissions might change. Could you give us some insights?

MR. SLATE: When we looked at the 1985 Rev. Proc., which was to expire in 1991, we neither felt comfortable with the notion of rolling it back nor of completely extending it forever.

MR. JAMES E. HOLLAND, JR.: There are basically two concerns. First, the automatic approval has been used to change to methods that do not meet the requirements of the regulations. In 10-20% of a sample taken that there was nothing to show the basis of approval for changing the funding method; neither a Private Letter Ruling nor a Revenue Procedure. The people just changed. In another 10-20% of the cases, the required plan administrator's agreement, which is part of the requirements for automatic approval, was not included with the Schedule B filing.

MR. KRA: You're looking at the issue of benefit accruals or credits during periods of leaves of absence or other periods of nonservice. I believe this question came up right after the initial regulation packages were started, for example, the integration of the 401(l) regulations with respect to long-term disability, that is accruals for benefits for individuals who have gone out on long-term disability. How would that fit into the context of the 401(l) regulations? Would that be also part of that set of issues that you're looking at?

MR. HOLLAND: I will not make any promises of that sort, not that we are insensitive to those concerns. It's just that, when you have the scope and magnitude of the regulations that we're putting out, every issue that comes up cannot be dealt with in the context of regulations. That's why you have requirements for follow-on revenue rulings. To the extent we can deal with some of the issues concerning leaves of absence, we will. To the extent it appears that the issue, and anything else for that matter, is narrow in focus, it may be left to be dealt with later. It's a question of a trade-off between how much you can deal with in the context of a regulation and how to get it out in a timely manner.

A good example that is totally removed from the 401(a)(4) regulations: the regulations, under Section 401(a)(9) concerning minimum distributions. The 1984 regulation package was about eight pages long. Three years later, after all the questions of every little detail, the regulation had grown from eight double-spaced pages to approximately 200. Many like guidance on broad-based issues. Some like additional guidance on issues much smaller in scope. I won't say that it will or won't be covered in the final package.

MR. DAVID P. WARD: A follow-up question on the change-in-cost method. The employer or the administrator often has not stated agreement with the change in method. We had some plans which changed the method. We had been working with the administrator on that. The administrator is signing the Form 5500. Are you suggesting the administrator also ought to prepare a separate certification to the Schedule B showing it agrees with the method?

MR. HOLLAND; I believe the Revenue Procedure 85-29 specifically states that the plan administrator is to attach something to the Schedule B. There is no reason not to sign some attachment if agreement exists.

MR. WARD: Can you give us further guidance on what's likely to happen? Will you give us longer-term guidance on change-in-cost methods soon?

MR. SLATE: Well, I think the plan is to get this study done and have a Rev. Proc. out by early 1993 that would give you appropriate guidance. It may be to continue with the 1985 Rev. Proc.; it may be a tightening or a loosening. But one of the things we're not going to do is come out with something late. I mean whenever we complete the study we'll give guidance.

MR. DREW ANTHONY JAMES: In Notice 89-45, for early retirement windows, will there be any narrowing of the scope of amendments needed to comply with that particular notice?

MR. HOLLAND: My answer is very preliminary. Everybody has their own list of what they would like as an exception to 89-45. The top of the list includes Cost of Living Adjustment (COLA) increases. Others are amendments on plan termination to distribute excess assets to nonhighly compensated employees, window benefits, exception from the phase-in procedure, and amendments to comply with 401(a)(4). In this process where we draw the line? If you must test increases where highly compensated employees might benefit to a significantly greater degree, then guidance would be provided. IRC 415 puts the limits on benefits without regard to who's highly compensated or not highly compensated, and even nonhighly compensated employees have some limits on benefits. We expect the 401(a)(4) regulations have to come out first. The time table following is not known.

MR. RANDY D. KELLEY: Will W-2 pay be included in the 414(s) safe harbors under the final regulations?

MR. HOLLAND: Likely yes, but we can't give any absolute statements until the regulations are out.

MR. KELLY: With regard to the employee (and family) aggregation rules applicable to 5% owners and the top 10 most highly compensated employees, when will we see any guidance for allocating defined benefit amounts?

MR. HOLLAND: The final regulations will not necessarily address that, and it may the subject of a separate project. Some of the simplification proposals would repeal the family aggregation rule.

MR. KELLY: If a corporation uses the SLOB rules to qualify all its component corporations and plans, and one SLOB maintains a defined benefit plan, and that defined benefit plan must be tested under the 401(a)(4) general rule and, therefore, has to be segmented into various component plans, will the final regulations require that each component plan pass on a controlled group basis or can the entire plan qualify on a controlled group basis? (The 410(b)(5) issue).

MR. HOLLAND: Let me make sure I understand the question because it's easy to go astray here. The SLOB rules help define what the employer is before you even get to testing the plan for coverage. Start out with a controlled group. If you have a separate line of business here, then the employer for 410 and 401(a)(4) purposes becomes the separate line of business, and within that separate line of business you have many plans, and you would test average benefits for the respective particular plan only among the separate line. The question is whether or not you have a qualified SLOB under the 414(r) regulations. That's a separate question. Once you establish that you do have a SLOB, then the SLOB is considered the employer for the plans of that employer.

MR. KELLY: Right, but it's necessary for each plan to pass 414(r) on a controlled group basis. That is, each plan must meet the nondiscriminatory classification test on a controlled group basis.

MR. KRA: Let me rephrase the question. Once you qualify that you have a separate lines of business, that you've gone through the SLOBs, it's a qualified separate line, it's passed administrative scrutiny and everything like that, then there's a requirement that each plan that's being tested, even though it's gone through the rest of the rules on the basis of its line of business, must pass 410(b)(5) on a controlled group basis. The regulations seem to give us the unsafe harbor as the gatekeeper for that test. If within a given plan the total plan, passed the 410(b)(5) unsafe harbor on a controlled group basis, but now in order to pass 401(a)(4) must be tested on restructuring, is each one of those components required to pass the 410(b)(5) unsafe harbor?

I believe many readers of the regulations believe that the regulations do require each one of the components to pass 410(b)(5), and I do know that that was an issue that was raised in the oral testimony at the SLOB hearings.

MR. SLATE: Right. By the way another related issue is whether in passing coverage you could use the old reasonable classification test as distinguished from the safe and unsafe harbor dichotomy. There is a debate whether that will be in the final regulations.

PANEL DISCUSSION

MR. MITCHELL I. SEROTA: I represent one client with fewer than 50 lives that is in the mail hauling business, and according to the Department of Labor Standards, all mail haulers must have a money purchase plan into which the employer puts 75 cents per hour. Meanwhile, there are some office workers who take care of all the paper shuffling. What sort of plan can they have? Collective bargaining is not involved. Must they also have a money purchase plan of 75 cents an hour or is there any discretion in what the employer can do? Because of some government regulation the bulk of the employees are required to have a very specifically designed plan.

MR. HOLLAND: The exemption is that, if your plan doesn't cover any highly compensated employees, you get a free ride through 401(a)(26).

MR. SEROTA: Good enough. I have another question with respect to the 401(l) regulations. I trying to recreate an offset plan under the new definition of what an offset plan can give, and reading final average compensation definitions and going through that process. That seemed fine. At the point where there was the maximum offset allowance, and that the final average compensation is restricted by maximum offset allowance, I don't understand the introduction of the concept of final average compensation.

MR. HOLLAND: It's in the law itself, although there doesn't seem to be any particular rationale to having a definition of final average compensation in an offset context that differs from average annual compensation in a more general sense.

MR. KRA: Consider a controlled group that operated many different defined contribution 401(k) type plans, throughout the controlled group. In 1989, the company using good faith compliance under separate lines of business legitimately had separate operations, different businesses, good faith separate lines for 1989 and 1990. Finally by some time in 1990 the company decided to merge all the plans and create one plan. This group would like a determination letter on an amended plan that covers 1989 and 1990 only, because of the comfort level that comes with such a determination letter, especially since all those plans were merged into one, and if there's a taint in any one of those predecessor plans, it can carry through forever into the merged plan. Can the group do this, and when can it come in for a determination letter on 1989 and 1990? Would it be possible for the group to get a determination on good faith compliance of separate line of business, if in every other respect, the plan meets the forms?

MR. SLATE: No. I don't know how pertinent 401(k) is to your question, but there is not going to be a determination letter program for good faith compliance.

Our concept of good faith for the years 1989 and 1990 is going to be an abuse concept. To the extent we can catch it in the determination letter process and let you know, maybe you can correct it. Otherwise, it will get picked up on audit.

MR. STEVEN G. VERNON: A client has about 30 different pension plans. Many of them have identical benefit formulas. The biggest plan, passes by a mile, and we don't want to test every single plan – particularly those plans that have identical formulas. Would that be considered good faith compliance, if we say because the big

plan passes, then these other, littler plans with identical formulas pass, given that we've looked at the demographic for 1989 and 1990; and 1991.

MR. SLATE: Perhaps, yes, while you're in the good faith period, you're running a significantly less risk. Once we get into a period where we have definite guidance, I really think you're well-advised to get yourself determination letters wherever you possibly can.

MR. VERNON: But you're saying it's risky once the regulations are solidified. A company acquired another company, and actually stopped the formula December 31, 1991, and the formula stopped won't fail, but we haven't done the test, and then coming in January 1, 1992 is a safe harbor. Under good faith does the plan pass up until 1991?

MR. HOLLAND: This is probably acceptable but I don't have all the facts. Merely because you have a merger or an acquisition doesn't throw you out.

MR. SLATE: We hope to give some guidance of what our view of good faith is during this period. I don't know how that guidance would take place.

MR. KRA: You indicated that we may be seeing some guidance in cash balance plans. Would it be possible to give any indications of where you think any of these issues may fall out?

MR. HOLLAND: We may do a safe harbor for the final regulations. It's complicated by the fact that cash balance plans tend to be somewhat varied. In some an employee who separates from service still gets the benefit of the hypothetical interest increase on his or her account. Others tell the employee that if he or she separates from service, he or she does not get the benefit of the interest increases on the account. The first type is the easiest to regulate.

The other type has significant problems from 411. We won't stretch the accrual rules, the backloading rules, to accommodate cash balance plans. In any safe harbor, where we would do an accommodation it is in the Section 401(a)(4) area, particularly when interest rates can be used for accumulating and testing. Safe harbor is a problem if 417(e) requires a distribution that is higher than the hypothetical account that people have.

MR. JAMES: Governmental plans are subject to the 401(a)(4) regulations in 1993. Will there be any special rules, any exceptions, any additional grandfather provisions for governmental plans? The state anticutback rules are practical issues for the governmental plans.

MR. SLATE: Deferring to 1993 gives an opportunity (1) to start thinking about how to comply with things that are clearly inevitable, and (2) to tell us what you think we ought to be considering. I suggest that you take advantage of that opportunity.

MR. KRA: As part of the small plan audit program you find that a significant number of these plans are using actuarial methods as opposed to assumptions that are improper. Assumptions are subjective. Methods are delineated in regulations. In

those situations where you find blatant violations of regulation, is the IRS referring the actuary to the Joint Board for disciplinary action?

MR. HOLLAND: The answer is, I hope so. About 1985-86, the internal rules within the IRS on referral to the Joint Board were changed. We do not know the extent of referrals.

MR. KRA: In a situation a number of years ago we took over an account, and we were very uncomfortable with the prior actuary's methods. To accept the amortization bases and the credit balance we went to the IRS for an approval of a change in funding method from entry age normal to entry age normal. The IRS approved the change with certain requirements on setting up certain amortization bases to handle certain facets of the situation. The letter specifically stated that the letter was being given because the prior actuary's methods were unreasonable and did not meet the requirements. I would prefer he be referred, if he habitually uses improper funding methods.

Our profession should be doing things in accordance with the rules as outlined. If we disagree with the rules, we have the right to petition Washington to change them or, alternatively, I believe there is a procedure with a Schedule B for filing a Schedule B where the actuary differs from the stated published guidelines of the IRS, where the actuary feels that the IRS is incorrect. The actuary can file such a Schedule B with proper disclosure.

MR. SLATE: I presume the actuarial profession does a good job and self regulates as do other professions.

MR. KRA: Where there's a difference as to the definition of reasonable, I would not be referring to the Joint Board for enforcement. That is a judgment issue. Where there has been a clear, blatant violation of regulations and rules, that is an area that should be followed up on. Many of us in the profession don't know what our peers are doing because it's being done through private filings with the IRS. Granted, I mean Schedule Bs are public documents. But we're not going in and auditing them. Where the audit does uncover something, it should be looked into.

MR. GAIL E. JOHNSON: I've had a few small plans examined. Your people did a fairly decent job, and they were fairly understanding.

Could we get some kind of a letter when they're done that just says our examination is concluded, and they're not taking any further action?

MR. SLATE: That's a legitimate comment. In the income tax audit process, the Exempt Provider Organization (EPO) is a section unto itself. Our new Assistant Commissioner John Burke, a superb manager, has met with the exam people and gotten firm commitments to get those letters out. The second thing is that he is changing the process possibly by January or February 1992, so we have complete charge of any pension issue, start to finish.

MR. JOHNSON: I'm worried more about my cases that are fine, than other people's cases that have a problem.

MR. SLATE: But 30% of these are fine, but those letters haven't gone out, and I think that it would relax people. It would suggest a certain amount of reasonableness to our process.

MR. JOHNSON: The new 401(a)(4) regulations are likely going into effect in 1992. In new plans three things are the five-year limit on past service, the 35-year rule for accrual, and the target interest rates. If I put in a plan now, am I going to be unreasonable if I use, say, 6% for a target interest rate as opposed to the new 7.5% or 8.5% for a plan that's effective 1/1/91?

MR. KRA: That is, if you stay with that same proposed safe harbor range until the regulations are final, is that the only range or could an administrator still use the old rules during the good faith period assuming that you leave the range unchanged in the regulations, but the regulations are effective January 1, 1991, and use something else in 1991 as good faith?

MR. HOLLAND: When you're in the area of good faith, and you're looking at the existing revenue rulings. I think the answer's yes.

MR. SLATE: Right. I think that had the change been statutory, I don't think we would be sympathetic. But right now good faith would basically be the new statute and the old interpretations as they would apply.