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RECENT RULINGS AND REGULATIONS UPDATE -- LATE-BREAKING DEVELOPMENTS

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The panelists will review rulings, regulations and announcements which have been issued in the last year. This is intended to be an overview and not a detailed analysis.

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I'm from The Segal Company and I'll be moderating this session. Since we have an expanded panel, I don't have to say very much, but let me just go through a few items, as I know there aren't too many late-breaking developments. In fact, the most important late-breaking development was a subtraction, rather than an addition. There's still a lot of discussion, and a lot of things still being considered on Capitol Hill, so I'm just going to go through a list of four things that we might call context, things that we ought to look for in future legislation, because they keep reappearing.

The first is higher tax rates -- "picking on the highly paid" I call it -- higher tax rates for highly paid people, executive compensation as a target, the removal of a deduction for compensation over $1 million, which appeared in one of the proposed bills. On the other side of that is reduced capital gains, which will probably happen. That's a small counterbalancing item. The second is continued emphasis on defined contribution plans in all forms, IRAs, simplified employee pension (SEP) plans, and 401(k) simplified testing. The third is enhanced portability. That's been on the agenda for probably 10 years as a high-priority item. Now in contrast to that, there is proposed elimination of five-year averaging. And the last is the potential vulnerability of insurance products, and the inside build-up and (loan) treatment on corporate-owned life insurance.

Those things have appeared in one form or another in all the pieces of legislation and in the President's budget message. We're likely to see them resurface, but probably not in a tax bill this year. If you're looking for a consistent theme in this, the only one that is apparent is incoherence.

MR. ADRIEN R. LABOMBARDE: Up on Capitol Hill, there may be a lot of moving back-and-forth, and questioning, and not too much certainty about where to go. But there is some activity on the regulatory front. The recent IRS Announcement 92-29

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delayed the effective date for the nondiscrimination rules, and actually went a step further. Previously, there was a 1992 effective date for 401(a)(4), but there were earlier effective dates for many of the other regulations, such as 401(l) and the like.

IRS Announcement 92-29 says that for private, nonexempt employers, the effective date is 1993 for the regulations for 401(a)(4), for the compensation limitation under 401(a)(17), for the integration rules under 401(l), for the coverage rules under 410(b), for the qualified separate line of business (QSLOB) rules under 414(r), and for the definition of compensation rules under 414(s). So it really expands the scope of the delay of the effective date.

Don't think that anything related to nondiscrimination at all is completely delayed until that point; 401(a)(26) is the biggie, and the participation rules are still in effect beginning in 1989. Also not on that list are 401(k) and 401(m). An important point with respect to that is that you can no longer restructure the plans in order to pass the actual deferral percentage (ADP) test under 401(k). So if you're seeing restructuring as a 401(a)(4) rule, that is correct. It is a 401(a)(4) rule, but the delay of the 401(a)(4) rules until 1993 does not give you restructuring for 401(k). There were also some previous regulations on optional benefit forms. Those continue to have the previous effective date and those were not delayed.

For private tax-exempt employers, the date is delayed until 1995. For public employers, it's also 1995. However, there's a distinction between those two. For private tax-exempt employers, it's 1995, but you have to use reasonable, good faith compliance from 1989-94. Public employers are simply deemed to comply. You don't have to apply any of this until 1995 for state and local governmental plans.

There is apparently word around Washington that we're going to be seeing a little bit further specificity on that as well for public employers. For public employers, 401(a)(26) and 401(k) may, in fact, be a part of the list. In other words, you may not have to apply the participation regulations, for example, for the public employers until 1995.

Does this delay mean repeal? I say probably not. I see a lot of activity in Treasury and the IRS to try and use the time frame to try and fix some of the holes that are perceived as being in the regulations. I see a lot of indication that they're going to stand fast on the regulations, though there's no real movement toward a complete overhaul. The patches that are being talked about are exactly that. They're considering fixing some of the rules with respect to the way in which service is treated, because there have been a lot of complaints about that. They're looking to the questions with respect to data collection, because there have been a lot of problems and questions raised with respect to how perfect the data has to be in order to perform the calculations for the general test. And they are looking to the general test to see if there's some way of providing, not a replacement for the general nondiscrimination, but something that would be a simplified version of it that could be passed by certain plans in certain circumstances.

With this kind of direction at the current moment, I don't see any sign of repeal. As long as things are still hanging out there in the wind, I imagine there's still always a chance that the Treasury could fail to come up with some fixes in the current rules to really satisfy anyone. On the other hand, I see some indication from some employers that they are taking this period of delay as a sign that there may be a real chance of repeal, and they've drawn back and are sitting tight waiting. And those employers do face a risk of getting to the end of this year and being in the same bad shape that they were in at the end of last year; they will have very little time to get their act together.

Regarding transitional compliance during the interim, what do you do if you're a private, nonexempt employer and you're supposed to be using reasonable, good faith interpretations between 1989 and 1992? A number of things from the IRS give us some guidance on that. I would recommend Announcement 91-38. Announcement 91-38 does deal with the transitional period, and gives us such goodies as "Alternative IID is extended through the close of the remedial amendment period." Although Announcement 91-38 came out before Announcement 92-29, you can read that to mean through the end of 1992. Alternative IID can even be used by plans that had previously done an amendment. There are some plans out there that amended to what they thought were safe harbors in 1989 or 1990, and they read the final regulations and found that there are some additional problems that they hadn't contemplated. Those plans can use Alternative IID for the 1992 year even if they had not previously used it. Of course, they have to comply with all the constraints of Alternative IID, such as the restriction of distributions for super highly compensated employees. Excess accruals under Alternative IID can be disregarded for testing nondiscrimination, for example in 1989 and 1992. Notice also that when using Alternative IID, it doesn't restrict you from the availability of the safe harbors past 1992. You get to that by walking through the rules in the regulations, which you can use for a fresh-start. If a plan were under Alternative IID, and a highly compensated employee received an accrual that would otherwise bounce it out of the safe harbor, as long as the fresh-start rules are applied, a safe harbor still is permitted to be used past 1992. The same doesn't come through quite as cleanly when using the general test. You really have to go into the fresh-start rules for the general test, if you want to get the same kind of pass-around that Alternative IID may have given you in terms of excess accruals or allocations.

During the transition period, nondiscriminatory availability can be tested as of the close of the plan year. That permits some time to make an amendment. If an amendment is made as of the end of the year, then technically a certain optional benefit form wasn't available during the year, and Notice 91-38 says that's okay. Amendments can be grouped for purposes of judging potential discriminatory effect. If accruals were frozen through Model Amendment 3 -- and there is now a follow-on amendment -- the follow-on amendment in and of itself could conceivably be viewed as being discriminatory until it is put together with the Model Amendment 3. Amendments can be grouped in that way.

Regarding reasonable, good faith interpretations an IRS memorandum was sent to regional commissioners on October 16, 1991. It's not a notice, or an announcement, or a revenue ruling, or anything like that, but it is available at the tax publication services. It gives some guidance to the regional commissioners, regarding how to interpret reasonable, good faith compliance. Generally, reasonable, good faith compliance is an application of looking to the statute and asking yourself what the statute says, and what the statute means. I have to say that carefully, because a lot of people say, "Okay, now 401(l) doesn't apply until 1993, and so there could be a primary insurance amount (PIA)-offset plan for the earlier years, right?" Well, be careful about that. There's a lot of question about how PIA-offset plans fit into 410(l). At the very least, if you don't have a floor in there, the 50% floor that says "benefits can't be reduced more than 50% of what they would be without the offset," then I daresay you don't have a reasonable, good faith compliance of the statute, because the statute as of 1989 required 401(l). On the other hand, 401(l), by virtue of the statute, doesn't have rules talking about the uniformity of disparity. So if you're willing to stand up and say "I'm using a reasonable, good faith compliance, but my disparity is not uniform for 1989-92," then you may have an argument. Just be prepared that it will be an argument that you might have to make before one of the agents of the IRS.

Of course, the plan is operated in accordance with the final regulations, it's deemed to be reasonable, good faith compliance. A caution here. When we talk about operation of the plan, there has been a fair amount of question out there on this. I've seen this more than once, and I had advised against it. Then some word came through, vis-a-vis the Q&As that were at the enrolled actuaries meeting a couple of months ago. And that has to do with operation of the plan, without actually adopting an amendment. That is, you can operate a plan in reasonable, good faith compliance, by adopting an amendment that you feel to be a reasonable, good faith interpretation of the statute. But if you were simply operating the plan by a mechanism, or by a benefit formula that is not in the current terms of the plan -- say before, tax reform, for instance, for a PIA-offset plan -- and you decide to operate the plan by placing a floor in, or by using a 401(l)-type formula, but there's some documentation that is not tantamount to an actual live plan amendment that's been adopted, be careful of that. There may be numerous violations with respect to contract law, and with respect to Title I of ERISA. The IRS has given us notice by virtue of these Q&As at the EA meeting that they may not even consider that to be a qualified plan. There are questions with respect to definite determinability and the like. So when we talk about operation of the plan and a good faith interpretation, I'm really talking about a good faith amendment of the plan. The only other way that I know of to have operational compliance is through one of the methodologies that was given in IRS Notice 88-131, that is Model Amendment 3 or Alternative IID, or the like.

There are some rules that were stated in the memorandum to the assistant regional commissioners. I like the first which regarded Revenue Rulling 81-202 in testing for discrimination. There had been some talk from the IRS that it was simply going to eliminate Revenue Ruling 81-202 entirely. In this notice, it did say that it's okay, to test for discriminaton under this Revenue Ruling even when using the projected method. However, you do have to incorporate the IRS 414(s) definition of compensation and the new methodology for imputing disparity. Notice, as I pointed out before, that the reasonable, good faith standard does not apply to previous regulations that have been issued on optional benefit forms. There had been a revision of those earlier regulations with respect to not having to satisfy the average benefit percentile test when that's being applied.

Prior IRS administrative positions regarding grants of past service will be the relevant standard with respect to amendments with past service. The prior IRS administrative positions basically looked at the relative length of past service given highly compensated employees (HCEs) versus nonhighly compensated employees (NHCEs) in making the decision as to whether a plan amendment was discriminatory or not. Administrative procedures applicable to restricted amounts, the High-25 rules, can still be applied during the transition rules. I've really received more questions on the flip side, that is, can we use the new rules to get rid of some of those amounts that we were holding on the side, with respect to the High-25? And that in fact is the case, too. You can go to the new regulations on that.

A lot of contributory plans that I see are going noncontributory. But if you do remain contributory during the transition period, the plan can satisfy the good faith standard by having the same benefit level on a total basis, and the same contributions for each participant.

Probably the most important item under coverage is that if you previously had a favorable determination letter, and there's been no significant change, then you don't have to rely on what the IRS calls "the safe and unsafe harbors" under the coverage rules.

I basically gave up that terminology when I wrote my book, because people were confused trying to connect the safe harbor under coverage, with the safe harbor under nondiscrimination, with the safe harbor under 414(s). They're different, independent, completely separate rules. And they don't tie together in any real definite way. There are some crosses between them, depending on the procedure, in the direction that you're going in designing the plan. If you use a safe harbor under one, and a safe harbor under another, and the like, there are some implications of them. But for all intents and purposes, view them as separate rules.

Here we're talking about the safe and unsafe harbor of the coverage rules. You don't have to apply them, as long as you had a previous determination letter that said the plan was nondiscriminatory. The average benefit percentage test does apply. Notice we are still saying this is a reasonable, good faith interpretation of the regulations until 1993. The average benefit percentage test still does apply. I would basically say for most applications of the average benefit percentage test, you can go pretty far down the pike of applying the final regulations as they are. Unless your reasonable, good faith interpretation is that you're using estimated data or something of that type, there's not really a whole lot they're giving us here, because you do still have to take all plans into account. There's a zero benefit for anyone who's not participating in the plans. I've run very, very few average benefit percentage tests where I wouldn't want to use imputed disparity. In most of the ones that I've run, I would want to use imputed disparity, and that's something that is explained in the regulations. Probably the most reasonable approach of going on either a defined-benefit (DB) or defined contribution (DC) basis is to walk through the regulations.

On the compensation limitation, here's one that when it does apply, is certainly something that you're going to want to take a look at. The new regulations on the compensation limitation under 401(a)(17) say that each year that the cost of living increases, the cost of living increases the ceiling. Each year when it increases that ceiling, the new ceiling applies only to compensation in that new year. For instance, in 1992, the new ceiling is $228,860. According to the IRS final regulations, if a plan had the highest three consecutive years' compensation as the average compensation, the highest average under the final regulations that could be had for 1992 would be the average of $228,860, which is the 1992 limit, $222,220, which was the prior year's limit, and $209,200, which was the previous year's limit. Those three averaged together comes to $220,093. That's almost $9,000 less than the current limit. So the current limit is $228,860, the highest average using the previous three years is $220,093. In other words, each year you only use the limit against that year's amount, and the previous year's compensation ceilings are frozen. This notice that came out to the IRS assistant regional commissioners said that rule would not apply for the transition period. Each year, when you update the compensation ceiling, you could update it with respect to all previous years. So the highest average annual compensation that you can now have in 1992 is, in fact, the current limit, $228,860. When the new rules go into effect in 1993, you will then have to fresh-start any of those individuals, and you're going to have to take a close look at the fresh-start rules and a close look at the 401(a)(17) rules with respect to fresh-starting those people, because in 1993, the highest average will now be 1993's limit, together with the $228,860, together with the 1991 amount of $222,220. So you're going to have to fresh-start them. But in the intervening period, you can give a slightly higher accrual to these people who have compensation in these amounts. Of course, it'll get worn away in time, if those individuals are not retiring within the next year or so. Also, the compensation limit in effect on January 1 may be used for plan years ending in that year, the usual rule, and the rule that'll take effect beginning in 1993 is a beginning-of-year rule on this.

Regarding qualified separate lines of business, reasonable, good faith compliance applies until the IRS begins issuing determinations. This was mentioned in this IRS notice to the regional commissioners. It's an interesting little point. One of the previous debt ceiling limitation laws actually said that when the IRS issued the regulations, they would not, in fact, go into effect until the IRS actually opened its determination program with respect to qualified separate lines of business. So when the IRS regulations under 414(r) say, "Here's the regulatory effective date, and now it's been extended to January 1, 1993," well, January 1, 1993 may not, in fact, be the effective date of those QSLOB regulations. If memory serves me correctly, I think there's a six-month period, once they open that program. But all of that doesn't matter anyway, because there are a lot of people saying the IRS is never going to open that program. And, as long as it never opens the determination letter program with respect to QSLOBs, essentially good faith compliance is what you've got.

What is good faith compliance on QSLOBs? The IRS has given us a couple of rules. It says you've got to have bona fide business reasons. Each QSLOB has to provide services to customers unrelated to the employer. That is, if there is a holding company or a headquarters, you may still have some problems here. It is going to stand fast on the 50-employee rule, and it is going to stand fast on the affiliated service group rule. Everything else is basically fair game. Again, you're going to have to take a look at the statute, and make a reasonable good faith application of those rules. But for a lot of people who are complaining about the QSLOB rules, their complaints are valid up to a point, if you're looking at what the situation might be if the final regulations come into play. But keep an open mind until that actually comes to pass. You may have some situations out there where the QSLOBs may actually be applicable at this point.

So where do we stand on the determination letter program? Right now, with the IRS rethinking the rules and looking back to the general tests and the like, I don't anticipate that it is going to open the program on giving determination letters to general test plans for some time to come. That should not scare an employer away from the general test, if it is passing the general test with flying colors. It shouldn't feel like it has to be coerced into a safe harbor. On the other hand, a lot of employers that I've talked with, do want the security blanket of having a determination letter in hand. The only way of doing that right now is through Revenue Procedure 91-66. Essentially there will have to be a design-based safe harbor, and it will have to be had with a plan that can pass the ratio percentage test without aggregation and without use of restructuring. Essentially we're talking about vanilla safe-harbor-type situations. If there are any contributory plans, you probably should wait until the general test rules come along, or some later program. Plans that are terminating should continue to be processed under Notice 87-57 and Revenue Procedure 88-9.

If you do apply for a determination letter for one of these safe harbor plans under the current program, you're going to have to give certain demonstrations. First, you're going to have to certify that the plan does comply with all of the requirements that I've stated above, in terms of the applicability of this revenue procedure. Then you're going to have to demonstrate that the participation rules of 401(a)(26) are passed. You're going to have to demonstrate that the coverage requirement is passed with respect to former employees. And if you're relying on a nonsafe harbor definition of compensation, you'll recall that under 414(s), you have to satisfy an annual, special nondiscrimination test by looking at the compensation inclusion ratios with respect to the alternative definition of compensation. In applying for the determination letter, you're going to have to give a demonstration to that effect. There are actually worksheets provided in the IRS revenue procedure for those demonstrations. If you've not already looked at them, I would recommend them, because it gives you a fairly good idea of the kinds of things the IRS is looking at, in complying with these regulations.

These rules are very, very complex. Can anyone claim to be applying the rules, and to have caught every single thing, and to not have missed a single element of what might cause the plan to fail? It's getting harder and harder and harder. It's difficult to say. There's something out there that you might have missed. During the past year, the IRS has opened up something that's called an administrative policy regarding sanctions, and I have a couple of notes on this here. I will, at least, address it quickly, and if there are any questions, we can touch on it during the Q&A period. Essentially, there are certain violations that might otherwise disqualify a plan, such as some 415 violations, 401(a)(4) violations, anything under 401(a) that would otherwise disqualify a plan. If it's an inadvertent error, and if it's a misrepresentation or omission of material fact, under certain circumstances, if you correct the error willingly and quickly, and clean up the mess that might have been left behind from that, then the IRS will not in fact disqualify the plan. It's my understanding it does not apply this administrative policy regarding the sanctions with respect to failure to timely adopt relevant amendments. So if you're facing this 401(a)(4) tax reform crisis, you really have to take those deadlines seriously and apply the deadlines with respect to the adoption of the amendments.

There are some operational criteria. The violation has to be isolated and insignificant. The plan has to have a history of satisfying the nondiscrimination rules. You have to have practices and policies in effect that are designed to catch the error. It has to come about simply by a failure -- by some omission of a fact. It's got to be an inadvertent error. You have to have your procedures in place. If you don't have those procedures in place, the IRS is not going to let this policy be used. And as I pointed out, the violation has to be immediately and completely corrected. A lot of this is a lot easier to demonstrate if you catch the error yourself. If you wait for the IRS to catch it upon an audit, you're going to have a more difficult problem trying to convince the IRS that you deserve to have the administrative policy apply.

At this point, I will step into the most important regulations and rulings from the past year. I am going to simply identify what these areas are. Of course, the main one was the nondiscrimination requirements. There were three main prongs for those typical requirements, with respect to nondiscriminatory effect of special events. The biggie was the requirement of nondiscriminatory amounts. The principle decision that everybody faces is the decision between whether to go with a safe harbor or whether to go with a general test. In most cases there's a design-based safe harbor, although there are some calculation-based safe harbors. The general test is a full-blown, calculation-oriented type of approach, which, until the IRS hopefully gives us some relief, does involve a fair amount of detail, a fair amount of collection of data.

Benefits, rights, and features have to be available on a nondiscriminatory basis. And basically there's a quantitative rule to judge current availability, and a facts and circumstances rule to judge the effective availability. The second two of these two prongs, that is the nondiscriminatory amounts and the nondiscriminatory availability, applies separately with respect to former employees.

There were also regulations issued on the coverage requirements, of course, and actually the coverage requirements and the nondiscrimination requirements basically fit together. You almost have the-chicken-versus-the-egg argument going here. If a plan fails, is it failing because of nondiscrimination, or is it failing because of coverage? They basically fit together so closely that it's six of one and half a dozen of the other. The plan that you put together for purposes of satisfying coverage must be the plan that satisfies the nondiscrimination. And a lot of the satisfaction of the nondiscrimination rules come back to coverage. Each particular unit that you're looking at for nondiscrimination has to satisfy the coverage rules. So these two rules coordinate very, very closely together.

For those of you still using QSLOBs, there is still a gateway to the coverage rules. The plan has to satisfy a particular employer-wide test. So even though you're applying the rules on a QSLOB basis, the plan still has to satisfy something that is looking to the entire employer and that essentially is looking at the lowest range, the lowest level, of the coverage rules, without using the average benefit percentage test; but it's the lowest level of the head-count-related rules. There is a ratio percentage test that simply looks at the head counts. If you don't satisfy that, you get a lower threshold under the safe harbor and the unsafe harbor. But in exchange for the lower threshold, you then have a calculation-oriented test that actually looks at the actual benefit percentage and contribution percentage that's provided to each employee, and that's the average benefit percentage test.

As I pointed out before, participation requirements apply beginning in 1989. That's the 50% or 40% rule that applies to each plan. You cannot aggregate the plans. If a plan doesn't pass, and you have to deal with that by combining plans, you must formally merge the plans instead of aggregate them. Under coverage, you could have aggregated without formally merging. Under participation, you might have to formally merge plans, if you want to combine two plans in order to get one of them to pass the 50/40% rule. For DB plans, you may have to look to the prior benefits and to the former employees, depending on the circumstances under the plan.

There were a number of rules related to nondiscrimination coverage and participation. I will see plans and ask why they didn't satisfy the safe harbor under nondiscrimination. With some of them it's because they have a PIA-offset plan. But in plans that were trying to use a 401(l) formula, and trying to get in the safe harbor, probably the biggest remaining hurdle is their definition of compensation and their definition of the average compensation. They're either not using a definition that complies with 414(s) or else they're using a 414(s), definition of compensation and they're not using highest three consecutive of final 10, or something that would otherwise give you average annual compensation. If a plan is going under a safe harbor, it must satisfy 414(s) with its definition of compensation. That does not mean that it must be a safe harbor definition under 414(s). You can use an alternative definition; for example, base pay. But if you use base pay as the plan's definition of compensation, and if it is going to go under a safe harbor, then you first must pass through the corridor of the 414(s) special nondiscrimination test and prove that your base pay definition is not in itself discriminatory. By so doing you demonstrate that the alternative definition is in fact a 414(s) definition of compensation, and thereby can be used and doesn't hinder the plan from getting into the safe harbor.

There was a particular question that a lot of people have had with respect to imputed pay during leaves of absence and rate-of-pay definitions. That is, you're not using base pay, but you're actually using rate of pay. The IRS gave rules that said if you use either of those, it is deemed to be reasonable as an alternative definition of compensation, provided certain additional criteria are met. But the IRS does not relieve those two special definitions (rate of pay or imputed pay) from this special nondiscrimination test under 414(s). So when using a rate-of-pay definition, you still have to walk through this annual test if you're trying to use that definition of compensation to get you through the safe harbor.

We already addressed what I consider to probably be the most important late-breaking development on limitation on compensation under 401(a)(17). I think a fair number of you have probably been to enough sessions where permitted rules on 401(l) have been beaten to death the last couple of years, but if there are any open questions on that, we'll address those. Regulations on qualified separate lines of business, cash or deferred arrangements, 401(k), and 401(m) on employee and matching employer contributions came out in the past year.

I think I'm just going to point to more federal guidance that came out in the civil penalties program. There is a grace period. If you have any annual reports that haven't been filed, now is the time to take a look at filing them. The failure to make required contributions is only for those of you who have unpaid contribution balances, including interest of $1 million on a particular plan. But if you do in fact have a situation like that, the PBGC is going to watch more closely this requirement that missed contributions, including missed quarterly contributions, be reported. You've got a very short fuse; it must be received by the PBGC in 10 days; you do not have 10 days before it has to be mailed. So if there are unpaid balances of $1 million or more, watch those quarterly contributions, or you're going to have to be reporting to the PBGC quickly. The PBGC also put out recently a statement of policy regarding the assessment of penalties. This was not a formal notice or regulation per se, but it did express the PBGC's policy with respect to how it is going to be looking at the penalty, which could be a maximum of $1,000 per day for failure to provide any of these necessary notices, such as the notice that I just mentioned under PBGC Form 200.

A couple of other late-breaking developments that ought to at least be brought to your attention include Financial Accounting Standard 109. You thought you were all finished with SFAS 87, SFAS 88, and SFAS 106. Now there is SFAS 109. Well, what is that? It's accounting for income taxes, and one keen example of where that could come into play is if you were using SFAS 106 and immediate recognition of the entire obligation. Under the previous accounting-for-income-tax rules, it was difficult, if not impossible, to set up a credit for future income taxes that would be paid, once those contributions for that obligation were made. The obligation was sitting out there as a liability, without this offsetting asset that would be for the taxes that would be paid in the future. SFAS 109 is basically to clean that up, so that in most situations, a taxpaying entity right now is going to be able to get the credit.

Just a week or two ago, there was an exposure draft that came out on reporting by defined-benefit plans of investment contracts. This is an amendment to SFAS 35, so it doesn't affect the DC plans yet. The FASB is still looking to DC plans, but for the time being this applies solely to DB plans. And the essence of it is that GICs, and contracts like GICs, that do not have a substantial insurance element, are going to have to be reported in SFAS 35 at market value, not at contract value. That is a proposal at this point. There is a comment period that extends, I think, through the end of June. The FASB is also working on developing some rules for stock options, and the AICPA is working on a new audit guide. Either of those two may have some implications for some of our other employee benefits.

Regarding legislative action on 401(k) plans you may see before the end of the year simplification in terms of letting us look to last year's data. We wouldn't have to wait until the end of the year to know whether the plan passes or fails. There would also be some safe harbors. There's a similar rule for highly compensated employees. We would be able to look to the previous year's data with respect to the compensation. Family aggregation would be repealed prospectively. That may not be a bother for 401(k) plans and other plans that have been doing family aggregation for some time now. For plans that have been under Model Amendment 3 and the accruals have been frozen for all this period, once the new accruals are actually put in place, beginning in 1993, retroactive to 1989, it's not going to sit all that well with some of these firms that would have to use the family aggregation rules for 1989-92. When you come back to 1993, if this rule is passed prospectively, the family aggregation rules would not be there, and you would be back onto free territory. In talking with people up on the Hill and people in the Treasury, I've basically been told to forget about it. They're not going to go retroactive on the repeal of family aggregation.

Incidentally, all of this was in the final version. There was a lot that didn't make it to the final version of the bill, but I find that particularly intriguing when you get to the next category, the participation requirement. There was, in fact, an outright exemption for DC plans from the 401(a)(26) rules, which would have been delightful. The 50-rule inapplicabilities would only have been for the purpose of applying QSLOBs to 401(a)(26). The 50-employee rule would still have been there for the QSLOBs. There would have finally been some relief for the full funding rule, but it would have been the kind of relief that's been kicked around for the last couple of years. Certain plans would be permitted to disregard the 150% limit, but that would have made life more difficult for the rest of the plans, because the Treasury would have been required to adjust the alternative full-funding limit downward, in order to keep tax revenues straight. Rollover rules would have been simplified at the cost of getting rid of five-year forward averaging. There would have been restoration of the IRA deduction.

There is a laundry list that's starting to form over penalty-free distributions. One of the things that didn't make the laundry list, but was in one of the proposals, was the final Senate proposal if I recall correctly. It would have given you the availability of making an IRA withdrawal for a first-time purchase of a car. It didn't say that it had to be a domestic car, which kind of confused me. With all the talk, you would have thought they would have said you couldn't use it on a Japanese car. It just said a car. I think the thing that frightened a lot of us is that once they start saying you can do it for a first-time home purchase, and qualified educational expenses, some of that makes sense up to a point. But once you start adding cars, and sewing machines, and vacations, and this, that, and the other thing, I'm not sure if we're really talking of retirement savings anymore. That did not make it into the final version, but that's the type of proposals that they do debate inside the Beltway.

MR. DAVID C. LINDEMAN: On the legislative front, the President's budget had four proposals that were relevant to the PBGC. One of the proposals was more generic. It went beyond the PBGC, it dealt with all federal insurance programs, and it was modelled after what Congress and the Administration had agreed upon in 1990 in the area of credit reform. It would have caused the budgeting for federal insurance programs to be done essentially on an accrual basis, or on a reserve basis. In effect, it would have forced the Executive Branch and the Congress to try to figure out what the long-term costs of these programs, to in effect amortize them over time in the nature of a bond essentially, and to build up reserves in anticipation of the claims coming in, rather than just say, "Oh, golly gee, see what happened," which is what happened in the S&L situation. It's, from our point of view, a very useful change. It would allow an offset against the revenue losses that are normally associated with minimum funding proposals, and it would get us out of the conundrum of having to offer up changes in the pension law or the tax law that we find independently undesirable, only because we have to do them as an offset against improved minimum funding, which is the kind of problem that brought us the 150% full-funding limit in 1987.

That proposal did not get a happy reception on the Hill, partly because it was tied up with perceptions of gimmickry and the tax bill, the middle-class tax break and what have you. The Congressional Budget Office (CBO) and the General Accounting Office (GAO) came down firmly in favor of the concept of accrual accounting or accrual budgeting. They weren't quite sure whether the mechanics were right, and whether the methodology was fully in place, but they embraced the concept. The CBO said some very useful things in its letter to Senator Sasser on it, including that Congress should be held harmless for revenue losses associated with making the insurance programs better under the Balanced Budget Act or the so-called "pay-as-you-go" rules. The CBO is working on a conceptual paper on it. I'm sure there will be a lot of discussion in the analytic community about it, so I predict that something useful will emerge in that area. It's not just good for the PBGC, it's sort of good for the government as a whole. It's a better disciplined way of thinking about the kinds of obligations the government's committed itself to.

Specific to the PBGC were three proposals in the legislative area. One of them is in bankruptcy, which actually was introduced last year. It was reintroduced in this larger bill this year, the Pension Security Act. One of the legs of the bankruptcy proposal is clarification of what we think the law has always given us, in either the tax code, or in ERISA. Needless to say, the Bankruptcy Bar has a somewhat different opinion. The second leg of the bankruptcy legislation is to recharacterize the employer liability claim from a percentage of the net worth of the sponsoring firm to a percentage of underfunding. There are a variety of reasons for that. Over time that net worth claim is going to be defeated by people artfully arranging their affairs in anticipation of bankruptcy, so it's going to be 30% of zero, notwithstanding our regulations. And so we'd like to make it 10% of underfunding, and then we'd like to gradually increase it. People have asked me why the PBGC, or for that matter, any other federal government agency, should have a priority position in bankruptcy. I think the only normative answer to that is that it is an involuntary creditor, and the premium payers are, in fact, the involuntary underwriters. If it could move to covenant itself in anticipation of a deteriorating situation, or in the face of a deteriorating situation, I think it probably should be an unsecured creditor totally and completely, except maybe for missed contributions. But it is not in that position, so the argument is that it should be compensated at the other end somewhat, and presumably that would have some economic incentives that would induce better funding behavior over time anyway.

The second proposal that's specific to the PBGC is a guarantee freeze. This is a very tough proposal. It says that if there is an underfunded pension plan, and a plan amendment is giving a benefit increase, that increase is not guaranteed until such time as it is funded. That's prospective only, and would apply on amendments after December 31, 1991. And another aspect of the same proposal is that any new plan amendment creating shut-down benefits, or any improvement in an existing plan amendment with shut-down benefits, would not be guaranteed at all. They would be totally out of the PBGC contract. Now you know they are early retirement benefits that are not anticipated in any fashion according to the funding, so the PBGC feels that they're inherently a moral hazard that can't be insured.

It's one thing to propose a guarantee freeze, and then just sort of assume that somehow through collective bargaining, or whatever have you, that funding will take care of itself. It's one way the PBGC could have addressed it, but in wanting to put everything on the table, and in wanting to deal with what it thought were some imperfections from what happened in 1987, it also made some funding proposals. These funding proposals have been characterized at best as inelegant in some respects. I'm willing to take the blame for that. Someone at the last Enrolled

Actuaries Meeting in Washington denounced them as the "demon seed of 412(l)." I rather like that myself. We at the PBGC know there are problems with them, and we're working with a task force of actuaries from different groups, with the Association of Private Pension and Welfare Plans, and with an ERISA Industry Committee and others to try to perfect them. So rather than getting into the details, let's just try to concentrate on what the purposes of the proposals are.

One of the things we want to get back to is what happened in the Ways and Means Committee version of the funding legislation of 1987, which was to have alternative stand-alone rules. The alternatives were (1) the funding standard account rules, (2) an underfunding reduction rule, and (3) what we call a solvency maintenance rule, but you can think of it as a cash-flow rule. If the plan comes under the underfunding reduction rule or the cash-flow rule, it really can't take experience gains or actuarial gains to offset its obligation to contribute. That may seem to some folks as being a fairly tough rule, but frankly, if that rule had been in effect in the 1980s, we probably wouldn't have very much underfunding in pension plans right now. That was a period in which, as you know, actuaries didn't necessarily predict high rates of return, but of course, we had phenomenal rates of return, and those rates have been captured by the plan. As I say, we wouldn't have very serious underfunding right now.

The cash-flow rule is sometimes thought of as a rule that is supposed to catch a plan, when it's about to run out of cash and keep it from being a hit to the PBGC. That's not necessarily what the purpose of this rule is. The rule would have the plan sponsor put back into the plan what was paid out. There are some exceptions for annuity purchases and lump sums. Exceptions essentially keep the funding ratio constant, but you have to put in what you took out, plus interest on the unfunded liability. That just holds the assets constant in real terms over time. It's directed toward flat benefit plans and unionized plans, typically with older workers or lots of retirees. They're extinguishing liabilities at a much faster rate than they're accruing liabilities. So in a relatively short period of time, liabilities come down to equal the assets, which have been held constant over time. These plans become fully funded on a termination basis, in anywhere from 10-15 years. So it's a very specifically directed rule at what are essentially the problem children for the PBGC, which are these structurally underfunded, collectively bargained, flat benefit plans, in contrast to final-pay, salaried plans, which are almost axiomatically overfunded on a termination basis.

As I said before, the rules have been characterized as inelegant, and I'm perfectly happy to take responsibility for them. But let me just put on the table a basic policy choice. You can either constrain the assumptions that are used in these alternative rules, so that you're funding toward something that bears some similarity to termination liability, and that means not just an interest rate constraint, but also something that takes into account possible gaining on mortality, and particularly retirement age assumptions. Or you can say, "Okay, we'll leave it to the actuary, or the plan sponsor, to make the assumptions, but we have to have some sort of feedback mechanism in case those assumptions are, shall we say, aggressive." The feedback mechanism the PBGC put into the proposal may not work, or may be too cumbersome, and, in fact, some folks have suggested some simplified alternatives that we'll be looking at. But that's basically a choice. It's got to be one or the other, because if we don't have one or the other, folks will be allowed to get away with not having to fund toward termination liability or anything that passes for termination liability.

There were some miscellaneous tax proposals that the PBGC had wanted to put into its legislation that didn't make it out of the starting gate. I mention them, because people do legitimately point out circumstances where you could be hit by the Excise tax on nondeductible contributions. If you wanted to try to fund up a defined-benefit plan and maintain a profit-sharing plan or another kind of defined-contribution plan, there's always the problem of the small employer with less than 100 employees trying to close out. There are situations where that excise tax should and shouldn't apply. The PBGC would like to relieve the quarterly contribution requirement on overfunded pension plans. When I say *overfunded*, I mean plans with more than termination liability, and a number of other miscellaneous things like that. And, unfortunately, they did not get scored for revenue loss purposes in a timely fashion, and therefore were not part of the legislation, but we are still seriously trying to take a look at those to put them on the legislative agenda eventually.

In the area of regulations, let me just mention a few things that are coming up. There will be a panel discussion dealing with notice about the insurer in the case of a purchase of annuity contracts, and the standard termination, or whether there should be other regulatory intervention in that regard. It's still being debated within the Executive branch between the PBGC and our colleagues at the Department of Labor as to exactly what we should do and how far we should go. As you know, we've gone through this advance notice of proposed rule-making. We're now sorting out the comments.

The PBGC will be putting out for comment very shortly a proposed regulation that would simplify the premium system. As you know, we did not get any opinion from the GAO. It is quite embarrassing. We're making lots and lots of effort, spending lots and lots of money to try to get our reserve for booked liabilities cleaned up, and we're also trying to get the premium system cleaned up. And as part of that, we're trying to simplify the system. What's simple for you is simple for us, in terms of computer logic, and operations, and whatever have you. There's some slight redistribution of the burden, to make the rules much more automatic, much more axiomatic, rather much more of a mindless exercise. It would also delay things a little bit, so that it's more coincident with the last filing date for the 5500. I think it goes in the right direction, but we'll be interested in your comments and we'll try to take them into account.

Finally, I hope sometime the PBGC will put out a proposed regulation on revising its employer liability factors. This is basically a parochial PBGC concern, or ought to be. We have tried over the years to mark our cost, our liability charge to employers, to what we think the market would charge in a standard termination, but we do it in ways that are, I think, legitimately thought as being counterintuitive. We would like to go to a more updated mortality table. Our interest rate will go up. We're going to change the form. We're going to take administrative loading out of the interest rate, and separately charge for it. You'll see a variety of things in the regulation, all of which have the effect, of course, of raising the PBGC interest rate. And in and of itself that doesn't mean very much, except that the tax code refers to that interest rate as a ceiling on what can be charged, or what can be used to compute lump sums when you're cashing out folks in a plan. The irony of it, of course, is a higher interest rate, smaller lump sums, less taxable income. I guess that has to be scored. I don't know. In any event, it's a bizarre set of interactions that have to be taken into account. I don't know really whether this will be shared within the administration, or with our sister ERISA agencies, because we haven't really shared it very much with them at this point. We need to determine whether the tax code should continue to refer to the PBGC interest rate, or some proxy for the PBGC interest rate, or some function of the 30-year treasury, or something like that ought to be substituted, so that we don't have this conundrum in the future. In any event, remember this would be in proposed rulemaking. There's plenty of time for a statutory fix to the tax code, if that's what's necessary, but you may want to think about that as you look at this regulation and comment on it.

MR. LABOMBARDE: Dave, if none of this gets through the legislation in the current year, since a lot of this is lifting the protections for the PBGC and bankruptcy, and improving the minimum funding standards, improving the status of the PBGC, one figures that if it doesn't fly, there might be something waiting in the wings with respect to premium increases. Could you comment on that?

MR. LINDEMAN: Of course, we always believe that the President's budget will be eventually enacted during the course of the year. That having been stated, one of the things that was inherent in the Office of Management and Budget (OMB) proposal that didn't get a lot of attention was that you're supposed to reserve or figure out what you should be reserving every year against future losses in these insurance programs. And to the extent that you don't change the nature of the program, so that long-term costs equal long-term revenue or long-term premiums, or you don't raise the program's own revenues, the premiums, to equal those costs, then the government is supposed to appropriate the deficiency on a year-by-year basis to make these costs open. The CBO, I think, has trouble with that, on the grounds that in its perception, these are supposed to be self-financing programs. And while that paradigm may make sense for the credit programs, where the avowed purpose of the program is to subsidize, it may not make sense for the insurance programs, and this will be one of the major things that will have to be discussed. I think people are legitimately worried, that faced with that kind of choice, if the Congress were to adopt the OMB proposal, the first recourse on the part of the politicians would be to raise the premiums. And the OMB model is saying that there's a deficiency between long-term costs and long-term revenues of somewhere in the neighborhood of $20-30 billion. So that would suggest fairly significant premium increases. I think there's growing impatience on the Hill with underfunded pension plans, and so there would be, I think, some sympathy, at least in some quarters, that that delta in premiums that would eventually occur would be mostly on the variable rate side and less on the flat rate side. But there are, of course, forces that like the current situation as well, so one doesn't quite know how that'll come out. You're talking about, in nominal terms, fairly larger premium increases, of course.

MR. DAVID P. WARD: Dave, could the rate for lump sums be changed to the current liability rate, so that terminating plans wouldn't be required to make a nondeductible contribution?

MR. LINDEMAN: I can't predict what might happen in terms of a statutory fix. Remember it's a ceiling on the rate you can use. You can always use a rate that's lower. When you look at our new regulation when it comes out, you'll find that our interest rate will track pretty closely to market interest rates, long-term commercial rates, or even the long-term treasury rates. So I would think an appropriate ceiling for the tax code might be something like 100% of the 30-year treasury rate. If you wanted to overtly preserve the inherent subsidy that now exists, you could have some lower function of the 30-year treasury rate for the first $25,000, if you wanted to put a ceiling on it. I think there's a problem that folks have with what's permissible for funding purposes, and what the plan provides in terms of a lump sum, but I don't think this proposal would address that issue.

MR. WARD: Adrien, could you give us some more specific examples of what an administrator might be looking at, if they're showing that they're looking for errors in transitional compliance to participation and nondiscrimination?

MR. LABOMBARDE: That is a broad question, but I will say I get it quite frequently. I'm not sure what to say, where to start, in terms of giving specifics, except that to point and say start with the statute. For instance, let's take participation under 401(a)(26), the 50 versus 40% rule. Now actually that's not a good one to start with, because you don't have reasonable good-faith compliance. You're only looking there at this point in terms of if you made an inadvertent error or a mistake, and it really dropped to 49 on one particular day, then you may be wanting to look to this administrative policy to correct it, as opposed to trying some other alternative course. So are we really talking about coverage and nondiscrimination? Perhaps.

MR. WARD: Let's say an administrator outlined several key points, and said he or she was aware there are some participation nondiscrimination requirements, and highlighted some of those things that are being watched during transition, and also, maybe made notes of what will be required when they fully come into effect. Should that be appropriate compliance?

MR. LABOMBARDE: Yes. I don't want to turn this into a marketing speech for the book that I wrote, but I want to make a comment about what I did write on nondiscrimination, because it may be to some degree relevant here. That whole enterprise started in part from a question that was raised to me about preparing a checklist for going through all of this. And I started preparing a checklist and one thing led to another, and it went further and further and further along. If you don't use the book that I wrote on this, I would advise you to very quickly come up with a very similar type of process, because the whole enterprise there was to develop something where you are looking through the steps. At my company, if someone asks how to apply this, I point them back and say to start with Chapter Two, Timing. Make sure you're looking at the plan years. If you're going to be aggregating plans, for example, they have to have synchronized plan years. You want to be looking to the timing for a number of other reasons. Walk into Chapter Three, Who's the Employer? The employer should be having materials there that can identify whether they have a controlled group and the like. Identifying whether there are any leased employees is in Chapter Four, and so on. I won't walk through the whole book, but essentially what I was originally trying to do came in response to someone asking a similar question, "Can you at least give us a checklist?" Because you do have to be applying this. And this is where it fits together with this administrative program that the IRS has – if the IRS going to come back and you're going to say you did not have a disqualifying event, you have to have procedures in place that show that you were making every attempt to apply all of these rules, and that any errors that you had were inadvertent errors. Now the IRS isn't going to find it too easy to accept that there's an inadvertent error, if you don't at least have some kind of a checklist process in place. As I mentioned, with respect to certain of the requirements, I would also point you to 401(a)(26) and 410(b) for former employees, and the 414(s) test; the checklists that are in the Revenue Procedure 91-66 are very, very good for telling you the kind of things the IRS is going to look for. You could almost take those, and by extension, develop spreadsheets or worksheets that would do the other material as well, that is not included on those demonstrations.

MR. MICHAEL PIKELNY: One of the items I read in connection with the delay of the nondiscrimination rule is that it will give the IRS more time to consider comment from practitioners, employers, and so on. My question, I guess, to Adrien is, do you know if the IRS is accepting new comments on these rules, or is it just considering comments it received previously with the formal comment period? I don't remember seeing an address as to where to send comments, and I'm not sure what it means when it says it will review comments.

MR. LABOMBARDE: It is definitely accepting new comments. It will review old comments raised again; that is, people are still raising comments with respect to a safe harbor for PIA-offset plans, for example. But the IRS is not just going back to the old files to look at the old comments and readdressing them. It is definitely looking at it anew. However, I would warn that at this particular point in time, whether or not this remains the case I don't know, but at this particular point in time, there is a very short fuse on it. We had heard rumors as recently as two or three weeks ago that strongly suggested that there would be some proposed regulations out on the street in April. It's April now. I frankly don't believe that you will actually see proposed regulations by the end of the month, but I do believe, from the people that I've talked with at Treasury and the IRS, that they are at least working fast and furiously enough on this, and that there could be proposed regulations soon, because that's how fast this process is moving. So now is the time to make comments. The signs I've seen are that the IRS is very, very open. I don't want to hold out on that promise that you're going to get everything you want, but this is a real attempt. The people that I've dealt with, and this goes all the way up to the top, to the people who are dealing with it in Treasury, are sincerely making an effort to do everything possible to make this thing work.

FROM THE FLOOR: If somebody has comments, because I'm seriously considering sending something in, where would they be sent to?

MR. LABOMBARDE: Evelyn Petschek, Benefits Tax Counsel at Treasury is really running a lot of the show in terms of rewriting this, and she is absolutely open to comments on this.

Now incidentally, while I'm saying that, I would also point out that for anyone who has public employer questions, there's a delay to 1995, Evelyn has also openly invited comment on the public employer side for resolving some of the open issues there.

MR. MAX ROSENBERG: Mr. Lindeman, do we have any hope in the future of seeing a coordinated policy between the PBGC and the IRS, instead of what we've been experiencing in the past, where the PBGC has been trying to increase contributions and the IRS has been trying to limit them? I think that's one of the problems we keep on facing.

MR. LINDEMAN: I call it "The Three-Bear Theory of Public Policy." The porridge has to be just right. I mean, it can't be too hot. It can't be too cold. Let me be philosophical about this for a moment. I think the problem goes back to the way the government looks at a lot of these issues. We are very much driven by a cash-flow accounting system in Washington. The President's Commission on Budget Concepts in 1967 determined that cash-flow accounting was pretty good for the federal government, most of the time, for most of the accounts. But in certain situations, like programs with contingent liabilities, it was not going to work. There needed to be something like what the administration and the Congress have come up with in credit reform, and is now being proposed in the insurance area some 20 or 30 years later.

I think there are similar problems on the tax side. Cash accounting for tax expenditures, or government receipts, or both, may make sense for most of the items most of the time. I think it's very hard when it comes to where you're talking about programs that have long-term liabilities associated with them. That may be true more generally than in just the qualified plan area. It may be true in the area of depreciation and other areas as well. And people are, of course, very comfortable with the current accounting system, so it's difficult to convince folks that they ought to start thinking about other ways of looking at it. And that's not just true with Treasury. I think that's true at the OMB and the CBO, as well as the Joint Committee. I think the problem with something like the full-funding limit, or the limit on the interest rate being used to calculate contributions under certain circumstances, is that it affects the timing of deductions and the timing of receipts, but it doesn't really get to the fundamental issue, which is that the difference between an after-tax and before-tax rate of return is the difference in that wedge that ought to be viewed as the long-term tax expenditure, assuming you believe in income tax theory. And that's a very different number. That's a different and usually a smaller number than just the kind of timing changes you get when you limit deductions. So I think it's going to take not the IRS changing its view on this, or even Treasury changing it's view, but it's going to take policy types at Treasury, in concert with folks on the Hill, in starting to think about these issues in a different temporal perspective than they have traditionally. And only then I think maybe you'll get some reconciliation.

Frankly, we at the PBGC are more sensitive to this than folks at other federal agencies, because we do want to push up the floor on minimum funding. I often say, "Extremism in the defense of funding is no vice at the PBGC." But we really do want to push up the floor. There are have revenue losses associated with it, and the people keep saying, "Well, then you pay for it by somehow limiting the folks at the top." That may not be good pension policy. That may be terrible pension policy under certain circumstances, and, in fact, if you take a long enough view, it constitutes risk for the PBGC.