RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 4A

EARLY RETIREMENT INCENTIVE PROGRAMS (BASIC)

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The panelists will cover early retirement incentive programs at an elementary level including:

- Design issues
- Communicating effectively
- Determining cost
- Ensuring success
- Pitfalls

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Suppose an employer, for whatever reason, needs to lower payroll expense. This does not lead, inexorably, towards an early retirement incentive program. There are a number of issues. The first question that the employer needs to ask is, how much? Does it need to lower payroll by 5%, 10%, 15%? The answer will affect what approach is used. If it's only 5%, a six-month hiring freeze might be all that is needed.

The second question that the employer should ask in looking at the man-power and payroll planning would be, in what time frame does the employer need to get a control on payroll? If the answer is, right now, then we're looking at layoffs or a window program, whether for early retirement or separation. If there's a longer time frame, other approaches might be used. Once the quantity and timing of what the employer needs to accomplish is pinned down, we can start looking closer at the types of programs that might make sense.

The third question that the employer can now ask is whether there are other ways of cost savings besides actually separating people that might be efficacious? In terms of separation programs, you might have layoffs or a window for early retirement, separation, or a combination. You could have a window program that had one set of provisions for those who were retirement-eligible, another set of provisions for those who were not. On the other hand, as I mentioned before, a hiring freeze is an alternative. Another possibility would be a salary freeze or salary cuts. I think it's common knowledge that in a number of actuarial pension consulting firms, employers

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have taken an approach of a combination of salary cuts, lower bonuses, and involuntary terminations. An employer might also consider transfers and demotions: same people, lower pay, different job function. Some employers have taken job sharing or a reduced work week as a way out. There's one employer that cut everybody's pay 10%, and gave everybody in the company every other Friday off. Half this week, half next week.

Once you take a look at what type of program, let's assume that the conclusion is made that people have to go. The fourth question is who? What type of people need to go? Is it across the board, or are there particular divisions or departments? Do we need to keep our older people for their experience, or are we on a deadwood hunting campaign, which typically can be code for severing the older generation.

A particular division is often what you're after. There's been a trend, in fact, to fine-tuning lately by looking at job title, classification, location, or any type of combination. So, you have to think about what type of people need to go. I know an example of one employer that has been reducing its work force fairly steadily for about eight years. And, it's a wave this year, a wave nine months from now, that type of approach. That employer has used two types of tactics. One is early retirement windows, with older people leaving. The other is involuntary terminations, which are on a seniority basis, where the younger people will go. This particular hourly work force now has about 10,000 people, all between the ages of 35 and 50, with hardly an exception. Graphically, the age distribution has the pattern and dynamics of the snake who ate the pig, as this demographic bomb moves in age. In any case, you have to look at what's left, at who remains as well, which is the point of this story.

Once you know whom you're after, then you can design a program. What are companies doing? Last year, there was an American Management Association survey of different policies. The people there conduct an ongoing survey. They print it up in their journal once a year. Of all the types of policies that can be offered, whether it's hiring freezes or transfers or voluntary or involuntary separation, or job sharing or a reduced work week, or early retirement windows the early retirement incentive is the only one that recorded a downward trend from 1987-90. Why? Uncertainty, I would guess, both on the Treasury side, with changes in the Internal Revenue Code, and on the Labor side, with the Betts legislation, both of which will be discussed by the other panelists later. But, lately, there's clearly been an uptrend. It is almost impossible to open up the business section of a major newspaper without reading about some company or other that has instituted a window. And furthermore, it seems to always be windows, all of a sudden. If you look back a year ago, right when 401(a)4 (the nondiscrimination section of the regulatory requirements for a qualified plan) was still very uncertain, and when the Betts legislation (or the anti-Betts legislation, I should say) had just been passed, there was a great deal of uncertainty. There were still a fair amount of downsizings, but they were involuntary layoffs.

Now, there have not seemed to be quite as much difficulties as were feared on the Labor side, with the Age Discrimination in Employment Act (ADEA). Nobody has yet gotten tremendously burned under the new legislation of which I know. And, the new regulations under Section 401(a)4 for the qualified plans are effective in 1993, with good faith compliance from 1989-92, so there is a last chance to do it the old way.

Another recent trend has been a decline in the acceptance rate for windows. It used to be that a program of five extra years of age and service would be almost certain to give a two-thirds acceptance rate. Now, such a program might have a one-third acceptance rate. But who knows, with the recent spate, what type of experience windows will have.

In looking at windows, the first thing that you must consider is defining the population for the window. Who is it, exactly, that should be eligible? You want to make sure that there are enough people in the eligible group, to fulfill the various legal requirements that Howard Peyser will discuss. As previously mentioned, the population can be fine-tuned quite a bit. You can define who's going to be eligible for the window by age and service criteria, by department, by job title, by location, by job classification, or any combination thereof. But there's a catch. The more finely you tune it, the more your legal exposure. And, if companies successfully fine-tune windows without legal consequences, then there might be legislative consequences.

In looking at windows, and the population to whom you offer them, you should also concentrate on the type of delivery system to use. Will it be a qualified plan, a nonqualified plan, or a severance plan? Qualified plans can use up surplus pension trust cash, avoiding corporate cash. There's some trend towards doing windows within a qualified plan, wherever possible. In fact, there's some trend towards doing severance-type benefits in certain circumstances within a qualified plan, if possible. However, suppose senior executives were being reduced, possibly in the case of a merger. In that case, you're not going to be able to do the window within the qualified plan, because it would be a benefit structure only to the advantage of highly compensated individuals. Most current programs, in fact, are broader. Severance plans are often for the younger employees, and again, as I said, you can combine the severance plan with the early retirement plan, and mix and match as you would.

After pinning down the population, the next step is to consider exactly what types of benefits you're going to offer. At this point, I'm focusing in on the qualified plan, early retirement window. What do people actually offer? Well, they typically offer extra age for both service credits and age credits. If the employees were 55 with 15 years of service, for purposes of benefit delivery they would get the same benefits as if they were age 60 with 20 years of service. Age 60 probably would have a much better early retirement factor. If you offer five years of age and service, it would be called a five plus five plan. If you offer three years of age and three years in credited service, that would be called a three plus three. Also, employers typically would include a severance benefit. You might have one, two, or if you're generous, four weeks of salary per year of service, given in addition.

Some companies will use a shorter final average pay period. Social Security supplements are used quite a bit, deferring the effect of the Social Security offset until age 62 or 65. These benefits are specifically mentioned in the new regulations, and Howard Peyser will go into them. I think we might see them more in the future. Rather than extra age for early retirement factor purposes, it's just as easy to simply give an unreduced benefit. Consider a window program that provides an unreduced benefit if age plus service equals 75. You can include lump sums, and to some extent salary continuation, in a window. You could include an alternative benefit formula. You might have an alternative cash balance formula, for example, that's

advantageous to people who would be going out through the window. In short, the forms of benefits that can be offered within the window are the full range that can be done within a qualified plan. Just like regular benefits are subject to the new 401(a)4 nondiscrimination rules, so too will the window increment. Less discrimination is allowed between the highly compensated and the nonhighly compensated than in the past.

Don't forget postretirement health and life coverage. People would certainly want to receive those benefits during the salary continuation period, and they would also want to retain the retiree medical eligibility. For example, if your retiree medical eligibility age is 55 and 10 years of service, and you're trying to induce people to leave through a window at age 50, and you're giving them an extra five years of age for pension purposes, they're not going to actually leave unless you do it for retiree medical purposes as well, and give them the same benefit as if they were age 55 on both sides of the coin.

The source of the benefit delivery can be complicated. One might not know until after the employee election, if too many highly compensated people elect a window relative to nonhighly compensated people. Some benefits that were planned to be provided through the qualified plan may need to be provided outside the qualified plan. In fact, the new regulations give an example of just that. In the example, only two people elected who were senior officers, and the IRS didn't think their example was one in which the benefits could have been legitimately paid out of the qualified plan. A second source of uncertainty may be a window structure subject to a condition. For example, assume an employer needs to reduce its work force by 200 people. If some number less than 200 elect the window, then the remainder will come through an involuntary severance plan, from less senior people. With that type of arrangement, which is fairly common, you have no idea whether it's all going to be from the window, or it's all going to be from the severance plan, or some mixture.

Now, communication of the program is also very critical. It must be communicated in a very forthright fashion. The best approach is to be complete and honest. Make sure that you have a full communication to everybody involved, because, as you can imagine, window programs involve more than their share of litigation. It's not only people who may be included who think they're more or less coerced to go out, whether rightly or wrongly, but also there'll be those who just missed being eligible who think it was unfair that they were excluded from receiving these possible benefits, and there will be people who retired under normal circumstances just prior to opening the window. There are always dividing lines. There will always be a last person who retired before the window was operational, and that person will always be upset. The only thing you can do, to minimize the difficulties, is to communicate as completely and honestly as you possibly can. Because of these types of touchy morale issues and legal complications, people tend to like to do windows all in one fell swoop, rather than having a series of them. A series of windows would have a lot of negative implications. Employees who want to retire may wait for the next window, and you could end up with the reverse effect of what you want.

One last point on timing. The timing has two aspects. The employer will send all who are eligible a packet explaining the extra benefits, perhaps five years of age and service and one week of pay for each year of service. The packet will instruct

employees to respond within the next, perhaps, 30 days. Those who agree to retire will have an opportunity, should they retire within the next six months, to get these enhanced benefits. If you don't get back within 30 days, the benefits would not be available. The employer will then see how this group elects, a month from now, and gather all the information. Perhaps, as the employer reviews the results, he will find that one of the individuals simply must be kept. Perhaps only one out of three people were needed to stay for some job function, and they all opted for the window. In order to combat that, build into the window a right to delay retirement for selected people for perhaps three or six months. This gives the employer a chance to gather resources and cover the job function in some other manner. It's crucial to do that. I think the classic example of an oversubscribed window was one of the very first reported in the press. DuPont apparently expected to have about one-third of the people electing, and had upwards of two-thirds. It is reported that DuPont did not want that number of people leaving by any way, shape, or form, and it was left in something of a hole. It's very difficult (in fact, it's impossible) to consistently and accurately determine exactly who might leave.

Now, in summary, lets review current trends. There's a big rush of windows happening right now, whereas early retirement windows had been declining over the past four years. The windows tend to use early retirement subsidies, and they tend to continue health benefits. In fact, you could have a negative-message window with the health benefits. Rather than inducement through higher retirement benefits, it is possible to do a window by saying, if you don't retire by some cutoff date, you will not have the full postretirement medical benefits because we are changing the program to a much lesser plan. People might scurry out to avoid having their benefits cut back. That has happened, and it has been very effective. But it did leave poor morale.

Involuntary programs should always be considered, but you have to be careful with them. The advantage of an involuntary program is that you can manage your ADEA exposure. You can provide less costly benefits, because you're not inducing somebody to have a choice, you're just getting them out. But, it's very, very difficult to pay involuntary benefits from a qualified plan. Also, you can't necessarily target the right people. If you're after so-called deadwood and if you're picking the people, you're probably going to have a great ADEA problem, if you think deadwood has a strong correlation to age. The only chance to get the right people in that type of a situation, if that was the evaluation of the employer, would be to offer a window and hope the people you want out do it on their own.

I think this gives a decent beginning summary of what windows do and what they are. At this point, we're going to shift into a more technical gear, and Howard Peyser is going to go over the regulations.

MR. HOWARD J. PEYSER: I'm going to talk about paying early retirement incentives through a qualified plan. There are obvious advantages that Eric alluded to in his discussion, as to why you may want to pay early retirement incentives out of the qualified plan. But, there are also various requirements that you have to meet, which may restrict the types of benefits and the amount of benefits that can be paid out of a qualified plan. What I'm going to try to do is summarize the major provisions of the Internal Revenue code that impact on the payment of early retirement incentives out

of a qualified plan. A full discussion of any one of these topics could take up my time, so my presentation is basically just a summary of what the considerations are in setting up early retirement incentives in a qualified plan. My agenda will address the following questions. Why use a qualified plan? What are the allowable types of benefits in a qualified plan, or the limitation on the amount of benefits that can be paid under a qualified plan under Section 415 of the Code, or the nondiscrimination requirements under Section 401(a)4 of the Code? I'll also discuss certain other plan qualification requirements that affect payments of incentives out of the qualified plan.

Why use a qualified plan? Obviously, the focus here is on defined benefit plans. It's rare, though possible, to use a defined contribution plan to pay some kind of early retirement incentive. One advantage is financial: You can use the surplus plan assets to pay the incentive, and also, even if there aren't surplus plan assets, the payment of the early retirement incentive out of the qualified plan can help the cash flow of the employer. Often these benefits are paid in a situation where the employer is not in the greatest financial shape. Another reason to pay the benefits out of a qualified plan is based on plan design considerations. If you pay the benefits out of the qualified plan, they kind of fit in to the benefit scheme that you already have and enhance benefits that participants are typically used to. But as I mentioned, if you use the qualified plan, you have to meet certain complex requirements.

The first requirement is to provide benefits under a plan that are allowable under the context of a pension plan. There's not a lot of concrete authority on what kind of benefits can be paid out of a pension plan, other than a definition of what a pension plan is under the Section 401 regulations that were actually pre-ERISA regulations. And a pension plan has to be designed to provide retirement benefits, whatever those are, or however you define them. There's no real definition. But the regulations also provide that you can include noncustomary types of benefits in a qualified plan. And an example in the regulations of a noncustomary benefit is a layoff benefit. There's a question raised here as to whether you can really pay a severance benefit from a qualified plan, although many employers do that. You can also pay certain types of ancillary benefits out of a qualified plan, such as Social Security supplements and certain types of shutdown benefits.

Now, what most employers do when they want to pay a severance-type benefit out of a qualified plan is they basically provide a severance-type benefit but allow the participants to choose that benefit to be paid in a form that's typically paid under a qualified plan, like a lifetime annuity or a qualified joint and survivor annuity. But I want to bring your attention to a 1987 Technical Advice Memorandum issued by the IRS, which clouded this whole area. Under the Technical Advice Memorandum, the plan provided a choice of types of benefits upon plant closing. It was a benefit that was triggered based on a plant closing. Basically, the employees had a choice of salary continuation up to nine months, or the actuarial equivalent of that salary continuation paid as a qualified joint and survivor annuity, or an annuity form paid under the plan. And this is typically, as I mentioned, what employers would do. The IRS, for various reasons in this Technical Advice Memorandum, said that benefit was not the type of benefit that could be paid out of a qualified plan, and basically recommended that the plan not be qualified because of the inclusion of this benefit. There hasn't been a lot more authority or information about the IRS position on this topic. From what I see, employers are still fashioning all types of early retirement

incentives payable through a qualified plan. But, you just should be aware that there is this Technical Advice Memorandum around, and that the IRS could come down and say that type of benefit that you're paying out of a qualified plan doesn't satisfy the definition of a pension plan. It's something to be aware of.

Now, Eric mentioned the types of incentives that can be paid out of a qualified plan. I'll go over them very quickly. You can reduce or eliminate early retirement reductions; accelerate vesting, which really is not that much help these days with the five-year cliff vesting mandated; credit additional service; and add additional benefit forms. Basically, you may provide that people who retire within a particular period of time get a lump-sum benefit that's not otherwise available to the other employees under the plan. And you can also provide temporary supplements, such as Social Security supplements payable when a participant retires prior to Social Security retirement age, pending receipt of the Social Security benefit.

The provisions under the qualified plan can either be time limited, basically a window-type benefit where employees can choose this enhancement only if they meet certain requirements and retire within a particular period of time, or they can be permanent features of the plan, basically written right into the plan as a permanent provision and are triggered upon certain events, such as a plant shutdown or a job elimination.

I want to turn to the limitation on the amount of benefits that can be paid, as prescribed by Section 415 of the Code. Usually 415 of the Code affects only the most highly paid employees covered under a plan. But in the context of a window, as I'll point out, or an early retirement benefit, you may affect much lower paid employees by the Section 415 limitations. Now, the general rule of Section 415 is that the maximum benefit that can be paid at Social Security retirement age is a $90,000 annual pension, which is indexed. For 1991, it's indexed to $108,963, or, if less, 100% of a participant's average compensation.

Now, there's one type of reduction in that dollar limitation that is going to affect the payment of benefits to participants who receive early retirement benefits. And that is a reduction based on payment before Social Security retirement age. Now, at age 65, with an employee who has a Social Security retirement age of 65, the maximum benefit is $108,963. But when you get to age 60, it gets reduced to $72,884. At 55, it's only $48,289, and at age 50, it's $33,308. There's a steep reduction in the maximum amount of benefits that can be paid in an annual life annuity form at a particular age. This will have an impact on the amount of early retirement benefits that you can pay under a qualified plan.

Not only is the dollar limitation reduced for commencement prior to Social Security retirement age, but also it's reduced based on plan participation of less than 10 years. So, if you are a participant in a plan for less than 10 years, you multiply the applicable dollar limitation that would apply to you based on your age of termination of employment by a fraction. The numerator is your years of participation in the plan, and the denominator is 10. The Code also provides that you never reduce the dollar limitation to less than one-tenth of the applicable dollar limitation for a particular year. It's really important, in terms of adding, let's say, a retirement window, an early retirement window, or amending a plan to provide a retirement incentive, that this phase-in over years of participation for the dollar limitation of section 415 applies separately to each

amendment that you provide! If you have an amendment to a plan that provides increased benefits, the maximum benefit that can be provided is limited by taking the 415 dollar limitation for that particular year, and multiplying it by a fraction, the numerator of which is the number of years of participation that you have subsequent to the amendment, and the denominator of which is 10.

The legislative history of the Tax Reform Act of 1986 provided the possibility of certain exceptions to this separate application of 415 to amendments, which would apply if an amendment wasn't primarily for the benefit of highly compensated employees, except that the IRS has not implemented any of those exceptions at this point. So, most employers, in setting up windows, will take into account this phase-in of the 415 limit with respect to the benefits that the window can provide.

Now, just to point out how low the numbers go, when you look at one-tenth of these 415 limits at age 55, the increase that you can provide through an amendment that's set up on a window benefit will only be $4,829. And that may really impede the amount of benefits, and the impact of the window, that you can have through the qualified plan. Let's look at an example of how this phase-in works. Suppose we have an early retirement window in which you must be 55 with 20 years of service in order to elect the window, and the window benefit provides unreduced benefits at the age at which you retire. In this case, the participant's normal retirement benefit is $25,000 a year. He's had 20 years of service, he's 55 years old, and he's accrued a $25,000 benefit. He doesn't necessarily have to be particularly highly paid to have that type of benefit. The general plan provisions provide that you get a 5% reduction for each year the benefit commences prior to age 65. So, someone who is 55 years old would have a 50% reduction in his benefit, or a $12,500 reduction. The benefit of the window, therefore, to give this person unreduced benefits, would be $12,500. And assuming that this person had a Social Security retirement age at 65, we get down to the maximum benefit that the window can provide at age 55, is really $4,829 per year. So, despite the fact that you're designing a window that has unreduced benefits, this person really can't get unreduced benefits, to the full extent, through the qualified plan.

Just two additional considerations with 415. One point is that, even if you provide a Social Security supplement-type benefit, which may be viewed as an ancillary benefit, there's an IRS private letter ruling that says that those types of benefits are also subject to the 415 limits. Another thing to be aware of is the effect of 415 excess plans that you may have, plans which are nonqualified, which cover benefits that can't be paid out of the qualified plan in excess of the 415 limits. If you represent an employer that has a 415 excess plan that covers anyone who has a 415 reduction, there may be an unintended result that that plan would cover the participant that I mentioned, who is limited under the window benefit, based on 415. You really have to look at your excess plan to see who those plans cover, and to make sure that, if you don't want the 415 excess plan to cover those kinds of benefits, you better make sure that the plans are correctly drafted.

I want to turn to the nondiscrimination requirements of section 401(a)4. As everyone knows, these are extremely complicated, and there's really no way to go into them, in any kind of detail, in this short discussion. But I just want to highlight some of the workings of how these operate. The basic message here is that because of the

nondiscrimination rules, you may not be able to pay the types of early retirement incentives you want to for highly compensated employees out of the qualified plan. The nondiscrimination rules focus only on what you can do for highly compensated employees. You can do whatever you want with respect to nonhighly compensated employees with regard to 401(a)4. There's a lot of flexibility for them. Just to set the background, the 401(a)4 regulations, both the proposed and final, make you test nondiscrimination on three levels. First, you test with respect to benefits, rights, and features, which would include early retirement subsidies, Social Security supplements, etc. Then you also have to look at the amount of benefit that's provided, and make sure that's nondiscriminatory. Third, if you add a benefit via an amendment, the actual amendment has to be nondiscriminatory in operation. The testing under the 401(a)4 regulations, as the final regulations have come out, depends to a large degree on the type of benefit that's paid. Obviously, a very common type of benefit, and one that's dealt with somewhat specifically in the final regulations for the first time, are early retirement windows. The qualified Social Security supplement is a new term that is included in these regulations. A qualified Social Security supplement is a temporary-type benefit that is made by plan design to be part of the accrued benefit of a participant. It's treated as a part of the accrued benefit, rather than an ancillary benefit. And, any of these types of benefits is a window, if it's offered to retirees or individuals who retire within a limited period of time.

Under the regulations, there's a special definition of early retirement window available for early retirement-type windows that are only available for a limited period of up to one year, and that span two different plan years. In those cases, in testing those kinds of windows, you get special treatment to the extent that you only have to test the window, generally, in the first year that the window becomes effective, and you can kind of disregard it in the second year.

Now, getting to the nondiscrimination with respect to benefits, rights, and features. There are two prongs to meeting nondiscrimination for benefits, rights, and features. One is effective availability, and the other is current availability. The effective availability aspect is the facts and circumstances situation that Eric alluded to. You can meet all the specific objective nondiscrimination requirements and still violate the effective availability rule if it turns out that the effect of that benefit is really only to benefit highly compensated employees. The current availability test is a much more specific, objective test. For current availability, the individuals who are eligible for the window have to either meet what's called the ratio percentage test, under section 410(b) of the Internal Revenue Code, under which the percentage of nonhighly compensated employees who would benefit under the window has to equal or exceed at least 70% of the percentage of highly compensated employees who benefit under the window. And I'll give you an example of this later. Or, there is something called the nondiscriminatory classification test, which is an easier test to meet. Under a nondiscriminatory classification, those who are eligible for the window have to satisfy what's called a reasonable group. And typically, if you specify a particular age as to the group who can get it, that would be a reasonable kind of classification. In addition, the classification has to satisfy a nondiscriminatory classification component. And that really is the same thing as the ratio percentage test that I mentioned before, but the 70% threshold is reduced to something lower than 70%, based on a table in the regulations of safe harbors and unsafe harbors. When you test current availability of a window, the regulations make it clear that you can treat all those employees

who are eligible for the window as having that window available to them. They don't have to actually elect the window to be treated as having it available to them. So, you can actually look at current availability from the population whom you made the window available to, as opposed to the population who actually elected the window. So you can look at this before the fact.

Let me give an example of another early retirement window with unreduced benefits to retirees who retire between December 1, 1991 and November 30, 1992. We have a calendar-year plan year, and you have to attain age 50 with 20 years of service in order to qualify for the window. Looking at those people who are eligible for the window, we have 100 highly compensated employees; 20 of those would be eligible for the window, and 80 would not. So the percent eligible is 20%; i.e., 20% of the highly compensated employees are eligible for the window. With respect to nonhighly compensated employees, we have 500 nonhighly compensated, of whom 40 are eligible for the window, or 8% of the 500. When we do this ratio percentage test, looking at the percentage of nonhighly compensated eligible divided by the percentage of highly compensated who are eligible, we get eight divided by 20 or 40%. We don't meet the 70% ratio percentage test, which is one of the criteria. However, based on the 410(b) regulations, under the regulations on minimum coverage under the code, the safe harbor percentage for this plan would be 32.75%, and therefore we would cover enough nonhighly compensated employees under this window to pass the current availability.

Getting to the amounts testing part of 401(a)4, an early retirement window is taken into account in both testing plans that qualify under the safe harbor, and plans that use the general rule. Under a safe harbor plan, if you put a window into a safe harbor plan, you may violate the rules that the subsidized benefits provided under the safe harbor plan be available uniformly to all participants. Therefore, the regulations provide some relief in allowing you to use the concept of component plans, to divide your plan into two components and test it. One would be for that group who is eligible for the window, and the other component would be for the group who is not eligible for the window. This gets more into the workings, and the details, of Section 401(a)4, but just be aware that, if you have a safe harbor plan, the window may affect the safe harbor, and you may have to do some other type of testing in order to make that plan work. Under a plan that's tested under a general rule, the window benefit is considered in testing the most valuable accrual rate. So, if you provide a very valuable or very expensive type of early retirement subsidy in your plan, and a significant number of highly compensated employees benefit under that subsidy, you may have trouble getting that plan to qualify under the general rule once you put the window into the plan.

Another type of benefit that's mentioned under the 401(a)4 regulations is an unpredictable contingent event benefit. An example of that type of benefit is an unreduced early retirement benefit triggered by a plant shutdown. In testing that type of benefit, we look at current availability and my view is that benefit would be available to all the participants in the plan, if the plan qualifies under the ratio percentage tests of a nondiscriminatory classification that I mentioned, then the benefit would meet current availability. It would also have to meet effective availability, and I assume that would be met. Both under the general rule and under the safe harbors, in amounts testing you take the unpredictable contingent event benefit into account only upon the

occurrence of the event, and only with respect to the employees who are affected by the benefit. So, you may have a plant shutdown benefit in your plan that isn't triggered, and in all those years that it's not triggered, you will not have to worry about it with respect to 401(a)4 testing. But in the year that it's triggered, you're going to have to take that into account in testing under the general rule, or determining whether your plan meets the safe harbor.

A final type of benefit that's dealt with under the 401(a)4 regulations is what's called an ancillary benefit, and an example of that would be a Social Security supplement that is not designed to be this kind of qualified Social Security supplement I mentioned earlier. Those types of benefits are tested under benefits, rights, and features in a similar way to the early retirement windows. Amounts testing, however, is not required for those types of benefits. You only have to look at it in terms of the current availability or effective availability. It does not go into the testing of the amounts of benefits under the general rule.

Very quickly I will go through a few other types of plan qualification issues that are triggered by early retirement windows, or early retirement-type benefits. Another is Code Section 411(d)6, which are the anticutback rules, which provide that you can't reduce accrued benefits, you can't eliminate or reduce early retirement benefits or retirement-type subsidies, and you can't eliminate optional forms of benefits. Under the anticutback rules, when a window closes, basically when the period for electing the window ends, we should be able to say that benefit disappears from the plan, and it's not included in anyone's accrued benefit who did not elect the window or was not eligible for the window. However, if the employer establishes a pattern of this type of benefit, basically closes a window and opens it again year in and year out, we may create under the plan, by operation, an accrued benefit whereby even those people who didn't elect the window or who weren't eligible for the windows would have that benefit included as part of their accrued benefit. Another point here is that, if you have a permanent provision in the plan that provides for job elimination or work force reduction of benefits, whether those kinds of benefits can be eliminated prospectively, with respect to employees whose jobs have not been eliminated or haven't been terminated, is an open issue. I think there's some good arguments that you could eliminate that type of benefit prospectively.

Another code requirement is section 401(a)26, which is the minimum participation requirement. Under 401(a)26, you have to cover at least 50 employees under a plan, or 40% of all employees. This should not be a problem when you provide a window benefit, even if the window benefit covers less than the 50 or 40% of all employees. Because, under the reproposed 401(a)26 regulations that came out in May 1990, they basically focus on the plan itself, and who is covered under the plan, not necessarily who benefits by a particular window or feature of the plan, which was the original provision of the originally proposed regulations. So 401(a)26 should not be a problem.

The requirement that benefits be paid as a joint and survivor annuity unless the spouse consents otherwise, will generally apply to all early retirement incentives under a plan, other than those which you can qualify as ancillary benefits. So therefore, in the typical case, if you want to provide a lump-sum benefit as your early retirement

incentive, you're going to have to get spousal consent, otherwise the benefit would have to be paid as a joint and survivor annuity.

Just two other issues to mention. It's possible that a window, basically by creating an additional benefit, would literally violate the antibackloading rules. But, the IRS has really not come down on this, or really focussed on this that much. Most times when people put in these types of window benefits, they really either disregard the accrual rules, or argue that the accrual rules should not apply to those types of benefits. I'll mention that Technical Advice Memorandum did say that one of the reasons that the benefit under the plan at issue, did not meet the plan qualification requirements, was because it violated the accrual rules. So this may be a method of attack of the IRS at some later time. And one final requirement is that benefits under a qualified plan be definitely determinable. Under this rule, the employer can't specifically designate by name who will be eligible for a particular early retirement incentive. However, an incentive can be contingent on a particular event, such as a plant shutdown or a job elimination program. There's a thin line between an employer designating individuals who would be eligible for a particular type of benefit, and having a job elimination program. The IRS hasn't really focused that heavily on this, but that is an issue to watch out for when designing a window.

I've basically covered a lot of ground and a lot of plan qualification requirements that affect providing early retirement incentives through a qualified plan. And I've tried to summarize and key in on the issues that you have to look at. If you put in an early retirement incentive program, it's best, before you actually start implementing it, to really focus on the plan qualification issues, so that you don't wind up in a situation where you've gone into a program, and then realized, after the fact, that you may have some issues that will present qualification problems.

MR. LOFGREN: I'd like to add one comment to that on Section 401(a)4, amounts testing. Suppose I have what has up to now been a very typical benefit structure of five plus five, extra five years of age and service. A 55-year-old with 15 years of service is going to be tested with 20 years' worth of integration into a 15-year period, with an age 60 early retirement factor, tested on a most valuable accrual basis for 401(a)4 amounts testing at age 55. If you have highly compensated people in there, and it's a five plus five and it's an integrated formula, it almost surely will not pass. You're going to have this highly compensated person way up above in your restructuring very often, and the answer to that would probably be to throw in the temporary Social Security supplement.

At this point, I'd like to turn it over to Cindy Combe to address the ADEA issues.

MS. CYNTHIA M. COMBE: The Older Workers' Benefit Protection Act (OWBPA), passed in October 1990, made a significant change to the ADEA, by changing the definition of what was covered. If you looked very carefully before, the act never said, "We cover all employee benefit plans, whether or not they are bona fide." And in fact, if you were observing the terms of a bona fide retirement plan, you could escape further regulation by the act. The first thing that the OWBPA said was, now that the act prohibits discrimination in the terms, conditions, privileges, and compensation related to employment, "including all employee benefit plans," which are now specifically included, described as including benefits provided pursuant to a bona fide

plan. The act then went on to amend ERISA to provide that an employer can observe the terms of a bona fide early retirement incentive program. But now with the new definitions, that isn't the end of the story. The plan continues to be regulated by the rest of ADEA. Specifically, the plan cannot require or permit the involuntary retirement of any individual within the protected age group, which is age 40 or older, but it does provide some safe harbors for the things that Howard has told you may be pretty useless through a qualified plan for highly compensated employees, at least: early retirement subsidies and Social Security bridge payments, either up to reduced or full Social Security benefit levels.

The legislative history of OWBPA does go into some detail about what you can do, and what Congress was really aiming at. What it was really aiming at was the early retirement incentive program where, for example, at age 60, you'd be paid one year salary if you left then. At age 61, this would be maybe half a year's salary. At age 62, it might be a quarter year's salary, and then nothing. So that you had some individuals who were not getting what the younger employees were getting. Congress did not like those provisions, and they are now gone. They are illegal. And, I would like to read this minuscule print quote from the legislative history, the Senate's statement of managers says that early retirement incentive plans that withhold benefits to older workers, above a specific age, while continuing to make them available to younger workers, may conflict with the purpose of prohibiting arbitrary age discrimination in employment. And, they also prohibit plans where older individuals are not given benefits under age stereotypes, like, "Well, they're retiring anyway, so they don't need this supplement." What you can do is, for example, give early retirement incentives that are a flat dollar amount, such as $20,000; service-based benefits, such as $1,000 multiplied by the number of years of service; or a percentage of salary to all employees above a certain age. The legislative history says that was okay before, and it's still okay. We're not out to destroy all of these kinds of plans. Similarly, if you want to do a flat dollar increase in pension benefits, such as $200 a month, or a percentage increase, 20%, these continue to remain lawful, as would Eric's type of plans, the imputing age and service, his five and five and three and three type plans. The statement of managers gives a specific example of a plan that kicks in at age 55. If you give employees five additional years of service and age, the statement is specifically saying that's still okay under the ADEA.

For severance pay, assuming that you fall within an ERISA welfare benefit plan, the amendments to the ADEA represent the first time that severance pay plans are now substantively regulated, in terms of what you can and cannot put in the benefit plan design. You can no longer design a severance pay plan that says, "You don't get it if you're going to retire and receive full pension benefits, or reduced pension benefits." What you can do, if you become eligible for an immediate pension, upon severance, is design a severance pay plan where you subtract out the value of retiree medical benefits, under limited circumstances. Suppose you have a contingent event not based upon age. You just want to shut down a division, reduce the work force, whatever, and an individual is eligible for an immediate pension. What you can subtract is a statutory minimum amount. You have to have a certain degree of richness of your retiree medical benefits. This doesn't have to be a specific shutdown bonus or anything. This can be a preexisting plan. And the statute gives you pre-65 value figures to use and post-65 value figures to use. As of the date of your contingent event, which is unrelated to age, the retiree health benefits have to be as

valuable as Medicare pre-65, and post-65 they have to be 25% as valuable as Medicare benefits. For those of you who are now going to sit down and say, how do I calculate value, don't go any further than the statute itself. Because it says, if you have benefits of a limited duration, you just value them at $3,000 a year. And this figure will be indexed for benefits pre-65. It's $750 a year, post-65. If you have unlimited duration retiree medical benefits, there's a flat dollar amount given in the statute that will be indexed. Pre-65 benefits are valued at $48,000, and post-65 benefits are valued at $24,000.

Before you design a severance pay plan where you're going to subtract the value of retiree medical benefits that you're giving, think twice. The act then says, if you're going to deprive someone of a certain level of severance pay because you've got retiree medical, then you're going to have to deliver on that retiree medical later! We're not going to let you amend it out of existence, and get out of your obligation. The act gives any "aggrieved individual" the right to bring an action for specific performance, to force the employer to deliver that level of retiree medical benefits. This provision means that, if you were looking at cutting back your retiree medical benefits for your SFAS 106 compliance, you don't want to do this, because you've just locked yourself into a certain level of benefits. You can also reduce severance pay by additional pension benefits that are made available as a result of the contingent event unrelated to age. It has to be made available solely as a result of that unrelated event, and not because the employees are going to become eligible for it anyway. And, after the contingent event, the individual has to be eligible for an immediate pension, unreduced. If the employees are eligible for a reduced pension, the amount of your permitted offset from severance pay goes down proportionately.

The other substantive regulation of severance pay, and it really is a substantive regulation of any benefit, subject to the ADEA, is the idea that you cannot condition receipt of severance pay, or a window program, on the employee's signing a waiver of rights under the ADEA. This was a great technique, and employers used it a lot to limit their litigation exposure from unhappy employees. Prior to these amendments to the ADEA, there were a series of cases dealing with severance pay plans where the judges were struggling with, well, if we're going to take away severance, or the employees' rights to sue and all that, it's got to be a knowing and voluntary waiver. And the courts came up with various formulations of what is a knowing and voluntary waiver. And prior to this Act, in the second circuit, the best statement of what was a knowing and voluntary waiver was in the *Borman* vs. *ATT* case, which essentially found its way into the statute, with a few little extras, on the employees' behalf. If you're going to design a plan that way, where you extract a waiver of rights in return for severance pay, you've got to meet, at minimum, a certain number of conditions in the statute, or else that waiver will not be considered to be knowing and voluntary. And, the most important of these conditions is that the individual must be required to waive the right or claim only in exchange for consideration which is in addition to anything they are already entitled to. This is a kind of a vesting concept, even though a severance pay plan might not be considered to be a pension plan, various state laws deem an employee to be entitled to severance pay if he has given service. The service is in exchange for earning the severance pay; at the time the employee is terminated, he gets it. And so, to ask the employee to waive his rights, in return for the pay, would be now illegal under ADEA.

I hesitate to stress that these state laws would probably be preempted under ERISA, but if you want to be fail-safe, when you're designing these plans, you would do a two-step plan, where you might give one week per year of service to everybody, but, if you'd like to sign our waiver, we'll give you two weeks' pay for each year of service. In other words, have specific consideration in the plan for that waiver. Don't slap a waiver onto a step that's already in a preexisting plan. Just put a new level into a plan, and get the waiver in return for that. The waiver also has to specifically refer to the ADEA, so those of you who have designed these before have to go back and stick that into the old waivers. And then there are procedural justice requirements, with respect to these waivers. Employees have to have a particular period of time to discuss the waiver with their lawyers, tax advisers, etc. This might be 21 days for an individual termination and 45 days for a termination as a part of a group plan. And, it must be revocable for seven days after execution. So, you would design it so it's not effective until the eighth day. Which leads, of course, to the question of what happens if somebody says, "I'll take it." They sign the waiver on, say, the second day of the 45-day period. They can revoke it for seven days, but they had a whole 45 days to elect. Practically speaking, you would still wait to the end of the 45-day period, plus seven, before calling that an effective waiver, if you wanted to be very conservative. And, people will differ on how they'll interpret this, but you really want to let the whole period elapse so that it can be a "knowing and voluntary waiver."

Now, I did want to review, briefly, severance pay under ERISA. Many employers still have a hard time grasping the notion that severance pay is an ERISA plan, particularly if they have it, just in terms of a policy, or a secret policy that maybe only the managers know about, and they select who will get it and who won't. It is almost impossible not to be an ERISA plan. It doesn't matter if it's unwritten. It doesn't matter if it's secret, it doesn't matter if it was never communicated, and it doesn't matter if your managers have the discretion only to pick one or two people. You've got an ERISA plan, and you've got to go through all the summary plan description, the annual 5500 reporting, unless you fall into an exemption, for example, top-hat exemptions, under ERISA. Perhaps the only way out of this is a one-shot deal. And the Supreme Court did say a one-shot deal, payments to everybody just one time, with no administrative scheme for ongoing determinations of eligibility and benefit payments, is not an ERISA plan. Anything other than that, you're under ERISA. So, you have to worry, once you're under ERISA, about what you are. What is that plan, once you're under ERISA? And the consequences for you can be very different. The Department of Labor has issued a regulation detailing whether the severance pay program will be a welfare benefit plan, which is almost entirely exempt from substantive regulations and is exempt from substantive regulation under ERISA, or whether it will be a pension plan, which gets you into gobs of requirements under ERISA for nonqualified plans, and under the tax rules, for qualified plans. For determining whether or not you have a pension or a welfare benefit plan, the key design characteristics are that the payments cannot be contingent on retirement, and that for a severance pay plan that's not an ERISA pay plan, you're basically looking at two plus two. The payments can't last more than two years, nor be more than two times compensation. For a window plan, a limited program of terminations, you have a somewhat longer period of time, either two years after the employee's termination or two years after normal retirement age, whichever is later. You can fit a lot within this welfare benefit plan definition. The two times compensation is troublesome, because

it is limited to that which would have been paid at the employee's usual rate of compensation. It's not clear that individual discretionary bonuses can fall within your two times compensation limit. You can, however, if you're designing a two-step plan where a waiver is attached to the extra benefits, design a plan that's significantly below two times compensation, and require a waiver for additional amounts, bonuses, discretionary bonuses, and so on so long as the overall aggregate benefit doesn't exceed two times regular compensation.

The other important item about being an ERISA plan is that, of course, you have to have a written plan document. So, we have to get those secret plans out of the closet, get them in writing, put the required ERISA basics into the plan, including who gets benefits, when, how, where, and why. And, we have to worry about any ambiguities in who has the power to determine questions of fact or eligibility under the plan. I'm sure you've all heard endlessly about the Supreme Court's decision, in *Firestone Tire and Rubber Company* vs. *Bruch*. Prior to *Bruch*, the standard of review for an administrator's or trustee's decision was, were they arbitrary and capricious based on the record before them? Did they make a reasonable decision based on that? Even if I, as a judge, would disagree. The practical effect of that was, you could run your plan the way you intended it to be run. After *Bruch*, the administrator's decision is not given deference, and the judge will hold a brand-new trial, and substitute its judgment of what it thinks the plan should say, if you have not specifically reserved to someone the authority and power to determine what the plan says. The reason I mention this is that *Bruch* was a severance pay plan. Firestone Tire and Rubber Company had a written severance pay plan that paid upon a reduction in the work force. But it wasn't really detailed about the other times the plan would pay. The company sold a division. It didn't pay severance pay benefits for those folks who continued to work for their new employer the next day, same desk, because the company didn't consider that to be a reduction in work force. And the Supreme Court said, you didn't reserve the power to make those final determinations in that document. So, the Court didn't have to defer to the company's interpretation. The Court thought it was a reduction in work force, and the whole division got severance pay. That can happen to any of these plans at any time, unless they are carefully drafted. And this is where your lawyer is your partner. It's also important not to do these things too quickly, and clean up the legal niceties, like putting the amendments in writing later.

There was another severance pay plan case, *Hosier* vs. *Midwest Fashioners,* a third circuit 1990 case, where a company got in trouble for waiting to include the amendments. The company had a very rich severance pay plan. The employer's managers developed a package, circulated it around, said, this is what we're going to do now, for our new, reduced, benefits. And they terminated a whole bunch of people, and gave them the newer, reduced benefit. And, sure enough, somebody sued, and the judge said, well, you didn't go through the formalities, there was no written amendment signed and adopted before you put the new severance pay plan into effect. So that plan is not valid. The old plan governs, the employees' win, they get lots more money. And so did everybody else from then on, who was going to be terminated, until the employer went through the mechanics correctly.

I have just one or two other practical considerations. If you're going to be bundling other benefits, with your severance pay programs, or putting them in your so-called

window programs, you then have to worry about COBRA, and you have to worry about the ability to cut down on a retiree medical plan. If you promise, in a severance plan, that you'll get benefits similar to what the actives have, unless you carefully qualify that promise, you may have just granted lifetime benefits where there were none before, and even where the base plan allowed you the ability to amend and cut back. And this is what happened in the *General Motors* vs. *Sprague* case recently, which is up on appeal now. Last but not least, in a merger or acquisition situation, if you're the acquiring company, be wary of agreeing to offer benefits that are substantially the same as what the other company did. You want the ability to change your severance pay plan. You want the ability to write in your Bruch protections and to cut back the plan if it's a little too rich for your tastes.

FROM THE FLOOR: I'd like to ask the speaker something about her statement that all these things are now severance-type things under ERISA for all practical purposes. Does that include so-called golden parachutes?

MS. COMBE: That is a very interesting question. There is a case that has held that a series of identical golden parachute agreements constitute an ERISA plan. More recently, the Department of Labor has issued an opinion letter, in July 1991, saying a special deal, a severance arrangement, for even one employee, could be an ERISA plan. So, the answer is yes. Then you start looking for your top-hat exemptions to apply.

MR. JOHN A. HERMANN: I have a question for Howard, or anyone else who'd like to answer it. How do you go about doing the discrimination testing for one of these plans? I agree with you that, in general, the additional benefit becomes part of the most valuable benefit for testing purposes. But isn't it also possible, as an alternative, to utilize a multiple benefits provision of the regulations, so that the basic plan can still be tested, how ever it otherwise was tested? And then, the open window is tested as a separate benefit, the argument being that the employees are getting the sum of the two, and you can test each of two benefits separately.

MR. PEYSER: Well, basically, if you want to separate plans, and test groups separately, you have to attribute all the benefits, rights, and features to each group, plus the basic benefit to that group. So, if you have the window group, and if you want to test that benefit separately, you include the window benefit plus the regular accrued benefit under the plan. And the nonwindow group includes just the regular benefit under the plan. You can't, under the restructuring rules, separate employees and have separate testing with respect to the basic benefit and the window benefit, done separately, with respect to a particular individual.

FROM THE FLOOR: Right, I'm not suggesting you separate it by individual. I'm suggesting you separate it by benefits. I think that is allowable under the general test. It may, in fact, help you in some cases if the plan in general would meet the safe harbor, because then you wouldn't have to get all the information for everyone for that portion. You'd only have to look at the additional benefits for those people who are covered under the window.

MR. LOFGREN: You could certainly separate by employee group, into those with the window, and those without. And, if you're a safe harbor on those without, you're

done with that group. But, then you're going to have to look at the total benefit for the window group, i.e., the window in addition to the basic benefit.

MR. HOWARD YOUNG: I have a question for Howard Peyser on the section 415 limits. First, do the age reductions apply to the 100% of salary limitation, and second, in your illustration, if the individual had 20 years of service, why did you come down to $4,800 as the limit?

MR. PEYSER: The dollar limit reductions don't apply to the 100% limitation. The service reductions do apply to the 100% limitation, but it's based on years of service with the employer, not necessarily years of participation with the plan. So, it's kind of the old rule before tax reform, with respect to dollar limits. In terms of reducing the person's benefit, under that illustration, we reduced it because his distribution was going to occur at age 55. It was because distribution was going to occur 10 years prior to his Social Security normal retirement age, as opposed to having anything to do with service.

MR. YOUNG: But you earlier had shown a $48,000 dollar limit as a result of that, and later showed $4,800.

MR. PEYSER: That's because the window was putting in an additional benefit of $12,500. And there's a special rule, under 415, that you have to test amendments that increase benefits by a separate dollar limitation. And, therefore, that $12,500 was what was tested, versus the $4,800.