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DIALOGUE WITH THE IRS

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Panelists: JAMES E. HOLLAND, JR.
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Representatives of the IRS will address current issues. The second portion will be a question and answer session with the audience.

MS. KAREN KRIST: During the last 12 months, the IRS has given us plenty to think about with final regulations, delays of final regulations, modifications of final regulations, proposed modifications to the final regulations, and perhaps at some point, final regulations. At least it has an interest in keeping us busy. In addition, it is doing a lot more than simply working on the 401(a)(4) regulations, and it's those other areas that we're going to discuss. With us are Jim Holland and Joan Weiss from the National Office of the Internal Revenue Service. Jim is a graduate of the University of Virginia and an Associate of the Society of Actuaries. He teaches pension law at the George Washington University Law Center, and he is the Chief Actuary at the IRS. Joan Weiss is a visiting actuary at the IRS, a Fellow of the Society of Actuaries, and has a Ph.D. in economics from the University of Michigan.

Jim has some opening remarks. After that, Jim and Joan will go through and answer ten prepared questions. After that, they will take questions from the floor.

MR. JAMES E. HOLLAND, JR.: What I want to cover is something Joan will touch on both now and during another panel she is on titled "Recent Rulings and Regulations Update – Late Breaking Developments." We are looking at some of the problems brought to our attention after the publication of the 401(a)(4) regulations. I'm sure many of you have comments or suggestions and we want to hear them. It would be more productive if you put your comments in writing and send them to the Service and the Treasury. We can make some suggestions on addresses; we published one already for one of our issuances.

As Karen mentioned, we're working on more than 401(a)(4). Because we intend for this session to be a dialogue, I think we'll only hit some of the highlights. One thing I felt I ought to deal with right up front is the litigation that recently concluded. We recently concluded some tax court litigation in the small-plan area regarding actuarial assumptions. Posttrial, the process is that each side gets to write an opening brief. Then each side gets an opportunity to write a reply to the other side's brief. We are at the stage in all the cases where we are replying to the other side's brief. The court will evaluate, weigh the evidence, and eventually write a decision. I don't have a particular timetable for when the court will reach its decision. Because we're still in the brief-writing stage, I will not have much to say about the cases. I can answer some very specific questions. If you weren't involved and you obtained the brief of one side and read only it, you would be convinced because you don't know anything else. Then when you got the brief for the other side, you would be convinced and would wonder if this was the same trial. If some questions come up in your written material, we can look at it. Let's go on to something I think is more interesting and get with our program.

MS. KRIST: Announcement 92-29 stated the effective date of the nondiscrimination regulations was being postponed. What is the current status of these regulations?

MR. HOLLAND: As the question suggests, Announcement 92-29 postponed the effective date of the 401(a)(4) regulations to January 1, 1993, including related regulations. Of special note in the Announcement was that there were two regulations that still had the original January 1, 1989 effective date. The effective date of those regulations was also extended, specifically the regulations under 401(l) and 410 of the Code that would have been effective back to January 1, 1989 now have a delayed effective date of January 1, 1993. The only nondiscrimination type regulation or related regulation that has a 1989 effective date is the regulation under 401(a)(26). That one still has a January 1, 1989 effective date. As the Announcement indicated, to formalize this delay, there will be further issuances, such as changing the regulation to change the effective date in the 401(a)(4) regulations. During this delay, we are evaluating comments received after the publication of the final regulations. Many people have expressed varying concerns of one sort or another about the administrability of the final rules. We've been talking to many groups as you'll hear more specifically, and we're continuing to evaluate the effect of the final rules on plan administrators, practitioners, and other people who have a stake in the eventual rules that they will have to apply in practice. So that process is ongoing, and we are very much looking for suggestions and constructive comments to make things practicable from an administrability point of view, simpler from an understandability point of view, yet at the same time, we want to achieve the goal of maintaining nondiscrimination. There is a happy medium somewhere in there; we hope to achieve it, but there is a way to go yet.

MS. KRIST: Joan, Jim just talked to us about this Notice, but can you give us a hint about what sort of modifications you're looking at in the 410(a)(4) regulations?

MS. JOAN M. WEISS: At the same time we extended the deadline for the effective date as Jim mentioned, we requested further comments or suggestions to facilitate compliance with the regulations. In fact, since the publication of the final regulations and even further back, we've received numerous written responses from practitioners and taxpayers. These are circulated to the entire group that are working on the regulations, and we spend a fair amount of time discussing them. We at the Treasury and IRS have also met, and continue meeting on a regular basis, with many groups of taxpayers and practitioners who have an interest in the regulations. We've met with companies, consultants, actuaries, and groups representing these groups. These people have provided valuable input to us, and as Jim said, we have sought and we continue to seek input in a number of general areas.

These are the areas that practitioners have indicated are important to them. I'm just going to go over some of the general areas that we're looking at. The first area we're looking at is increased access to the safe harbors. More specifically, are there specific items in the regulations or specific provisions that keep employers out of the safe harbors and what might easily or rationally be done to make the safe harbors more accessible? The second topic is how might the general test be modified, how might the performance be made simpler and more user friendly? I will talk about the third area a lot because we actually have gotten to this is the simplification of the data requirements. This is one area where the actuarial community especially has been helpful, and what was released does represent a lot of helpful suggestions from practitioners. The fourth area is the treatment of compensation and compensation updates. The fifth area that interacts with the compensation is service crediting. We're especially looking at situations where service is credited other than with the employer in the very strict control group sense. Our overall goal is to reduce the taxpayer burden in complying with the regulations. As you probably know, the first piece of guidance we're referring to is the data process issued recently. We've issued it in proposed format; again I'm underlining what Jim said about inviting taxpayers and practitioners to comment. We anticipate that much of our future guidance is also going to be issued in this proposed format. The idea being that we anticipate comments, we welcome comments, and we will give them our attention. As Jim said, the written comments are generally best because that way we know exactly what you've said and we can circulate it among all of us.

Announcement 92-81, which again was issued recently, was the first item in the series of the guidance we're going to be issuing. This proposed Revenue Procedure may be relied upon while the guidance is still in proposed form. This Revenue Procedure or proposed Revenue Procedure talks about four basic areas where we hope we've simplified compliance with the regulations. The first of these is the quality of the data. We've said that if precise data is not available at reasonable cost, you may substantiate compliance with a reasonable substitute. The second item is single day snapshot testing. Employers, rather than having to test all year can, at the end of the year, or quarterly, take a snapshot on a single representative day and use that data to substantiate compliance. The third item is the definition of highly compensated employees. To facilitate the snapshot, employers need a way to determine the highly compensated employees on the day they take the snapshot. That is the third item in the proposed procedure. The fourth item is testing every three years. If there are no significant changes, an employer can perform the substantiation testing once and then rely on that testing for the next two years. I'm just going to spend a little more time on each of the four requirements. If I don't cover something you're interested in discussing, please submit it in the questions.

Before I do, I just want to review a little bit about what sections we feel this data procedure covers. The first of these is the general coverage rules under Section 410(b). The second is the amounts of contribution and benefits and the benefits, rights, and features under Section 401(a)(4). The third item is to determine whether a compensation definition is nondiscriminatory under Section 414(s). The important point to note is unless the procedure states otherwise, it does not cover amounts testing under Sections 401(k) or 401(m). In performing these tests, you are still required to determine the actual allocations at the end of the year and to do the full year look back.

A couple more remarks on the quality of data: The idea here is if you don't have precise data at a reasonable cost, the employer may substitute what we've referred to in the procedure as substantiation quality data. There are two tests for substantiation quality data. The first of these is, is it the best data available at reasonable cost? The second is, has the employer reasonably concluded that demonstrating compliance with these data establishes a high likelihood he would satisfy the requirements if precise data were available and he used it? The two operative words here are reasonably and high likelihood. I gather all sorts of litigation and general guidance on what reasonable means. The idea of high likelihood means you have to look at how close to the line you come when you're testing, how good are the data, what is missing, and so on, to determine whether you think it is reasonably likely that you would pass the test if you were using precise data.

The second area is the snapshot testing. I had some trouble as an actuary separating the data from the date, but we do think of these things as conceptually different. The idea here is that you can test on the basis of the employees on a single day. In other words, you pick your day and you look at the employee population on that day. The idea, however, is that the day you choose must again reasonably represent the workforce you test and the coverage of the plan that you're testing. Generally this choice of a single day must be consistent from year to year. As I said, in a typical defined-benefit context, the snapshot date will be the same day you collect your data if they are representative. Normally you'll look at your valuation data and decide if it's substantiation quality data or if you need to get some more information to bring it up to that level. Again, we focus on the cost of getting this information. The use of the same day and data, the linkage, is probably not as strong in a defined-contribution plan, but you may still want to do something there if you need January 1 data to test your defined-benefit plan and you need to do some 410 coverage testing. You also may have to look at a defined-contribution population on that date. You may have to, however, wait for your allocations at the end of the year to test the defined-contribution plan itself. Another point worth mentioning is that you have to take into account amendments through the end of the year if you use, for example, valuation data on the beginning of the year. You also need to consider whether the population on the testing date is reflective of the population that will be affected by the amendment. Items to watch out for here are early retirement windows and plant shutdowns.

The third item in the data procedure as I said was determination of highly compensated employees. You look at your population generally on one day, and make a reasonable approximation to 414(q)(7) compensation. The usual four categories of highly compensated apply, and maybe this is extraneous for actuaries but you need to annualize or project the compensation to get what a full year's compensation would be for people who have been employed for the full year. The last item is the three-year cycle, which is obvious. You test once. If nothing changes, you can use that test for the next two years.

MS. KRIST: Jim, what you're thinking about and that you're interested in listening is very interesting. But how long is this going to take? It's late May and we now have one more year. When do you think we'll have some final, final regulations?

MR. HOLLAND: Well, I'm not sure I refer to these things as coming out as regulations.

MS. KRIST: What do you call them?

MR. HOLLAND: I call them administrative issuances under authority of the regulations. They may be somewhat substantial, but let's agree they're certainly not regulations. The real question of timetable is a tricky one. I don't have any magic dates, and I will tell you from personal experience any date I give you will be wrong.

We do realize this is late May. We started this process about the middle of February and then we postponed the effective date. We've gotten to the point where we've done a lot of talking with various groups. The data procedure, as we call it, is based upon many of the suggestions and comments that we got from the various groups we spoke to. We know that the service and compensation problems illuminated by the postregulation comments are probably the next biggest concern. In chronological order, I would suspect that probably will be the next thing that gets out, but I'm not going to try to put a date on it. I'd like to think it would be soon, but I've been around enough to know that even when things are all agreed upon, just getting something drafted and out is a lot of work. Words are important, especially to the lawyers that are involved. That just takes time. We will work very hard. I think in the near future, you could look for some more. As to a specific date, no, you won't get one out of me unless you torture me.

MS. KRIST: Since our effective date at the moment is January 1, 1993, we've been under good faith compliance for several years now. Joan, could you give us some insight about what exactly constitutes good faith compliance? Do those old determination letters we have in our files give us any help?

MS. WEISS: One of the questions we all get asked at the IRS is just what is reasonable good faith. It's a term everybody uses, and it's hard to pin down. When I think about reasonable good faith, I think of two things. One thing I think of is something that takes into account all the relevant facts and circumstances. The second is that you act in accordance with a reasonable interpretation of the statute. So what is reasonable good faith? It's acting in accordance with reasonable interpretation of the statute based on actual facts and circumstances. This means, at least to me and maybe Jim differs here, that you can rely on pre-TRA 86 positions unless they were specifically modified by the statute. For instance, obvious cases of modification by the statute include 401(a)(17) on the compensation limit, and permitted disparity under 401(l). Generally good faith involves being able to rely on any of the proposed or final regulations that we have issued. I'm not going to say they're blanket safe harbors, but in general they can be relied upon as safe harbors.

It also seems to me that it's worth pointing out how the recent Announcement changed reasonable good faith from what it was before. It now moves reasonable good faith to a couple of areas where it didn't exist before. Prior to the Announcement, Section 401(l), if you followed it, you had to follow the regulations. Now you can go back to January 1, 1989 and use reasonable good faith. The same is true for the average benefit percentage test under 410(b). I also want to mention a couple of sections where reasonable good faith doesn't exist where the statute and the regulations need to be followed. The three sections that come to mind to me are 401(a)(26) on minimum participation, 411 on the vesting and accrual of benefits, and 414(q) on the definition of highly compensated employees.

Okay, can I give you some other help? Is there something else that might help you on reasonable good faith? On October 19, I believe 1991, the IRS issued a directive to field agents about just what reasonable good faith is. While I'm not sure whether it was or wasn't meant for the pension community, it's been widely circulated. People have said that having seen this guidance, it tended to help shape what they as practitioners thought and their intuitive ideas about just what constitutes reasonable good faith. So the National Office of the IRS is in the process of updating the directive. Now of course, as Jim says, we never can promise when anything will come out, but one of the things that is fairly high up on our agenda and that we're working on is to update and provide guidance as to what our field agents will be looking for when they determine whether actual employers have met the reasonable good faith guidelines. Again this is not a promise, but one suspects those guidelines will be circulated.

MR. HOLLAND: Let me address the part of this question that concerns determination letters. Right now, and we expect in the future, our determination letters will not cover whether you are in compliance with a reasonable good faith standard. Our determination letters look at the form of the plan, taking into account the effective date of any changes. They don't deal with anything in operation, and will not deal with the period prior to the effective date of plan changes. Let me be very clear here. Assume that you are doing a Tax Reform Act 1986 amendment some time next year for a client. It's submitted to the IRS. You could make the amendment effective January 1, 1993, or you could make it retroactively effective to January 1, 1989. If you make it effective as of January 1, 1989, you're changing your benefit formula four years ago, and the determination letter will cover whether the plans in form are a qualified plan for that period. If you choose to make the amendment effective January 1, 1993, the period from 1989 through the end of 1992 will not be covered by the determination letter. It will be a period of reasonable good faith compliance. I hope that distinguishes what is covered.

I might add from a policy standpoint, it gets very difficult to write a determination letter on reasonable good faith. You're looking at more than the form of the plan, not knowing what changes the plan went through meanwhile, or how it was administered in operation. It seems to me that one possible component of reasonable good faith is what people did in the interim. Anyway, the determination letters will not cover reasonable good faith; that will be left to examination. I would suspect that if people rendering advice to their clients don't get too far away from the statute, then they're probably okay. There are interpretations that have to be made, but I would expect that only some things out toward the extreme might not be considered reasonable good faith.

MS. KRIST: While we're talking about determination letters, currently there is a program open for safe harbor plans. Do you anticipate opening any other program? It seems to me it would be difficult to have a nonsafe harbor program while the regulations are still in something of a state of flux.

MR. HOLLAND: Right now it's somewhat difficult to expand the determination letter program to nonsafe harbors when we're still issuing guidance. Therefore, it will remain closed until we get out our guidance. I would add that there will be one exception. Until this point we kept employee stock ownership plan (ESOPs) out of the determination letter program, even those that desire to meet safe harbor designs -- your plain vanilla ESOPs. We will soon extend the determination letter program to such ESOPs, with everything in the safe harbors. Note that things like age-weighted profit sharing plans, which seem to be the highlight at the moment, are under the category of general testing, and within general testing under crosstesting. They cannot get a determination letter at this time.

MS. KRIST: Jim, could you talk just a little bit about the 10-year phase-in of the 415 limits, and the late unlamented Notice 89-45?

MR. HOLLAND: For many people, this will be good news. Notice 89-45 was revoked last week by the release of Revenue Procedure 92-42. Revenue Procedure 92-42 will be formally published in the June 1 Internal Revenue bulletin, but we released it to the press last week. It revokes Notice 89-45 effective for amendments adopted on or after August 3, 1992. It also provides a special option: an employer may choose to apply the revocation retroactively for an amendment adopted before August 3, 1992. This is an employer choice that can be made on a case-by-case basis. It will enable an employer to take an employee limited by an amendment, say a year ago, and increase the employee's benefit today by treating this amendment retroactively. If he so chooses, the employer can do this only for current employees, not those employees who terminated in the interim period, from the time of the amendment to now.

There is a special deduction option for certain employers who had limited benefits in accordance with the amendment. They can increase the deductible limit in the current year to take into account where they might have been had the prior amendment not been applied to limit people's benefits. The Notice shows an example of how this deduction option is calculated. We deliberately delayed the effective date of the repeal of the 10-year phase-in because some people might be calculating window benefits today and may have cost those benefits out assuming that they would be limited by the 10-year phasing rules of Notice 89-45. We want to give such employers the opportunity to choose whether they want to incur the higher cost. For amendments after August 3, 1992, there will be no 10-year phase-in. If and when we ever decide to reimpose the 10-year phase-in, you will see it in a proposed regulation. If there are questions about it, we'll be happy to take them. If it gives any comfort, the process of revising it started last year. We've been talking about it for a long time, which gives you an example of why I won't predict publication dates.

MS. KRIST: Are plant shutdown benefits (benefits that are triggered only upon the shutdown of a facility), 411(d)(6) protected? That is, can we safely take these benefits out of the plan before the plant shutdown has occurred? The General Council Memorandum (GCM) number here is 39869.

MR. HOLLAND: That is a question that many people have been wondering about for some time. The Service has addressed it internally in the GCM you mentioned. It was released a couple weeks ago. The GCM, for those of you who haven't read it, does two things. It addresses whether a plan may have plant shutdown benefits and then it addresses the question of whether they are protected accrued benefits. The conclusion reached is that certain types of plant shutdown benefits are permissible, social security supplemental-type benefits and subsidized early retirement benefits are examples. Other plant shutdown-type benefits, those in the nature of layoff benefits, are not permissible. In the class of plant shutdown benefits that are permissible, the GCM concludes that, if there are unpredictable contingent event benefits under 412(l) of the Code, they are not protected benefits until the unpredictable contingent event occurs, i.e., the plant shutdown. So that would mean that the IRS Section 411(d)(6) protection is not there if there has not been a shutdown and the benefits could be removed. Once the shutdown occurs, then under the analysis, they become protected and they cannot be taken out of the plan. There is some commentary in the GCM about funding of shutdown benefits. I think it was intended to apply only to current liability and not to more general calculations of 412. It has been pointed out to me that it can be read to say that for 412 purposes totally, you don't take plant shutdown benefits into account. I don't think this is the case and we probably will have to modify the GCM in that respect. It doesn't talk about the probability of plant shutdown or any of those notions that get very sticky (because of the yes/no proposition of whether you take them into account). That is not the focus of the GCM but be warned about it.

MS. KRIST: Joan, Revenue Procedure 85-29 gave plan sponsors broad authority to change funding methods with certain restrictions. That revenue procedure expired once and was extended and it has expired again. We are doing valuations and wondering whether we need to go through the general approval process or are we going to get another extension of 85-29?

MS. WEISS: One of the things I get to do as the visiting actuary is take my turn answering questions on the taxpayer hot line, and I think if I had to take a frequency tally of questions, I think this one is the winner. Yes, we are going to extend it. As usual, I have been warned never to tell anybody when, but rest assured, the extension will come out. I'd say there is a high likelihood that the extension will be a one- or two-year extension in the same form as it currently exists, similar to Notice 90-63 that extended it the first time. That is all there is to say about it because I can't promise anything on the date.

MS. KRIST: Question nine asks for some clarification about a multiple-employer plan. What is the relationship of the multiple schedules B that must be filed for such a plan, and does this mean that the assets are allocated to separate subplans within the single plan, or are the assets available as an unallocated pool?

MR. HOLLAND: This is going to be one of the provisions that will either make lots of folks happy or drive them mad. You have one plan and all the assets are available for all the participants. It just so happens that the participants work for different employers. A good example of this would be a joint venture where the employers or the partners in the joint venture maintain the plan. There are other examples such as some of the association-type plans where each employer elects to join the association, contributes to the one fund, and the participants receive benefits, sometimes counting service with all the employers that are contributing to the fund. The key thing here is all the assets are available to provide benefits to all the participants. That means there is one plan, one series 5500 form and one Schedule B.

Now the fun comes in when you have to calculate the entries on that Schedule B because you have to do as many separate calculations as there are employers, as mandated by statute. For calculation purposes, you must treat this as if the total plan is made up of several separate plans, make separate calculations, and aggregate the results from each of the "subplans" and put these summed entries on the Schedule B. You do not have an option to do one calculation. At one time, existing plans had an option to go one way or the other; they made a choice. Anything created today or anybody who did not make that election back then does not have a choice. This means each year you're going to have to divvy up the assets. If you strictly follow the requirements of the law, each year you allocate the assets as if all the employers withdrew. I know that we haven't even begun to grapple with this problem. I would suspect that until guidance is given, any reasonable interpretation of what this means is acceptable and it may have some inconsistent results. I think it is very likely the procedure will be different from simply tracking the assets from year to year saying this employer put them in and so forth. My understanding of the reason for this is to deal with the predicament of an overfunded plan where a new employer comes in and cannot make deductible contributions, and yet the older employers are not willing to share the overfunding with this new employer who can't contribute anything. This is the problem that caused the existing 413(c).

MS. KRIST: There has been a question as to whether the reconciliation account that is shown on the Schedule B should be subtracted from the actuarial value of the assets for purposes of Section 412. What is the position on this?

MR. HOLLAND: Let me take some time to explain how this comes up, and I think that will be helpful from many points of view. Where does this animal called the reconciliation account come from? It's not in a statute, it's not in a regulation, it's not even in a revenue ruling. It was an attempt to be helpful, both to practitioners and to the Service. I'm quite aware there will be those that say any additional line I have to fill out isn't helpful. However, there is a requirement in the regulations that many of us call the balancing equation: the value of benefits must equal the sum of the actuarial value of the assets adjusted by a credit balance, the unamortized balance of the amortization bases, and the value of future normal cost. This equation was written into the regulations with a caveat that the Commissioner may provide otherwise. This was probably not thought of at the time as important, but is turning out to be a very wise qualifier that was put on the equation.

I don't think it was foreseen at the time, but in the dozen or so years since that regulation was issued, we've had several changes in Section 412 of the Code that are guaranteed to make the equation fail. These changes are the differing interest rates at which certain things are calculated. It started with the Single Employer Pension Plan Amendment Act of 1986 (SEPPAA), in which funding waivers are amortized at a different rate than the valuation rate used to value liabilities. OBRA 87 made the circumstances worse by introducing more interest rates. There is one for quarterly contributions that are paid late, there is another for funding waivers, and yet another for current liability. The different interest rates produce charges to the funding standard account, yet they don't change the unamortized balance of the normal bases. We spent many years since ERISA pounding the equation of balance into our agents' heads and talking about it with enrolled actuaries; this equation had to work and was a check on whether things like gains or losses were correctly calculated and if other bases were set up properly, etc. Somewhere in everybody's system, they realized this and they used it.

These new interest rates came along and the equation didn't work anymore. There may have been grief when our agents took a look at this and said you did something wrong. We thought it would be useful to have the known explanation for a variation from balance reported on the form in a way that people can track. In addition, we found out over the years since ERISA employers have from time to time changed actuaries. Once in a while, a new actuary tries to become comfortable with what the old actuary did and has an impossible time finding out why things didn't work. The balancing equation doesn't work because often there is a valuation report, but the underlying work paper or hard data isn't there. The reconciliation account would allow the Service and other actuaries to look at a plan and determine whether the requirement to balance is satisfied.

Unfortunately, the reconciliation account took on a life of its own. The notion that it should be subtracted from the assets was never intended. The reason you do any adjusting of the assets, such as for a credit balance, has to do with double counting. You don't want the same contribution to both produce a credit balance and reduce the normal cost (for example, under an aggregate-type method). However, there are some funding methods where the unamortized balance is maintained at the valuation rate. Actuaries saw that when contributions were made, things came out of kilter and somebody said: "Ah ha. To get around this we'll adjust the assets by the reconciliation account." While it certainly did that, there isn't any justification for it from a legal point of view. There is no double counting problem present. This is a situation where the balance equation just won't work. I think we are going to recognize this and change the instructions to indicate you don't have to make this adjustment. There isn't any actuarial reason I've heard to make an asset adjustment from the point of view of counting charges and credits.

I had an interesting experience recently. It's a technical point in a way, even though the forum I was writing for was nontechnical. We had a funding waiver where we had some conditions and the company went bankrupt. We asked for the waiver to be paid off earlier than the statutory period. If you think about it, this would create a credit balance as we think of it in the funding standard account. We didn't want them to use this credit balance to meet future years' obligations so we had a minimum credit balance condition. When the company went bankrupt, they didn't contribute for one of the ensuing years and failed to meet our condition. We said our waiver blew up. Put aside the excise tax and how the court regards it. We were locked into an unexpected battle about whether this credit balance condition made any sense. So I had to write an affidavit for the bankruptcy court explaining where a credit balance came from in a way that would be understandable to a judge who knew nothing about pensions. I am told I succeeded because we weren't thrown out of court. When you have to explain some of these more technical points, it brings home that any sort of adjustments have to come out of a statute or the regulations that are written under statute; it is not because they have some nice mathematical result (or what had at one time been a pure mathematical result destroyed by subsequent law). It's an interesting lesson.

MS. KRIST: We have received a stack of interesting questions. I will read the questions, and either Jim or Joan will give the answers. If they want to give different answers, we'll also give them the opportunity to do that.

The 401(l) regulation provides for normalization or adjustments if lump sums are allowed. However, there is an exception for 417(e). The 417(e) regulation provides that the lump sum is the greater of the PBGC interest rate or the plan document assumption. Does this mean if the plan provides for 5% interest in calculating lump sums that normalization or adjustments under 401(l) are not required?

MR. HOLLAND: No. The idea of the 401(a)(4) regulation is to ensure a lump sum is not lower than the lump sum determined using the so-called 417(e) PBGC interest rate that is either the PBGC deferred rate or 120% of the PBGC deferred rate. Given this requirement, we didn't want to make you normalize merely because you had to comply with this requirement of law. When you're using other rates and you're giving the better of say 5% or this PBGC rate, you're going to have to normalize to see how your 5% lump sum translates into a permitted disparity.

MS. KRIST: If a plan terminated and the owner's benefit was cut back because of the 10-year phase-in rule, can the company recapture part of what turned out to be a reversion and give it back to the owner? Or, if you have to cut back the benefit pro rata, can you give a reversion back?

MS. WEISS: That is not exactly the way I read the question. The question I read was now that we've repealed 89-45 and attempted to provide some retroactive relief for people who have continuing plans, is there any way to get retroactive relief for a plan that is already terminated? The answer unfortunately is no. To be honest, we thought about it. We thought about how it might be done and we came to the conclusion that some of the statutory precedents just didn't allow it.

MS. KRIST: Under Section 414(a)(2), service with a predecessor employer not maintaining the plan is left up to the Secretary. Is there any guidance? What is the IRS position on whether such service must be counted for eligibility, vesting, and so forth?

MR. HOLLAND: Section 414(a) says you count service with a predecessor employer for certain purposes to the extent provided in regulations. This was in the statute along with ERISA; there have never been any regulations issued under it. One argument would be that unless there are regulations, you can't do it. I would suggest that most people credit service with a predecessor employer in many benign situations, specifically where there has been a buy-out of some sort, an acquisition or a merger. Often the seller has a plan and the buyer establishes a new plan along with the new company. The buyer takes assets and liabilities from the seller, along with the employees, and often the assets and liabilities from the seller's plan. In other cases, the buyer sets up a plan with no 414(l) transaction, but the buyer's plan has the same benefit formula and crediting, counts the service with the seller for benefit purposes, investing and everything else, and simply offsets the benefit otherwise payable by the accrued benefit that the participant has under the seller's plan. Here it's clear that the seller is a predecessor employer. I would suggest that we would allow many circumstances like that.

Among the concerns that were expressed to us in the service counting area from 401(a)(4), many concerned the predecessor employer-type transaction. Along with that is the situation where somebody leaves for a joint venture, comes back, and you count the service with the joint venture in your plan even though that joint venture is a separate employer. You let people go into the joint venture, encouraged them to go, and then credit the service when they come back. I think in many situations where there is an employment-related nexus, we probably would accept it. You can get into questions with some old Revenue Rulings hanging around about whether you have exclusive benefit problems. I don't think there are requirements that you do this unless we write regulations. Is it permissible? I think we'll allow many of these benign situations.

One thing I would point out that you should be warned of: you can carry everything to an extreme. I'm going to give you an extreme illustration. In one sense this is humorous and in another sense, for those of us involved, appalled might be a better term. One of the nonpurely actuarial issues, nonassumption, nonfunding method issues in some of our litigation involves service counting. It involved a unit credit issue but was tied up with whether the particular employee had 10 years of service for 415 purposes. The determination application submitted to the Service showed two years, the years since the entity incorporated, which was fine. At trial, the argument was made that the employee had predecessor service. It wasn't just simply some prior employer; it gets a little bit deeper than that. The service that was being claimed was as follows: it seemed the IRS employed this participant at one time here in Chicago, and during the tenure with the IRS this person supposedly had an outside tax practice for which the participant claimed he had received the requisite approval. He was claiming service with his outside employment tax practice for 415 purposes as a predecessor employer. The appalling part is, according to what this individual claimed, he also litigated his first tax court case during this period. I don't see how any of this could happen today. I know we have strict rules about outside employment and conflicts of interest. I think claiming predecessor service for any purpose was a bit extreme. I am positive this is absolutely no good in the litigation we are arguing.

I suggest, having heard one extreme that is no good, when you look at predecessor employment, it's not essential and you want to show an employment-related nexus. One general suggestion: I know many of you don't do taxability work under 402, but there is something called the same desk rule. I would think of predecessor employment in that vein.

MS. KRIST: Accountants often do not properly allocate contributions on defined-contribution (DC) plans, especially integrated plans. When will there be a standard, such as enrollment, required to administer DC plans?

MS. WEISS: That must be a plant. I have on my desk right now a proposal from the American Society of Pension Actuaries (ASPA) to set up that type of standard. I think it's something we need to think about: are contributions allocated properly, are participants' rights protected versus the obvious extra paperwork burden and the extra certification requirements? I think this is one of those areas where we have to weigh the cost against the benefits. It's certainly an item under consideration. It has been proposed and we're giving it serious concern, but I'm not sure that there is any action coming too quickly.

MR. HOLLAND: I would add it may be very likely such a change would require some legislative action. I don't think it would be easy to create a whole structure similar to the enrolled actuary structure by regulation. Stay tuned, it's not here yet. I'm sure it would be well publicized if it ever comes to pass.

MS. KRIST: Under the 401(l) regulation, if a participant enters the plan halfway through the plan year, can we use one half of the social security wage base, and if not, why?

MR. HOLLAND: There is a requirement in the regulations that if you have a short plan year, the integration level has to be prorated. The question comes up, must I do that or may I do that when someone enters the plan part way during the year? I think it's clear you don't have to prorate the integration level for someone who enters part way during the year. The question is a little bit sticky and a little bit unclear looking at the regulations on this point. If you prorate it for someone who enters, often this turns out to be the fairest thing to do, especially if it benefits low-paid employees. The regulations are very unclear so I warn you that anything I say is still up in the air. I will say I can't think of a particular reason, let's say a 401(a)(4) reason, why something like that should be prohibited. The one place I looked to see what can be done is our List of Required Modifications (LRM). I don't think we've updated them for the final regulations.

LRMs are in the master and prototype plans approved in Washington to make it easier for sponsors to know what we expect and what we will be looking for. We publish predrafted provisions, language we feel covers what has to be in the plan. We adjust this language from time to time as requirements of law and regulations change. This list of required modifications is what we expect to see in your plan, and we encourage sponsors of these plans to use our canned language, this pattern language we make available. We updated it for some of the tax reform requirements but not for the final regulations. I expect you'll see a more concrete answer at first there. Whatever appears in the master and prototype area would certainly be allowed in any other type of plan.

MS. KRIST: What is the outlook for including actual base pay as a 414(s) safe harbor?

MS. WEISS: Before I answer, I want to review. Base pay is not one of the definitions that is allowable under 414(s). If you want to use base pay, you have to take an acceptable 414(s) definition and show the included pay is more favorable to nonhighly compensated employees than to the highly compensated employees. So there are two ways I want to answer. I can't say never on anything. I don't think using base pay itself without the test is something we're seriously considering, although it is on our list of items that have been suggested. However, given the new data procedure that says you can use approximate base pay and an approximate 414(s) definition to test it, it should be easier to show that it isn't a disadvantage for lower paid people to use base pay. I think base pay has become a little more usable.

Expanding a bit on that, there is an area where we are seriously considering some changes, again nothing is promised. Right now you can't use rate of pay beyond 30 days after the person's been employed. Practitioners have said that doesn't square with what they do, and it's convenient for them to be able to use a rate of pay for more than 30 days. That is one area we are looking into. We are also looking at the definition of 414(s) compensation. Again, please make any concrete suggestions that you have for us in writing.

MS. KRIST: This is a multiple part question. The scenario is, we have a defined-benefit (DB) plan that owes a contribution at December 31, 1991. On that same date, this plan merges with an overfunded plan. The full-funding limit will be zero for 1992. First, does the plan need to make a contribution for 1991? Second, if it makes a contribution, is that contribution deductible? Third, what will the 1992 Schedule B look like?

MR. HOLLAND: The last part is easiest to answer; it will depend on whatever the calculations are for 1992, which will presumably show a full-funding limit of zero. Now, do you need to make a contribution for 1991? That is a tricky question. Let me rephrase it for my benefit. Do you have to make a contribution? No, you don't; however, if you don't, there will be a first tier, or 10% excise tax on failure to make that contribution. There will not be under these facts a 100% excise tax. The reason is, for the following year, you're fully funded and correction has occurred. Can you go ahead and make the contribution and deduct it? Well, presumably it was within the deductible limit for the 1991 year, and yes, you can go ahead and make it and deduct it under this fact. The fact that you're overfunded in a later year doesn't have anything to do with the earlier year. So the employer has some flexibility. They can put the money in and take a deduction for it under the facts as I understand them for the 1991 year. Or the employer could choose not to make the contribution, but pay 10% to the government, knowing that they're fully funded for 1992. A lot is placed on knowing that you're fully funded for 1992.

MS. KRIST: Is the IRS considering safe harbor relief on integrated unit benefit plans using fractional accruals but with service limits less than 35 years?

MR. HOLLAND: I know there have been many comments submitted, and some of them have to do with integration. Considering it likely that we'll consider everything at least once, is it likely that we'll do this? I don't know if there is any particular problem created by the 35-year requirement, which comes from a statute. So I don't think it's the highest item on our list of consideration regarding 401(a)(4).

MS. KRIST: Here is a situation and then a question. The actuary valued death benefits last year by simply loading the otherwise calculated normal cost and liability, and this year added decrements and ancillaries. Is this a change in funding method or is it a change in assumptions?

MR. HOLLAND: It's a change in method. You've changed from calculating the cost of ancillaries from specific loading to doing it just the way you would calculate using the same method you used for calculating your retirement benefits. It's a change in the way you go about it as opposed to the level of loading or anything else.

MS. KRIST: A company implemented an ERISA excess plan to provide benefits limited by the 415 phase-in and now wants to apply the new rules retroactively. Again we have two questions. First, can it do so only for benefits to be paid in the future, and second, can it do so for benefits already paid in 1992 from the excess plan? If so, would reimbursement of the employer for benefits paid be considered a prohibited transaction?

MR. HOLLAND: I like the second question because it is easier and that is up to the Department of Labor. They get the say on what a prohibited transaction is. If you pay close attention, the questions seem to concern the excess benefit plan. We at the IRS don't have any jurisdiction over excess benefit plans. Here the qualified plan can let the benefit rise up, starting this year or treat it retroactively for the current year as opposed to prior years; it could do many things. As far as what happens with the excess benefit plan, I'm not sure that is our concern from the point of view of the qualified plan. I suppose you run some risk, although it may not be great, that your excess benefit plan is no longer deemed an excess benefit plan. Given that the definition of those tends to be more within the purview of the Department of Labor, I can't offer you an opinion.

MS. KRIST: We're back to 413(c) again. The old proposed regulations on affiliated service groups said that if two employers that were not otherwise related had to be aggregated as an affiliated service group, then the minimum funding requirements for a plan covering employees of both employers must be determined under 413(c). Since that time, 413(c) has changed as described earlier in question nine. Does the answer to question nine also apply to affiliated service groups?

MR. HOLLAND: I think this is a good question. It appears you have two employers that are an affiliated service group but you have one plan. They are an affiliated service group but they are not a control group of corporations. So they're put together by 414(m), but not by 414(b) or (c). This is a very important point because the result is there is one employer for qualification purposes. There is a list in 414(m)(4) of what they're put together for; 412 isn't on that list, so they're a multiple-employer plan within the meaning of 413(c) for funding purposes. This means you have one plan for this one employer, this affiliated service group. When you do your funding calculations, you do separate calculations. The person who asked this was very astute to notice this. It's one of those funny little consequences I'm sure nobody focused on when this statutory change was made. If you have an affiliated service group, watch out. If your plan covers different entities in the group, you must do separate calculations. I haven't thought much about this since the legislative change; we've been doing other things. Is it worthwhile to note this with the instructions to Schedule B or somewhere else?

MS. KRIST: Apparently 413(c) is more of an issue than I realized – we have another question. We have a multiple-employer plan, except here plan assets are available only for the participants of each respective participating employer. All assets are in a single trust, but allocated each year to the employees. Separate normal costs are calculated each year, and there is one plan document. Does this require separate 5500s and Schedules B's for each employer?

MR. HOLLAND: As I understand the facts, the answer is yes. It requires separate 5500s and separate Schedules B's. The key to it is the assets. All the assets are not available for all the participants. There are several walls so that if employer A puts in money, that money can only be used to pay the benefits of employer A. This is different from the one-plan multiple employer situation where employer A's money can conceivably go to pay for the benefits for employer B's employees.

MS. KRIST: Revenue Procedure 85-29, change in funding method, has been extended several times in various forms. You just said this will be extended again for one or two years. Will this ever be permanently extended? Will it ever not be extended?

MR. HOLLAND: The idea of limiting the broad approval for change in funding methods is something we've been looking at and will continue to look at. We've seen many things that give us cause for concern, and we will be studying some areas. First, we might have been too presumptuous that actuaries knew what an acceptable funding method was. Most actuaries know what funding methods are acceptable. The funding methods that were put out in Revenue Procedures 81-29 and 80-50 seem to be the vast bulk of the changes. However, we have seen some methods, particularly in our small-plan audit program, that don't bear any relation to a funding method. There are some very extreme things going on. When we took a sample of 50 Schedule B's, we saw that 10 apparently changed funding method without any sort of authority. They didn't follow Revenue Procedure 85-29, they didn't have any sort of class ruling or individual approval, they just changed. This has given us some cause for concern. We are going to follow up on these concerns to see if we can get an idea of how widespread this problem is. I think even if we cut back the extension of this broad automatic approval, it is likely that you will continue to see automatic approvals that cover the most normal situations. We're talking more in terms of cutting out the fringes rather than cutting out the bulk of normal administration of plans.

MS. KRIST: I would just like to interject a word here. I did spend a couple of years doing what Joan is doing as a visiting actuary. Jim had assured me that I would see things I couldn't have dreamed up and he was right. My favorite was an actuary who was valuing a plan that provided for normal retirement at age 65 and early retirement at an earlier age, I think age 60. He calculated the accrued liability for retirement at age 65 and at age 60, added the two together and proceeded with his valuation. It's always satisfying to tell this story to a room of actuaries because people laugh. If I ever tell it to a room full of actuaries and nobody laughs, I'll worry.

This is a follow-up to an earlier question; I think it's a very good question. The earlier question had to do with overfunded and underfunded plans that merged on December 31. What would the answer have been if the two plans merged earlier in the plan year, but the merged plan when it gets to the end of the common plan year is fully funded? Are there any funding requirements?

MR. HOLLAND: I think there are. How Revenue Ruling 77-2 applies is turning out to be a controversial question. One of the plans is going to be the surviving plan, and that plan will have an amendment during the year to bring in additional assets and liabilities. The other plan has a short plan year and goes out of existence on July 1. You have to look at the funding requirements for that short plan year separately. Now which is which, it may not be clear from the context of the question.

MS. KRIST: Let's say the short year is for the overfunded plan so for its short plan year, it has no funding requirement. The survivor, when we get to the end of its plan year, is also fully funded.

MR. HOLLAND: I think the survivor may have a funding requirement because this would have the effect of an amendment during the year; you would have to apply Revenue Ruling 77-2. It talks about prorating for all costs or liabilities, that type of application. I know that has been quite an issue with many people, and we're still working on trying to resolve it in a way that makes everybody happy if there is ever such a thing to do.

MS. KRIST: Is it at least an open question?

MS. WEISS: This relates to another question about even one plan. If you adopt an amendment that prospectively reduces benefits, and the full-funding limitation would apply at the end of the year, how does that work? I think it's a related question that is still under consideration.

MS. KRIST: How are quarterly contributions to be determined for a short plan year?

MR. HOLLAND: I will offer a couple of suggestions. One that I think makes the most sense is just to see when the next normal quarterly contribution date is and pick up from there, and then somehow transition off it. That gets the money in timely. Other people have proposed prorating the annual requirements and then somehow taking that prorata amount and putting it in quarterly throughout the short year. Instead of one payment, you'll have a series of smaller payments. I guess I can't say that is wrong. This is an interpretation of the Code and in the meantime, until we publish something, you do have the right to make a reasonable interpretation there.

MS. KRIST: Under Code section 412, in the part where you remove the right to hold bonds at book, there is a possible exemption mentioned for a dedicated bond portfolio. Has this exemption been activated yet? If not, will it ever be?

MR. HOLLAND: The ability to value dedicated bond portfolio at amortized value as opposed to market value can only be done under regulations. We haven't issued regulations to date allowing that. I would guess that knowing our agenda and knowing we need to do (401)(a)(4), we'll get around to looking at that question a little bit down the line, even in the funding area, so I won't predict a date. There doesn't seem to be a particular need for it at this point in time. I think you do need the regulations for that.

MS. KRIST: This is a question about the difference in the full-funding limit in the 412 and 404 calculations. The 404 full-funding limit is zero, but the 412 full-funding limit is greater than zero because of the existence of a credit balance. First, must the credit balance be reduced, and second, is it fair to disallow the plan sponsor to recognize the credit balance while also forbidding deductible contributions?

MR. HOLLAND: Those are two separate situations. In the situation where you're fully funded for 404, you have a big credit balance and you're not fully funded for 412, your credit balance does get reduced under those narrow circumstances. Think of how this might occur. I set up a plan with a 10-year base. I pay it and deduct it over 10 years. At the end of that 10 years, my full-funding limit is my normal cost for year 11 assuming assumptions are realized, there are no other amendments, etc. . . . Yet there is a big credit balance and an existing 30-year base that I've only amortized 10 out of 30 years for 412. Of course, we expect that credit balance to go down, and you may be just a little bit overfunded so your full-funding limit is your normal cost, maybe even a little bit less, so you put in something. For 412 purposes though, your credit balance sort of gets written down over time unless your plan gets way overfunded.

Part of the reason for this goes to the second part of the question. This money is there for 412 purposes because somebody paid contributions into the plan at a rate faster than the minimum required. That is what causes a credit balance. The total credits to date exceed the total charges to date. The fairness here is, let's suppose something happened so that with or without this credit balance, the plan would be fully funded, say an absolutely huge gain. It wouldn't be fair to the employer who made this advance contribution and would have had no contribution required for the current year had this money not been put in to have that credit balance applied when they would have been fully funded anyway. So that is why, in the proposed regulations, we said that for 412, you subtract the credit balance from the assets for full funding. The idea is to preserve the credit balance. The employer contributed faster than required and would not have had to contribute in the current year because of full funding, and yet we don't want to see that credit balance wiped out. Next year, the stock market will go back the other way; maybe it will have a big loss or something else happens. We want the employer to have the ability to use the credit balance that was built up by an advance contribution so we preserve it. This is related to the first part where they were fully funded for 404 but you need to think through it. You have differing policy goals and differing consequences in the two areas. I hope that takes care of the question.

MS. KRIST: If I use the special deduction option under Revenue Procedure 92-42, the increase in maximum deductible contribution, does my minimum contribution under 412 change? Joan, can you remind me what the special deduction option under Revenue Procedure 92-42 is?

MS. WEISS: Jim talked about this earlier. The special deduction option has to do with the employer who has been using the phase-in, and decides to get rid it retroactively. He has a one-time option in the year he does it to do what we've been calling the multiple bites of the apple – to take a multiple-year amortization for the maximum deductible contribution. If the employer decides to do this, his limit adjustment changes in ways that are laid out in the revenue procedure. The question, and this is one that we've had on the phone many times, is what happens to my minimum required contribution if I decide to do this? The answer is nothing. You treat the revocation of the phase-in as a plan amendment, and you amortize that over the normal 30 years for a plan amendment. So, in effect, under 412, you have a regular plan amendment. It's only under 404 that you get some increased deductions if you want to take them in the initial year.

MS. KRIST: With the repeal of the 10-year phase-in, if a plan, presumably with the blessing of the Department of Labor (DOL), reimburses the plan sponsor for the benefits paid under the excess plan, can this deemed second payment to the employee be rolled into an IRA, and what is the payment date for 60-day purposes? Do you want to restate this so I can understand it?

MR. HOLLAND: I think I keep some people out of trouble here. If you go back and check, I think the prior question on the excess plan has to do with what the excess plan did. Here we have a suggestion where somehow the qualified plan gives the employer money from the qualified plan to reimburse the employer for what was paid out of the excess plan. I think you have problems with that. The question presumed that was with DOL blessing. You have more than a DOL question; you have an IRS question. You have an exclusive benefit requirement under the Internal Revenue Code, an exclusive purpose requirement under the Title I requirements. You have some real questions when the qualified plan tries to reimburse the employer for whatever they did in an excess plan. I would suggest it's not a good avenue to go. It may be that the employee gets benefited twice, or you choose to go ahead and keep 89-45 for this amendment, but you don't want to pay money from a qualified plan to the employer in these circumstances. You also have a question from the IRS point of view.

What wasn't apparent to me in the question is from where does the employee get the money. I will presume what is meant is that there was some sort of distribution to the employee, say a lump sum, and now the benefit goes up because you apply 89-45 to an earlier amendment. You choose to apply it as revoking the limitation on that earlier amendment and you pay them out a second time. There is an interesting question of whether that can be rolled over. I know of many cases where an employee received two lump sums (they received one lump sum in one taxable year and an additional piece because of an erroneous calculation in a later taxable year). We have ruled it cannot be rolled over. I think situations of this sort are not clear cut. I know that the equities lie on the side of allowing the second piece to be rolled over because they would have done it the first time. I think that some of this will have to be addressed in the larger picture where we have some of these second distributions. This is not the only area where this type of equity argument can be made. I don't have a ready-made answer for you; I think it's something we'll be looking at more over time.

MS. KRIST: There are a couple of questions about 401(h) accounts. How do you report the assets for 401(h) funding, which is the retiree medical subaccount in a pension plan on Form 5500? The Schedule A from the carrier calls it a pension plan, but it isn't linked to any particular plan and it doesn't have its own plan number. Do you file a separate 5500? Do you include the assets in items 35 and 36 with a pension plan? Do you set up separate accounts for a highly compensated employee, and do you have to have a triggering event to start paying out?

MR. HOLLAND: First, a 401(h) account is a special medical benefits account provided under a qualified pension plan. It's a part of the plan that is walled off from the rest of the plan to provide medical benefits to retirees. So there is no separate Form 5500. You still have one plan, just with a wall between part of the assets. I am not sure of the answer to the specific question about the line items. It makes sense to report the assets there, but show that they are part of a 401(h) account. Whoever asked it, please come up and leave me their card and we can get back with you. Or I can give you somebody to contact in our operations division who should know the answer to that. They write the instructions for these forms. It's a good and valid question. I just never thought about it and never looked into it.

Regarding the question about separate accounts for highly compensated, key employees, there is a class of employees that is not the same as highly compensated. If the key employees are 5% owners, you are required to have separate accounts for each of the individuals in that class. What's more, the amounts that go into these accounts are counted as annual additions for 415 purposes. All the other employees can be in one big account. So key employees, okay. There has been talk of making it 5% owners but right now, it's key employees. A key employee has to be an officer or an owner. Salary alone will not make you a key employee. It keys off at the top-heavy definition.

MS. KRIST: Here is another 401(h) question. An existing well-funded DB plan covers both active and retired members, and the employer wishes to establish a 401(h) trust to pay retiree accident and health benefits. May the plan be split into two plans, with one providing pension benefits to retirees only, and the other to active members only so that only under the retiree plan a 401(h) trust can be created thus avoiding any vesting cost determination under the now active life-only plan?

MR. HOLLAND: This is one where whoever asked it should think about it a little bit more. Not from the point of view of whether or not we can do this, but whether it achieves the goal you desire. Yes, you can split a pension plan into two plans, no problem. It's one for retirees, one for actives. Keep them both going. Under 414(l), if there are any surplus assets over and above that for a termination liability, you have to allocate them proportionately between the two plans. So I can't put all my surplus with the actives, nor can I put it with the retirees; I have to share the surplus. So if it's an overfunded plan, they might still be overfunded afterwards especially if it's the 150% of current liability limit that makes them overfunded. Given that, I will note that you can't put money into a 401(h) account if the plan is fully funded because of the limitation that the 401(h) account should be incidental. The law was changed to override our analysis in an earlier GCM so that if you have an overfunded DB plan, you cannot establish a 401(h) account. You can establish it, but you can't fund it so there is no money in it. When you consider these things, I wonder whether this scenario of splitting the plans achieves the goal of the person who asked the question. I think the regulatory requirements may lessen the impact of having something just for the retirees only. Note that the question did not say what was meant by well funded.

MS. KRIST: For a real change of pace, here is a question about a qualified domestic relation order (QDRO). It's not an unusual circumstance where a QDRO awards a participant's retirement plan balance to a divorced former spouse as an alternate payee. What is the IRS position regarding an immediate distribution to the alternate payee? The subparts are on whether it's a DC pension, profit-sharing plan, a 401(k) or 457 plan, or a 403(b) Tax Sheltered Annuity (TSA). Also, is there a 10% excise tax presumably because this would be an early distribution?

MR. HOLLAND: It sounds like it. This is another one off the top of my head. It seems that this would have come up many times.

MS. KRIST: The Form 5500 requires a sponsor to report the number of participants who terminated and were not fully vested if a break in service hasn't occurred. The writer of the question says, this requires at least five years of prior data be maintained for participants even though the plan doesn't maintain a liability for such participants. The questions are, what purpose does this serve, and does the IRS have any suggestions for plan sponsors who don't have such data available? If the plan allows a participant to buy back the forfeited benefits upon rehire, does that buy-back provision effect whether you want to count these people or not?

MR. HOLLAND: Well, the problem I have with this question is the suggestion that the plan doesn't have a liability. Let me see if I fully understand the facts. Participants terminate and were not fully vested. They may be partially vested or they may not have been vested at all, but they have not had a break-in-service so there has been no forfeiture of benefits under the break-in-service rules. I don't believe there is mention here of a cash-out occurring. What happens if the plan terminates? I think you have to pay them. Let me put it another way. I can point to one court decision that said you had to pay them. To say that the plan has no liability may be a quick and dirty rationalization of what you think is happening, but I wonder if anybody has examined this.

Let me take a moment and talk about something. I know the lawyers are aware of this but maybe you're not. This was a case that eventually went to the Circuit Court of Appeals, I think it was the First Circuit, called the *Crystal Coin Shop* case. Here are the facts in *Crystal Coin*. It was a defined-contribution plan. A nonvested participant who was zero percent vested terminated employment one month before the plan terminated and was not paid any benefits on the termination of plan or anything else and sued for benefits. The court found that the person became vested upon termination. The rationale of the court was there was no break in service under the break in service rules that would allow a forfeiture of the individual's benefit. Even though there was a cash-out provision in the plan, the provision called for notice to employees. The provision was not operative because the things that were supposed to have been done for a cash out were not done. Given the only two ways to get a forfeiture were a break in service or a cash out, this person had not forfeited their benefit and became fully vested on plan termination a month later and was to get a benefit. I know the IRS has no quarrel with this court decision. It seems that the legal rationale applied in this case would be applicable in this question.

When someone has terminated employment, if they haven't had a break in service, you have to look at where their forfeiture is. Until that forfeiture of benefits occurs, you have a liability, so you need to review the question in that light. Why is this requirement there? Is it to consider these terminated vested? Because they are still terminated participants, they haven't forfeited anything. You can get into issues if the plan does terminate before they've lost their benefit of whether they should become vested. This is not a trivial problem. It's something we've alluded to. Many people come up and ask us who are affected employees on a plan termination? In one sense, the courts have already answered that in the *Crystal Coin Shop* case. The solution there was a lot easier. They could have followed the cash-out provisions. In other situations, there may not be such a clear path.

MS. KRIST: Can you talk a little about whether a zero cash-out provision would solve some of these problems?

MR. HOLLAND: It seems to me a zero cash-out provision could, but you'd need to follow through and treat it the same way. In the same sense, you may have to provide for what happens if the person does return and buys back. If you have a zero cash out, you may have a deemed automatic buy back as well.

MS. KRIST: So I not only have to give him a notice that I've cashed him out of nothing but when he comes back, require him to give me nothing to get back his credit?

MR. HOLLAND: It's probably what happens. I didn't make this case up; you could go find it for yourself.

MS. KRIST: Here is a follow-up question for a 401(h) account; it's an interesting possibility. The tax deduction for a contribution to a 401(h) account is 1/3 of the contribution for the normal cost. Suppose I set up a 401(h) account for some but not all of the participants in a pension plan. Is my allowable deduction based upon the entire normal cost for the plan or simply for those participants who are covered by the 401(h)?

MR. HOLLAND: This idea of 1/3 the normal cost goes to the incidental requirement, the so-called 25% rule being 3/3 going to the normal cost and 1/3 to the 401(h). That is a total of 4/3 with 25% of the total monies going to 401(h). Keep in mind, I don't think we're concerned that only certain participants would be covered by the 401(h). It's still going to be incidental based on the entire plan, and incidental is a plan question as opposed to just a certain participants question so I think it could be 1/3 of the total normal cost. There are issues of discrimination; what group is covered. Let's assume this is not a problem. Remember again that if the plan is fully funded, even though you can calculate a normal cost, the maximum is zero. It's not a question of normal cost anymore if you're fully funded.

MS. KRIST: If a company terminates a defined-benefit plan and makes a contribution that isn't currently deductible in order to provide the benefits, is this required contribution subject to the excise tax for nondeductible contributions?

MR. HOLLAND: There is a question of a required contribution. I presume the person who asked the question meant required for purposes of Title IV. There is nothing in the Internal Revenue Code that requires an employer to fully fund the plan in order to terminate it. We've had underfunded plans terminating for years. However, looking at it from the Title IV perspective, you have an employer who wishes to put in enough money to fund the benefits so that they can get a standard termination. You don't get a full deduction for it under the Internal Revenue Code and do you have a 4972 tax. We're trying to get to the point where we can say that for years after the year of contribution, you do not have any additional 4972 tax. You might have it once that final year but in later years where you get to deduct this money over time, you don't. There is a project under way. In fact, Joan has done an extraordinary amount of work on it but we still have work to do. We're trying to lessen the impact of the excise tax on this predicament. I don't think that the policy or legislative purpose behind the creation of the excise tax had this in mind. We're trying to see if we can get there legally.

MS. KRIST: But at the moment, the answer is no, you can't?

MR. HOLLAND: The answer is it's not clear. I think the bottom line is that any way we cut it, there will at least be a one time 10% tax.

MS. KRIST: Back to 401(a)(4) again or the associated parts of it. If a pension plan uses a nonsafe harbor definition of pension earnings such as base pay, a test is required for nondiscrimination. In the test, the pension earnings can be expressed as a percentage of W-2 earnings. The test would be done for the highly compensated group and the nonhighly compensated, and I think the question is, is the following an acceptable test? If the ratio for the highly compensated was 98 but it's 95 for the nonhighly compensated, would that be considered all right? If you're covering 98% of the compensation for the highly compensated and 95 for the nonhighly compensated. . .

MR. HOLLAND: We'll get back to that in a minute.

MS. KRIST: We'll be returning to this. Multiple-employer plans again. Are any special adjustments needed to the Schedule B if one or more companies are over-funded and the other companies aren't?

MR. HOLLAND: The company that is overfunded doesn't have to make a contribution. The companies that are underfunded who are not hitting full funding do, even though the one may be overfunded to the extent that it dwarfs the others. You have the same rule for 412 as you do for 404 so even though the total plan may be way overfunded, all due to one employer, everybody else has to make a contribution. You may have to worry about that a little bit in putting these components together. Keep in mind for the overfunded one, the full-funding limit may simply be zero, and the full-funding credit may be a fixed amount just to take care of the charges with respect to that employer. So mathematically when you add them up, I don't think you have any imbalance. Whatever the full-funding credit is for this overfunded employer will simply take care of the charges for that employer so that comes out to be zero, and you have everybody else's funding requirements here so when you add them up, it shows up that way. It will mean that the amortization bases for that one employer may have to go and for everybody else, you keep them. That is why I urge that you keep good papers, maybe attachments to the Schedule B, to show how you got there. This will not be obvious from the face of the Schedule B.

MS. WEISS: I'm going to get back to the question that we deferred a few minutes ago. The question is we're testing whether a definition of compensation is nondiscriminatory under the regulations under 414(s), and the standard that I think the questioner was looking at is as follows and I'm going to read it: "An alternative definition of compensation under this paragraph is nondiscriminatory if the average percentage of total compensation included for highly compensated employees as a group does not exceed, by more than a de minimis amount, the average percentage of total compensation included under the alternative definition for the employer's nonhighly compensated employees as a group." I'm therefore interpreting the question to mean if the highly compensated have a 98 and the nonhighly compensated have a 95, is that de minimis? My gut feeling is no, it's not, but I think this is a distinction each employer has to make for himself. It also may be an overtime thing, and you needn't test every year. A priori, I don't think one can say that the difference between 95 and 98 is always de minimis. What do you think?

MR. HOLLAND: I think if you designed it so it's always 90% of one and 95% of the other, you might have a problem. If it happens to be just this year, you may not.

It seems that the 413(c) scenario may still be confusing some people. Let me take the time to go back over it. As one example, somebody had two organizations that were affiliated but were not a control group. Here it was a couple of hospitals, a good example where you have some common ownership at the 50% level, and this may be an affiliated service group but there is no control group. For 412 and 404 purposes, if it's not a control group of corporations, these are separate employers, but there is one plan. All the assets can be used for employees of either hospital. You do one Schedule B. As you go into your Schedule B to do the calculations, let's assume that things are a little bit simpler, you're using unit credit. You get your normal cost, your accrued liability, your assets separately for all the employees in this hospital, for all the employees in that hospital. Find out what they are separately, what their deductible amounts and minimum funding requirements are. Then when you got the answer for each, you combine them and report the combined amounts in the Schedule B because it's just going to be one Schedule B. It's one plan, just two employers that don't constitute a control group.

If you have to deal with this on a practical basis, this is one of those things where you need a chart or a matrix to see whether you have one employer or separate employers, one plan or separate plans, and then whether its filing requirements are more than one or just calculation requirements. Here it is calculation requirements. This creeps up when you don't expect it. Two things have some sort of an affiliation agreement. I've seen it many times, because hospitals have had a lot of trouble over the years. I know I've received many waiver requests from hospitals around the country, and one solution to their problems, their cut back in reimbursements, is to merge in some respect. They have an affiliation agreement with another hospital in the area where they trade off the strengths and the weaknesses of each so they can somewhat work together. But the ownership is such that they're still separate entities and they might have one plan, so you're going to have a 413(c) situation. I think there are other practical examples that may arise. Be very, very careful of that. I hope this clarifies the situation. Again in that type of situation, use one Schedule B but very separate calculations. That is why I again urge you to have separate work papers or attachments to show how you got there.

MS. KRIST: If you have a waiver and you're amortizing it, is the amortization amount locked in at the rate in effect initially or do you reamortize it at the new rate each year?

MR. HOLLAND: You reamortize it. I'm presuming it's a new waiver, not one issued before the Single Employer Pension Plan Amendment Act of 1986 (SEPPAA). It's like a variable rate mortgage. Each year you look at the interest rate and you redo it. Remember it's a different rate than when you pay late quarterly contributions.

MS. KRIST: We all know that you pay interest on late quarterly contributions. How long do you pay interest in one case if you're eventually granted a waiver of that quarterly, and the other case, if you never make the quarterly?

MR. HOLLAND: It seems that what happens with the second one is you have the quarterly contribution, the late charge for the year, the interest rate for that year at 175% of the federal mid-term rate. Then the next year you have a funding deficiency, and you start off additional quarterly contribution requirements that get interest at 175% of the federal mid-term rate applicable for that plan year, and it just keeps going like that.

MS. KRIST: So each quarterly dies at the end of its relevant year and you start over?

MR. HOLLAND: Some 8-1/2 months later, you may have interest on interest and you may have overlapping periods as well in there because the interest gets added on, and then you start off in the beginning of the year again so you may be charging interest twice for the same 8-1/2-month period. Now when you get a waiver, it's going to cut off there, and then you set up a waiver base for the waived amount and then the waiver amortization takes over.

MS. KRIST: This is a question about 401(a)(9), age 70-1/2-required distribution. Once annuity payments have started under 401(a)(9), is 401(a)(9) violated by the payment on subsequent retirement of a lump sum for the remaining balance of the participant's account?

MR. HOLLAND: I think there are several issues tied up in this. You started payments under 401(a)(9), and then you pay out a lump sum. One question is, do you have another triggering event, can you roll over this money? Second question is, can you even do that, does that meet the minimum distribution requirements because you supposedly start off in the form of an annuity? Now it may be that you're paying them because you have to. I have to look back in our rulings to see whether that second distribution would qualify as a lump-sum distribution once you started annuity payments. I recall that our ruling position has generally been that you don't unless there is some event like a plan termination. Note that there is nothing to prevent a plan from providing that if you hit age 70-1/2, you pay out the money in the form of a lump sum. I don't think this problem is within the service distribution requirement by this time perhaps. Pay them out, let the participant roll everything over except for the minimum for that year and then it's the participant's problem.

MS. KRIST: Are early retirement windows a benefit, right and feature; are they tested as such; are they tested as amounts or are they tested as both?

MS. WEISS: This is my opinion, after one reading of the regulations: unfortunately for people doing the testing, they're probably tested as both. In fact, I can think of three ways in which early retirement windows may need to be tested. One of them is in Section -5 of the regulations as an amendment because Section -5 goes to the timing. Is the timing done in such a way as to unduly advantage the highly compensated? The second is under Section -3, which is an amount. Looking at the window, one way of testing this is to restructure the people eligible for the window and the people not eligible for the window, and is each of these two a valid 410(b) group? The third way is as a benefit, right and feature; you've got to look at both prospective eligibility and then actual eligibility. What are the two words for that? Current availability and effective availability are the terms used in the regulations.

MS. KRIST: Under the DB plan the top 25 paid early termination restrictions are escrow arrangements currently allowable for lump sums as it used to be under the old rules?

MR. HOLLAND: Yes, and I think we're somewhere in the process of publishing that position so people have something they can point to and rely upon for using the same old escrow rate. Joan will talk about this at the Recent Rulings and Regulations session a little bit more.

MS. KRIST: Can you say a little more about specific areas in which further guidance under 401(a)(4) may be forthcoming?

MS. WEISS: I see three general areas where we're working toward further guidance. I'm going to cover in more detail some of the things I talked about before. The first of these is the general test. We realize one major problem with the general test is what I might call outliers. That is we have a formula that is generally nondiscriminatory but there is some quirk in the data. Let's say you have a 30 and out and you have one employee hired at 15 in the mail room. Now he's 45, he's just crept over to highly compensated, and you find he has the most valuable benefit in the plan when you test. This type of outlier, I'm not saying how other people might rule it, is one for which I have some sympathy. We're looking at what might be done to something like the general test; what kind of relief is necessary for formulas that are generally nondiscriminatory but get caught by outliers? We're also looking at other modifications to the general test in areas where again it's been suggested to us that the benefit is nondiscriminatory but somehow the test fails.

A second area we're looking at is service crediting. Right now the regulations allow you to impute up to six months of service. The practitioners we've talked to have said there are valid reasons why you may need to impute more than six months for various layoffs or leaves of absence. We're looking at possibly extending the six months.

We also understand there are circumstances where other service is traditionally granted beyond the boundaries of what might be the traditional employer or the traditional control group. Obvious situations are mergers and acquisitions, joint ventures that are 50/50 so that the joint venture is in neither control group but the two parent companies may want to grant service to the people in their plan or at least keep these people whole. We've also been told about the multiple-employer plans that we've been discussing. Another possibility is industry associations, Blue Cross/Blue Shield comes to mind, with reciprocal service crediting. We're looking at whether there is a valid business reason for crediting the service where it generally applies to highly compensated and nonhighly compensated. We're trying to set up some ways of looking at this to remain nondiscriminatory but recognize what real business practices in the real world are.

A third area might be pay increases. When someone transfers to the joint venture, they may keep their benefit in the old plan and the old employer may want to keep this person whole by giving him pay increases. We need to look at these situations and see which ones are reasonable to consider and which ones aren't. I guess if I had to characterize where we're going, I'd say our focus is on reasonable rules, rules that recognize what employers are doing in the workplace, while keeping up the nondiscrimination standards. We're looking at these rules both in terms of the safe harbors and in the general test, and we are interested in reducing the taxpayer burden.

MR. HOLLAND: If we receive comments, examples and suggestions that show other ways to soften the impact of these regulations from a compliance point of view, we will consider them. We've received comments about permitted disparity. We've received comments on what may be considered simply technical points where the regulations on their face force you to go through a more circuitous route to demonstrate compliance when it would be nice if you could go there directly. You're going to be testing it even in situations where there will be no substitute change in what you have to do to show compliance. The way you get to setting up the test is through a roundabout route that sometimes bothers people. It's fair to say we will consider anything else that comes to mind. That doesn't mean you will necessarily see changes, but we are very much interested in easing the burden of compliance.

Again I urge everybody to put their comments in writing. On a practical basis, I might add that just to say you don't like something because it doesn't do something you want to do for your client is not necessarily the best way. What does it do that you think is inappropriate. Give us the example that shows what would be good, at least to you. Of course, we could always disagree. What is obviously good fails under the requirement that you're complaining about? That adds a certain power to your argument, and was suggested for a way to demonstrate it. Oftentimes something written to deal with one set of circumstances inadvertently picks up another situation that nobody's ever heard about, and you don't know that until the person who was inadvertently hurt complains. So we still have time and we'll be looking forward to the thoughts you have.

MS. KRIST: The regulations result in problems for plans that use an interest rate to determine lump-sum benefits outside the 7.5–8.5% range unless required to do so to comply with the PBGC rules. Can a plan that uses a straight PBGC interest rate instead of 120% for amounts over $25,000 meet the PBGC exemption?

MS. WEISS: I think the strict answer to the question is no. The exemption only applies right now for people using 120% of the rate, for distributions over $25,000. However, this is one issue that has been brought up to us. It is on our agenda of things to consider, but I wouldn't take any action based on that. We're seriously reconsidering it and I'm not sure where we're going to come out.

MS. KRIST: This is a five-part question. Can the following be charged against the pension trust assets: Financial Accounting Standard *FAS 87* expenses? Presumably this is the actuarial fee to calculate them.

MR. HOLLAND: This seems to be a question for the Department of Labor. Why don't you read the list and then I'll throw some thoughts out and urge people to check with the Labor Department?

MS. KRIST: The whole list here is *FAS 87* expense, *FAS 88* expenses, costing plan changes, benefit staff salary based on percentage of time spent on pensions, and an asset/liability study.

MR. HOLLAND: I think what concerns me about this is whether these expenses are expenses of the plan or expenses of the employer, to see what the employer would want to do or meet an obligation of the employer. There is a question about the exclusive benefit rule here, too. The question is, is this for the benefit of the employer? It doesn't do anything for payment of benefits to the employees. Does this violate those exclusive purpose, exclusive benefit rules? It seems to me that it very well might. Again though, this is the Department of Labor's call; it should be directed to them. I think that there is a very good possibility when you consider who benefits. So before you do it, you might want to run it by the Department of Labor.