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UNITED STATES PENSION TOPICS – LATE-BREAKING DEVELOPMENTS

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Recorder: ARNOLD F. SHAPIRO

- This session will review current issues and recently published or expected regulations.

MR. ARNOLD F. SHAPIRO: I am the moderator for this session. I am at Penn State University, home of the Nittany Lions football team. We do not win all the games, but we win lots of them. With me is Harry J. Conaway. Harry is a principal of William M. Mercer Incorporated and heads their recently formed Washington resource group. Harry is the person that people at Mercer go to when they want legal opinions and insights, so he is clearly a person worth listening to.

Harry will talk about the big picture. And then I will be talking about the special topic of small plan audits.

MR. HARRY J. CONAWAY: I am going to do the legislative topics and then turn it over to Arnold to do small plan audits. Once he finishes, I will take up the topic of recent regulations.

When I was thinking about how to organize current legislative topics, I arrived at the conclusion that perhaps the best way to do it is to organize legislation into a series of questions. First, will there be deficit reduction legislation this year? Second, will there be tax legislation this year? Will there be pension simplification legislation this year? Will there be labor-oriented pension simplification or employee benefit simplification this year? And will there be PBGC legislation, family leave legislation, and national health reform? That seemed to me to be a sensible way to organize the topics.

You may wonder why I would start with deficit reduction legislation? Well, the main reason is that over the last six or seven years the Omnibus Budget Reconciliation Acts have been the major legislative vehicle to which various employee benefit provisions have been attached. Budget reconciliation and deficit reduction legislation happens to be, and happens to have been in the past, must-pass legislation. The Congress must get behind it or else face sequestration under the Gramm-Rudman-Hollings provisions.

And so what happened is that the budget reconciliation legislation was like a magnet, attracting all sorts of other, frankly, nongermane type legislative changes, many of which affected employee benefits. So the question now is, Will there be deficit reduction legislation in 1991-92? And surprisingly the answer is probably no. The reason is because as part of the 1990 Omnibus Budget Reconciliation Act, OBRA 1990, Congress also adopted the Budget Enforcement Act of 1990. And it's in

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that Budget Enforcement Act where Congress essentially bought itself at least a two-year, and perhaps a five-year, holiday from serious deficit reduction actions.

Let me quickly describe why. Under the Gramm-Rudman-Hollings approach, there was a fixed dollar amount of federal deficit that the federal government could achieve. It could not have a deficit in excess of the fixed dollar amount. Let us say that it's $100 billion. Then Medicare expenditures might be greater than expected. Tax collections might be lower than expected. In the latter case, it's because of the recession. Perhaps Medicare expenditures would go because of the recession as well. Each of these might make worse the projected deficit. Let us say the combined effect was a $30 billion additional shortfall in the federal budget. A $130 billion deficit. Under Gramm-Rudman-Hollings, Congress then had to take action -- increase taxes, close loopholes, cut back the expenditures -- closing that $30 billion shortfall. Coming back within the $100 billion deficit limit that we are using in this example.

Under the Budget Enforcement Act, however, things are both much more complicated and much less meaningful, or much less strict. It has been compared to Section 89, in the fact that there are many, many more complicated changes to much, much less effect. There are really now three parts to the budget procedure that Congress has to satisfy for 1991 and 1992.

The first part is that there are spending limits on discretionary programs, like energy, like the environment, like education. Those items generally do not affect employee benefits. Then there is a pay/go (pay-as-you-go) requirement. A revenue neutrality requirement, that applies to legislated changes that increase mandatory programs such as Medicare or Social Security, or decrease tax revenues, such as the provision of Favorable Tax Treatment to Employee Benefits, and the extension of expiring tax provisions, such as educational assistance or group term legal services.

So this pay/go requirement must be satisfied with respect to each piece of legislation that has the effect of worsening the federal deficit, either by increasing expenditures of mandatory programs or decreasing tax collections.

Last, there are the overall limits that apply to the aggregate program, not only the discretionary programs, but also the mandatory programs. The overall limit is sort of analogous to the Gramm-Rudman limit. Let us stick with the $100 billion overall deficit limit. What is different under the Budget Enforcement Act? What is different is that Congress now adjusts the $100 billion limit on account of what are called economic and technical changes.

Now what are economical and technical changes? Those are really changes in experience. If Medicare expenditures are going to be more than expected, let us say $20 billion more than expected, the $100 billion deficit limit goes to $120 billion. Tax collections are down because of the recession. Let us say they are down by $15 billion. What happens? Under Gramm-Rudman-Hollings, Congress would have to find ways to make up that $15 billion shortfall. Under the new Budget Enforcement Act you just increase the deficit limit. In our example, from $120 billion now, to $135 billion. So in this way for 1990 and 1992, deficit reduction in terms of the overall federal government deficit operates on the basis of projections. It does not operate on the basis of the actual dollars coming into the government through revenue, or the actual dollars going out through expenditures, and mandatory programs, or in the discretionary programs.

What is the net effect of this? No political need to do serious deficit reduction legislation this year or next year. On the one hand, it may make you cynical to hear this, Congress has in effect relieved itself of the need to take serious action. On the other hand, you may not believe that the deficit is a major problem. You may believe that what comes along with these Omnibus Budget Reconciliation Acts, the various other provisions, are unjustified. You may view this as a good change.

Regardless of how you evaluate it, however, for 1991 and 1992, and it is very unlikely there will be serious deficit reduction legislation.

That does not mean, however, that there will not be budget bills or appropriations bills. Congress still has to appropriate dollars for the agencies to spend. It still has to authorize monies for various federal programs, such as Medicare, Medicaid, and Social Security. And so there will be those pieces of legislation and there is likely to be tinkering in various areas of Medicare and Medicaid. But these are not serious changes, not broad changes, that are likely to significantly affect employer-maintained plans.

Second question. Will there be tax legislation? Notwithstanding the absence of deficit reduction legislation, will there be tax legislation? Will there be a tax bill this year? Mr. Rostenkowski of the Ways and means Committee, and Assistant Secretary Gideon of the Tax Policy Office and Treasury have each spoken to this issue recently. The current conventional wisdom is that it is not likely that there will be a tax bill this year. Now, why would Congress have a tax bill this year? It seems that the primary motivation at this point for a tax bill would be to extend the various expiring tax provisions that are currently in the law and are said to expire at the end of this year.

There are three employee benefits related provisions in this package. I think there are nine expiring provisions. One is the Section 127, educational systems program exclusion. Second is the Section 120, group legal services exclusion. Lastly there is the 25% deduction of health premiums for the self-employed individual, partners, and sole proprietors. Each of these is due to expire at the end of this year. If Rostenkowski and Gideon are correct, they will not be extended before the end of this year. And employers, partnerships, and sole proprietors will again be put in the position of having to take a tax position, guessing whether Congress ultimately will extend those provisions some time next year. So employers once again will be put in that difficulty.

Why is it likely that there will not be a tax bill this year? First off, each of these extenders would cost revenue. And under the pay/go requirement, legislative things that cost revenue have to have offsetting revenue enhancements. And at this point, very few congressmen seem willing to endorse revenue increases, either through increase taxes, closing loopholes, or cutbacks in Medicare and Medicaid.

Second, many of the Democrats are reticent, Mr. Rostenkowski in particular, to send a tax bill from the House to the Senate, which then on the Senate side would be open to amendment. Why are they reticent? The Democrats, as you probably know, say they favor tax changes that would enhance the position of the middle class. This is their casting of the issue. The Republicans favor the capital gains changes, which the Democrats say would primarily favor the rich. And so we get into one of these debates; as you know from Civics 101 in high school, tax bills have to originate on the House side. So what is happening is Rostenkowski and the Ways and Means Committee are reticent about approving tax legislation which would then go to the Senate side, and be open to all sorts of amendments, including possibly a capital gains change.

So the extenders that I mentioned before are tied up in this larger debate that is going on between Democrats and Republicans. And the larger debate is likely to control whether legislation is passed in these more targeted areas.

Pension simplification. This is an area that again could get tied up in this larger debate, because much of pension simplification is, of course, tax legislation. And so, while there has been some progress on the pension simplification front, it is not likely that there will be serious action taken this year. However, as I said, there has been a lot of activity in this area. The administration has made its power proposal. Rostenkowski has a bill. Congressman Chandler has a bill. Chairman Bentsen of the Finance Committee and Senator Pryor of the Finance Committee have a proposed pension simplification bill in. Then Ways and Means Committee member Kennelly has a bill in, which is of interest to some. And then Mr. Gibbons of the Ways and Means Committee has a bill in, which is of interest to very few people.

The major areas of simplification that are being focused on in the debate in Congress at present are enhanced salary reduction, simplified employer pensions for small businesses, that is, employers with fewer than 100 employees, essentially enhancing the ability and the attractiveness of salary reduction plans for these employers, and 401(k) type arrangements for these small businesses. There are proposals to simplify the testing of 401(k) plans for all employers. The Chandler bill and the Bentsen and Pryor bill would provide safe harbor alternatives to the current law Average Deferred Percentage (ADP) and Average Contribution Percentage (ACP) tests. Essentially there would be a safe harbor matching contribution approach and then a safe harbor nonelective contribution approach. These two proposals seem to be favored by the private sector. The Rostenkowski bill, however, which is the more likely bill to move once action becomes likely, takes an entirely different approach. It throws out the existing ADP and ACP tests and does not endorse safe harbor approaches such as the other bills proposed. What the Rostenkowski bill would do is take the ADP for the nonhighly paid employees for year one, take 200% of that, let us say the nonhigh paid deferred on the average 3% of pay in year one. Take 200% of that, 6% of pay for year two. And that 6% limit becomes an individual high-paid employee limit for elected deferrals in year two.

So what you lose relative to current law is the ability to average among the high-paid employees in year two. Each individual high-paid employee would be limited to an elected deferral of 6% of his or her compensation in year two. While this looks like a liberalization of the limits, the provision would pick up revenue which translates into a cutback in the elected deferrals for highly compensated employees.

From a simplification perspective, you would still have to run the ADP test for the nonhighly paid employee. However, Rostenkowski and the administration, which favors this proposal, argue that in going into a year, very soon after the beginning of the year, employers will know exactly what the limits are for the high-paid employees in year two, in the year in which they are in. So there would not be the need to do the averaging, and then do corrections after the end of the current year. That is the simplification argument.

Distributions is another sort of category of changes that would be addressed by pension simplification. There are provisions that would simplify the rollover of distributions into IRAs and other qualified plans. There are very controversial provisions that would eliminate five-year and ten-year averaging and capital gains treatment of lump-sum distributions from qualified plans. There are proposals to eliminate the exclusion of the deferred recognition of net unrealized appreciation in employer stock that is distributed from a qualified plan. Also, there are rules that would relax the 401(a)(9) minimum distribution requirements, effectively permitting, in most cases, not in all cases, distributions to commence at the later of, the year after an individual attains age 70 and a half or retires. Currently distributions have to commence on April 1 of the year after the individual attains age 70 1/2, even if the individual is still working for the employer. So this would be welcome relief to many employers.

Leased employees. All of the bills would simplify the leased employee rules by substituting a control test for the historically performed test under Section 414(n). The net effect would be that in nearly all cases where an employer does not think of the individuals as leased employees, they would not be treated as leased employees. And in those cases where the employer is actually controlling the activities of the leased individual, then that is when the employer would have to worry about the leased employee rules. You would not have any surprise leased employees.

Nondiscrimination rules. The Chandler bill would make a lot of changes to the recently proposed, and now finalized, regulations under 401(a)4, on pension nondiscrimination. Isolating those things that have not been modified in the final regulations, the proposals would permit employers to treat the three different Social Security retirement ages as a uniform retirement age, both for safe harbor and for general test purposes and permitted disparity integration purposes. There would be relaxation or simplification of the separate line of business rules, so that more employers could utilize the separate line of business rules in doing their nondiscrimination testing.

And lastly, and this is the Kennelly proposal, and I include this just to illustrate the general point that simplification is in the eye of the beholder. Mrs. Kennelly's bill would repeal permitted disparity, Social Security integration, beginning in the year 2000. The argument being that permitted disparity rules are some of the most complex rules in the qualification area and their elimination would simplify the requirements. I would imagine that many employers would disagree with that characterization of the permitted disparity rules, and argue instead, that they permit a sensible pattern of replacement ratios of preretirement salary through qualified plans and Social Security.

Just to finish simplification, it is unlikely that Ways and Means will move a tax bill from the House side to the Senate side. So I think its unlikely that there will be legislation in this area, absence some sort of agreement not to append capital gains and similar proposals to a tax bill on the House side.

Also at issue is revenue. Many in the private sector who had supported pension simplification have come to oppose the proposals, basically because the revenue neutrality pay/go requirement, that I mentioned earlier, requires cutbacks in some of the favorable tax treatment for pensions. Primarily, in these bills, it's in the area of five- and ten-year averaging and capital gains. Many commentators and many of the associations in Washington that follow pension legislation are of the view that the elimination of those favorable tax rules for lump-sum distributions are not worth the benefits that would be provided in other parts of the legislation. So, what we now have is not only uncertainty among the Congressmen and Senators about moving legislation, but we also do not have consensus in the private sector about the value of moving these bills. So, that is really an added reason for the probability that there will not be legislation this year.

Moving to the labor scene and the labor committees. There are really two categories of bills that may move this year. Why may they move? First off, they are not tax bills. Second off, they do not involve revenue. So it is possible for Congress to take action in these areas. Of late, there has been more activity in the Employee Retirement Income Security Act (ERISA) of 1974 preemption area. The Supreme Court had recently ruled, in its Pilot Life decision, that state law remedies against an insurer for "unfair insurance practices" (state law remedies primarily reduce to punitive damages and consequential damages) were preempted by ERISA, where the insurance company was involved in the administration of an employee benefit plan.

Senator Metzenbaum and some others have made proposals that would cut back the scope of ERISA preemption in this area and in the area of prevailing wage requirements and apprenticeship programs. These essentially say that ERISA does not preempt state law remedies such as punitive damages and consequential damages against an insurer with respect to the administration of employee benefit plans. This would not relate to self-insured plans, particularly where insurance companies were not administering the plans. Also, it would obviously introduce great state-by-state variation in the system of remedies and requirements that would apply to many insured employee benefit plans.

In particular, the Washington associations are very concerned about the chilling effect it would have on managed care programs. Why would there be, in particular, concern about managed care programs? Because one of the intrinsic aspects of managed care is that some body, some board, some group, has discretion about whether the coverage in question will reimburse or will cover a particular procedure, particular days in the hospital, etc. And it's essentially the area of discretion which is most vulnerable to the claim by a plaintiff of an unfair practice. And so, it's really in the managed care area that the employer associations of Washington have identified the most likely negative impact of the ERISA preemption proposals that are currently being considered in Congress.

On the House side, the legislation has been approved by the House Education and Labor Committee. In late September it was approved but it has not yet gone to the House floor. Similarly, in the Senate. The Senate Labor Committee has taken up legislation. It has not formally approved the preemption legislation on the Senate side, although it's likely to do so. It is expected to happen sometime later this month.

Last year, in moving to the second category, there was much talk about tightening ERISA enforcement. In fact, the Labor Department even made a variety of proposals to strengthen ERISA enforcement with respect to fiduciary violations. The private sector pretty systematically opposed that. I do not think the Labor Department's heart was in the proposals, frankly. That was back when the Savings and Loan (S&L) crisis was first hitting the newspapers. And the Inspector General's report at the Labor Department was saying that the ERISA area was going to be the second S&L crisis. That has not turned out to be the case, certainly. And I think interest in the ERISA enforcement area has died down.

However, employer groups that are opposing the ERISA preemption provisions that I mentioned are finding that their arguments against ERISA preemption are adding strength to those who would favor ERISA enforcement. Primarily the argument is that state by state regulation is inappropriate and would subject many plans to a morass of different and often contradictory state requirements. What they are doing is arguing for a federal solution, which is the ERISA enforcement solution. And the Labor Department has recently been heartened by the voices of opposition to the ERISA preemption proposals. And there is renewed interest now in strengthening ERISA enforcement under the federal law. Not under state laws, obviously.

Metzenbaum is talking about adding a punitive damages and consequential damages, provision to ERISA. More modestly, however, the Labor Department is again talking about its proposal that it made last year, which provides for de novo review of administrator's decisions at the judicial level. It would enhance the ability of plaintiffs to recover attorney's fees and expert witness costs. There would be a bounty available to plaintiffs and others who report ERISA violations to the Department of Labor (DOL). There would be a strengthening of plan audits. There would be Multiple Employer Welfare Benefit Association annual statement requirements and other requirements are being discussed in that area, strengthened prohibited transaction penalties, and requirements that plans have written proxy voting statements available to participants.

So it is still too early to call what is going to happen here. The ERISA preemption legislation has had the most action recently. However, the opposition, as I said, has had sort of the strange effect of bringing back to the forefront the possibility of ERISA enforcement legislation at the federal level. So, that, in a nutshell, is what is going on in the labor area.

The PBGC area is another sort of labor category of legislation. There are four items I want to mention here quickly. First, Senator Metzenbaum has reintroduced his pension losers bill. His concern has been primarily with the fact that ERISA was adopted in 1974, and created the PBGC, and there were plans that terminated before the PBGC was created, and those participants lost pension benefits. That has been the general nature of his pension losers bill in the past. This most recent incarnation, however, is a little bit different. It provides a minimum benefit to all participants in pre-ERISA plans that terminated pre-ERISA with insufficient assets. But in this case, it's even if those participants are getting their full benefits under the terminated plans.

So, even though there were insufficient assets, those participants that are getting not only full benefits but also getting less than full benefits would have the right to these minimum benefits under the pension losers bill.

Who would pay the minimum benefits? The PBGC would pay the minimum benefits. Essentially it's a retroactive creation of the PBGC, for those participants who got less than their full benefits. For those participants who are getting their full benefits I guess its a wind fall. Its sort of like winning the lottery. The administration estimates that the cost to the PBGC would be about $500 million. Why is this important to us? It's important, first, because if enacted, the administration opposes it, but if enacted, it would be the first example of a federal mandate in the pension area. A small example, but it would be a federal mandate of the minimum benefit.

And second, all employers with defined-benefit plans should be concerned about something that causes the PBGC to incur greater costs, particularly where those PBGC expenditures would not be on behalf of PBGC premium payers. It would essentially be transferring dollars from current PBGC premium payers to other industries and other employees. And so that is the reason that the employer associations in Washington are very concerned about this.

The second category is annuities on plan termination. We are all familiar with the recent difficulties in the insurance industry. Executive Life and other insurance companies, with respect to not only GICs and other investment vehicles in ongoing plans, but also annuities purchased by terminating plans, primarily defined-benefit plans.

There are a variety of proposals that have been thrown into the pot in Congress. Let me just tick off four. One, it's sort of like coming full circle. The first would require the PBGC to guarantee annuities purchased on termination of a defined-benefit plan. This is something that is not likely to go anywhere. The PBGC and the administration strongly oppose it, and the potential revenue cost is immense. This is sort of a nonstarter from a legislative perspective. But it has been thrown out on the table. More modestly, there are proposals that would require the PBGC to review annuity purchases on plan termination. Essentially, a plan could not purchase an annuity and remain a qualified plan or satisfy the Title IV requirements unless the PBGC reviewed the annuity selection and annuity provider, and approved of that on plan termination.

This obviously would increase some cost, but it would not have the position of putting the PBGC and perhaps the federal government as an insurer of last resort for these benefits.

Somewhat more federal government oriented is the Senator Metzenbaum proposal, the Insurance Protection Act, which would create the Insurance Regulatory Commission (IRC). It would be much like the FCC, which would prescribe federal minimum standards for insurance companies and have the right to review insurance company practices, etc., and require insurance company disclosures to the IRC. As you can imagine, this is strongly opposed by the insurance industry.

Lastly, and this is sort of another way to require the federal government to guarantee these annuities. Instead of requiring the PBGC to guarantee the annuities, there are proposals to create a Federal Insurance Corporation. Essentially, the idea would be to set up a PBGC for insurance company annuities purchased on plan termination. It is not clear how this would be funded, but the idea would be just like the PBGC, a federal agency guaranteeing employees and retirees their retirement benefits through insurance company provided annuity contracts.

The third area of PBGC legislation, in light of the Ling-Temco Vought (LTV) decision, the PBGC is concerned about confronting very significant losses. Not only in the LTV case, but also in other cases involving distressed companies. There are some airlines that they are concerned about. They are talking about trying to get emergency legislation enacted this year. However, they have, in general, been stonewalled on Capitol Hill, and, in fact, they have not even gotten to the point of introducing formally emergency legislation to react to the LTV situation. So while this is an area, action is very unlikely. Lastly, there is some general PBGC reforms that were included in the Bush administration's budget: really enhancing the PBGC status in bankruptcy by letting it participate in the creditor's committee; enhancing its claims; tightening the minimum funding rules; and limiting the coverage of shutdown benefits. Action in this area is not likely at this point. However, the combination of these areas could coalesce to promote a more general PBGC bill which would address aspects of all of these categories: the pension losers, the annuities provision and the annuities issue. I think that is something to look for, if not this year, sometime next year.

Let me just quickly touch on the last two areas. The Family Leave Bill was passed by the Senate on October 2. It has not been passed by the House at this point. It was passed last year, as you know, and vetoed by President Bush. This bill would apply to employers with 50 or more employees. It would require 12 weeks of unpaid leave for the adoption or birth of a child or serious illness of a dependent. The employer would have to continue health benefits and the employee would have a right to return to his same or comparable job. The Bush Administration is saying that it will veto this version of the bill just like it vetoed last year's bill.

National Health Reform. There are really two categories of National Health Reform. The comprehensive reform, which refers to the single payer Canadian-style proposal. That is not going to go anywhere. There is talk about a pay or play proposal. That is not likely to go anywhere, certainly not this year or next year. Then there is talk about market reforms. Heritage Foundation has made a variety of proposals. In their broadest sense, they are not likely to go anywhere this year or next year. However, it is increasingly likely there will be incremental reform in this area. The administration has called for a summit on ways to save money in the health care area by simplifying the administration of health plans. There are various proposals in the small employer area to assist small employers in providing health benefits to employees, preempting state mandates, and requiring insurance companies to provide certain qualified health insurance products to small employers. There is talk about limits on malpractice recoveries. There are proposals to enhance the tax treatment of long-term care benefits. This is essentially making long-term care coverage like medical coverage, giving long-term care all of the same tax benefits that medical benefits get. The second big issue in this area, in addition to what is the right thing to do from a health policy perspective, is how to raise the money to pay the federal cost of providing enhanced access to health coverage. There is talk about limiting the tax exclusion for the employee of employer-paid premiums of health coverage and limiting the employer's deduction. There is talk about surtaxes at the individual and at the corporate level on income taxes. And some people are even talking about value-added taxes. Certainly, value-added tax would not be something that would be done for incremental reform. That would be something that would be associated with a comprehensive reform.

MR. SHAPIRO: I am going to talk about the small plan actuarial audit program. One of the things that was a concern in the past was that there was really nothing special on our program for the small plan actuary. And so this is something specifically for the small plan actuary, although a number of large plan actuaries have an interest in small plans too I guess.

What I would like to do is to run through the history and tell you some of the problems. And then tell you what is happening right now.

In terms of goals. The goal was very simple. Raise two thirds of a billion dollars. The target plans were those with five or less participants. The statute of limitations limits how far the service can look back, and so we are concerned with the years 1986-88. These, then, are the plans that the Service is looking at. The tactic? They are going to challenge plans with interest rates below 8% and retirement age assumptions below age 65 years.

Now, the issue that always comes up is what is so special about those assumptions. The 8% was explained in a speech made by Ira Cohen at the 1986 Enrolled Actuaries Meeting. What he said was as follows:

> We want to leave a range, and on the guidelines we came up with a 4% range. Therefore, if we allow, when there is experience, a 4% variation, we subtracted the 4% from the 12%, which is what the expectation [was], and came up with 8.

As far as the age 65 is concerned, Ira's comment was as follows:

> On the retirement age, we said, look, we are willing to accept a normal retirement age of 65. We are not going to question that. However, if you're using a lower retirement age, we want some basis to justify its use.

So that was Ira's interpretation of the Service's rationale for 8% and age 65.

The initial estimate was that there would be approximately 20,000 plans audited. With an 85% growth "success" rate, the average disallowed per plan would be $132,854. So the actuaries were clearly doing their homework. The tactic? Challenge all these plans.

These numbers have been revised currently. As of this month, the Service anticipates 11,000 plans. In fact, those plans have already been targeted; they know which plans those are. It involves 5,000-6,000 taxpayers, and, to date, 80% of the plans have been opened. This means that there are 20% of the plans yet to go, so if you have not yet been affected, there is still some chance that you will be audited.

For what it is worth, I understand that there are some places, like Dallas, where all this stuff started, where there will be no new cases. But those areas that were the last ones to hear about this problem are the areas where there are still plans to be audited. I do not know if that makes you feel better or worse.

Insofar as the kind of things people are most perturbed about. You most often hear the concern that it is a revenue-driven program; that the assumptions are arbitrary; and that there is limited regard for fact and circumstances.

Let us turn now to some of the things being litigated. Obviously, retirement ages less than 65 are important issues. There is an interesting twist that has been meeting with some success, and that involves plans that provide for an in-service distribution. In these cases, the relevance of a retirement age seems far less obvious.

Front-end funding. As everyone is probably aware, the primary case here is Mirza. In this instance, they used the unit benefit cost method, where 73% of the benefit accrual was in the first year and 27% of the accrual was done over the next three years. In spite of the fact that the Service is relying on Mirza as precedence, it is not representative of most of the small plans out there.

In terms of Mirza assumptions, the participation age of Mirza was age 43, the normal retirement age was 55, and the interest rate was 5%.

We did not hear about the normal retirement age, since it was not at issue. What was at issue was the fact that the first-year cost, to coincide with the high first-year benefit accrual, was $625,000. Also at issue was the 5% interest rate that was used. The argument for 5% was that the plan had no experience, and if you look at investment results in the market, including the stock market, 5% was not out of line, given conservative assumptions. However, this argument was not very persuasive in light of the fact that the funds were invested in six-month CDs, guaranteeing 11-15% or 16%, and 36-month CDs guaranteeing 12%. In spite of the reinvestment issue, the court agreed with the service that 5% was too low an assumption.

It is important to point out that since it was not a tax court, the court had no technical people involved. On the other hand, the finding was important because the U.S. Court of Appeals for the Seventh Circuit is a very strong circuit court.

Well what was the result? The result was that, while Mirza had anticipated a deduction of $625,000, the IRS revised the deduction to $116,000. The argument was that the past service liability had to be funded over 10 years. This resulted in a normal cost of $63,800 and past service cost of $52,200.

The major issue of the Mirza case, then, was that the past service liability has to be funded over 10 years. Unfortunately, that is not the issue that was publicized. If you were just sitting there drinking your cup of coffee in the morning and listening to the news, you did not hear that the funding method was 92% of the problem and that the interest rate was only 8% of the problem. On the contrary, the major issue being stressed is that the court required an 8% interest rate.

Another issue is envelope funding. You will recall what envelope funding is. You just take the cash value of the insurance contracts, plug it into your assets, and then fund the unfunded present value of benefits, including the death benefit. A question which arises is what assumption do you use for mortality. Do you use an insurance table or an annuity table? Also at issue, of course, is what interest rate to use.

Turning now to the upcoming cases. Overstatement of liabilities, of course, is the problem. Prior to 1990, IRC Section 6659A imposed penalties based on a sliding scale, ranging from 10-30%, depending on the amount of overstatement of pension liabilities. That section was repealed by OBRA 1989, and replaced by IRC Section 6662(f).

The judge for the upcoming cases is Charles E. Clapp. He went down to look at the Phoenix cases, and when he saw the extent of the issues, he asked that all the cases be brought to him. Once down there, he saw that there did not seem to be any obvious resolution, so he organized a meeting involving people from the Service and people from industry. Furthermore, he asked that both the Service and industry suggest lead cases.

The private sector put forth both an institutional case and a number of noninstitutional cases. The institutional case involves Vincent & Elkins, which is a firm of attorneys whose main office is in Houston, but which has a national and international reputation. It is a large firm involving about 130 attorneys. The firm itself had a master pension plan, but the plan of each attorney was essentially individually designed and funded. So these plans had an interesting twist. The issues of the case are a normal retirement age (NRA) of 62 years, a 5% interest rate assumption, and envelope funding. This case comes up in January.

Appendix A summarizes the other cases. The thing to note is that the private sector, in contrast to the Service, has attempted to segregate out the main issues. Thus, for example, they are presenting a situation of interest-only with experience and interest-only without experience.

MR. CONAWAY: I am going to turn to some recent regulations.

There is really not much here that I think that you are probably not already aware of. Let me just take you through some issues. For the 401(k) and 401(m), as you know, final regulations were issued about three months ago. And there are a variety of important issues addressed there. One important one is the availability of restructuring for 401(k) and 401(m) plans. The IRS has taken the view that restructuring is not available for these plans. So what you do is you look at the form of the plan. You take the single plan. You have to apply the ADP and the ACP tests on that basis. You cannot divide it into different component plans based on different lines of business, different divisions, different profit centers, salaried or hourly employees. However, and this is sort of increasingly of interest I think to employers, the IRS does acknowledge that you can set up separate 401(k) and (m) plans formally, and then simply put them together as you choose in order to run the ADP tests. So, while there are rules prohibiting taking apart a single 401(k) plan to maximize the high-paid elected deferrals under the ADP test, there are no rules about setting up formally separate 401(k) plans and then putting them together as you may choose, in order to accomplish the same objective. It's unlikely that you get to exactly the same benefit out of formerly separate plans with aggregation, but in many cases employers will be able to achieve much the same effect through formerly separate plans and aggregation that would have been available through plan restructuring.

What are the downsides to setting up formerly separate plans? Well, the requirement seems to be the Section 414(l) rule that there be a separate pool of assets set aside for the benefits in question. And, you get into the question of what does that mean in the case of defined-contribution plan, where an employee's benefit is based exclusively on the value of the assets in the employee's account? In trying to set up separate plans, you need to look for provisions about how plan administrative costs are paid. What you want to do, to the extent possible, is to allocate administrative costs to the accounts with respect to which of those costs arose. In the case of fraud, for example, where a trustee embezzles funds, you want to make sure that other accounts are not available to make whole the participant who had funds embezzled from his or her account. Those are the sort of things that the IRS looks at in the case of a defined-contribution plan to determined whether there is one plan or multiple plans.

So, once you have dealt with all sorts of master trust and separate trust issues, to create separate plans under 414(l), what else do you have to worry about? You have to worry about the 401(a)(26) minimum participation requirement. Each plan would have to have at least 50 employees, or 40% of all the employer's employees. You would have to file separate form 5500s. You would only have to get separate determination letters, to the extent that the employer was nervous about one determination letter for one plan not applying to other plans, although the other plans would be identical to the plan that got the determination letter.

So there would be the separate 5500s. But, that seems to be the big additional administrative cost to doing this -- the formerly separate plans with the reaggregation approach. You can do in 10 steps what the IRS will not let you do in one step. Many people believe that this violates the spirit of the no restructuring rule in the 401(k) regulations. All I can say on that is the IRS and Treasury were informed that this alternative path was available. Frankly, they are comfortable with employers taking the alternative path, because it does not permit retrospective maximization of disparities under the ADP test. It requires, in effect, the employer to declare the separate groups up front, at least in so far as which employees are in separate plans. There is no requirement that the reaggregation of the plans be declared before the beginning of the plan year. So while it may seem to violate the spirit, the IRS has, in effect, blessed this alternative approach as a way to get more out of the ADP and the ACP tests.

There are a variety of rules in the final 401(k) regulations modifying the ADP and the ACP. Most of them are clarifying or simplifying their rules addressing the compensation that may be used in running the actual deferral and actual contribution tests. One of the alternatives the IRS says it is going to revisit is to permit the ADPs to be calculated based on the compensation during the calendar year ending in the plan year. Reactions to the final regulations have caused the IRS to announce that they are going to be revisiting that rule. They are concerned that it permits too much gaming. I am not sure exactly what situation they are concerned about, but they have said that there may be some tightening of that regulation.

There were many comments submitted to the IRS requesting a different method for calculating which highly compensated employees had excess contributions. To those of you familiar with the proposed rules, essentially there is a step down requirement which looks at the highly compensated employee with the highest actual deferral rate. You reduce that individual to the level necessary to pass the ADP test or to the next highest highly compensated employee actual deferral rate. You keep stepping down until the plan as a whole passes the ADP test. However, because of the $200,000 cap in effect and because of the annual limit, the 402(g) limit on elected deferrals by an individual, it is really the high-paid, highly compensated employees who tend to have lower actual deferral rates than the lower-paid, highly compensated employees. So the correction method in the proposed regulation and the one that is included in the final regulation really penalizes the low-paid, high-paid employees before it penalizes the higher-paid, high-paid employees. The IRS's position is that this rule is mandated by legislative history, and so the IRS will not provide an alternative.

The pension simplification bills, that I mentioned earlier, do provide for the alternative method. That is, start cutting back the elected deferrals by the highest-paid, highly compensated employee first, even though that highly compensated employee may not have the highest rate.

There are changes to the hardship distribution rules. Without walking through the details, let me simply say that there are many employers who may have felt that the safe harbor approach to hardship distributions was unduly tight, and those employers went with the general test approach, the facts and circumstances approach, in the proposed regulations. Essentially, many believe that the balance between the safe harbor approach and the general test approach has been altered so that the safe harbor approach may be more palatable in some cases. In other cases, I think its arguable that the general test is more palatable.

I think the general point I want to get across here is that employers with 401(k) plans should probably revisit the way they want to satisfy the 401(k) hardship distribution rules because the balance has changed on several variables.

Here is one of the strange rules, and I can imagine how it ended up in the regulation. It has to do with union 401(k) plans. Union defined-benefit and defined-contribution plans generally are deemed to be nondiscriminatory under the 410(b) and 401(a)(4) nondiscrimination rules. However, in the 401(k) area, if a union negotiates and the employer sets up a 401(k) plan for the union representative employees, that plan is deemed to be nondiscriminatory, deemed to pass the ADP test for nondiscrimination purposes, but its not deemed to pass the ADP test for purposes of constructive receipt. Obviously, what an employer wants to achieve in setting up a 401(k) plan is the ability to override the IRS's application of the constructive receipt rule so that the employee's choice between cash and elected deferral does not cause the employee to be taxable on the elected deferrals. In other words, the elected deferrals should be pretax not after tax.

The service has said that the ADP test is a deemed test for these union plans for nondiscrimination purposes only. This means that of all the union plans, only 401(k) plans have to pass these ADP tests or the nondiscrimination test. Its a legal distinction. They say they are mandated to require satisfaction of the 401(k) ADP tests for constructive receipt purposes. They are not mandated for nondiscrimination purposes.

The way I imagine this developing is that somebody identified a legal distinction, and that meant that they had to create a legal difference in terms of a rule. I think what we have here is a case of a distinction where there really should be no difference recognized in terms of the practical effect of the rules. Many at Treasury will informally say they agree with that. However, I would imagine the meeting where everybody was winning on some issue, and this was somebody's issue to win on. So, union plans, for whatever reason, in spite of the fact that there is a lower annual cap, and in spite of the fact that the 401(k) plans cannot be as discriminatory as a defined-benefit or as a defined-contribution plan, the 401(k) plans have to satisfy the ADP nondiscrimination test.

Let me move to the 401(a)(4) final pension nondiscrimination rules. There are a whole series of issues that I want to highlight. I know there is another session that will go into these in much more detail. Let me simply mention a couple of these items so that those of you who have the issue can go back and look at the regulations in more detail.

The restructuring rules that have been included in the proposed regulations have been dramatically recast. There is really only one restructuring rule now available under the 401(a)(4) rules. And that restructuring rule is for employee group restructuring. And it's essentially a free-for-all. You can pick and choose your employees to put in whatever employee group you choose for restructuring purposes. However, you then have to test the restructured group under the 410(b) minimum coverage rules. If you are using the nondiscriminatory classification test, the employee group has to be a reasonable classification. So the free-for-all, in terms of picking and choosing, people on this side of the room in one plan, and people on that side of the room in another plan, you really only get that if you are passing the 70% ratio percentage test.

The rate-based restructuring rules that were in the proposed regulations are not stated as restructuring rules under the final rules. What they are, are really methods for applying the general test to the amount of contributions or benefits. Essentially, this is a rate-group method, which is intended to cure the various problems that defined-benefit plans had in testing under the proposed restructuring rules, both normal and most valuable accrual rates. So the rate group method purportedly resolves all of those testing difficulties.

One of the big pluses of converting a rate segment restructuring from a restructuring rule into a method under the general test is that no longer do the separate rate groups have to be tested separately as separate plans under the optional form of benefit rules, or under the rights and features rules, or under any of the other rules that apply to qualified plans. So, essentially you get to restructure on rates by creating rate groups just for purposes of the amount testing of contributions and benefits under 401(a)(4). You do not have to consistently follow that restructuring when you test under optional forms of benefits and other rights and features. This eliminates a whole host of testing issues that had arisen under the proposed regulations.

Subsidized lump-sum distributions. Why is that here? This is a rule that was in the proposed 401(l) permitted disparity rules, but I think it's more clearly stated in the final rules, and it's creating a problem for some defined-benefit plans that, for example, have subsidized lump-sum distributions. The issue is that the permitted disparity rules have to be satisfied with respect to each and every optional form of benefit. And, where there is a subsidized lump-sum distribution, it may be difficult for that plan. That may cause that plan to have to reduce the otherwise permitted disparity under the 401(l) permitted disparity rules.

There are special rules where the plan is calculating a lump sum using the PBGC required interest rate, the 120% and the 100%. You should know that if the plan is using the flat 100% in all cases, that is treated as a subsidized lump sum that may require reduction in permitted disparity. So, that is something to be aware of.

Data quality is an issue that came up under the proposed regulations and it continues to be an issue under the final regulations. Many had argued about how perfect the data had to be in running the general test. The IRS, while it has included some transition rules and some rules for estimating data, the general approach is that perfect data must be used in calculating accrual rates and allocation rates under the general test.

There is a transition rule, as I mentioned, particularly for compensation based data, prior to 1995. But, in general, this is the approach the Service is taking. So, many of the tests that might have been done on group based data in making reasonable estimates, may not pass muster if the IRS were to come in and audit an employer's plan. So this is something to be aware of. That does not mean that the employers have to affirmatively collect the more perfect data in order to run the tests. It is just that the IRS may raise the issue on audit, and may force the employer at that point to collect more individualized, more accurate data, in order to prove to the IRS that the plans pass the general test.

Cash balance plans. There is a safe harbor in the cross testing rules for cash balance plans. Essentially, creating a mechanism whereby the cash-balance plans can be tested not as defined-benefit plans, but as defined-contribution plans. Then, if the hypothetical contribution satisfies one of the safe harbors for defined-contribution plans, the cash-balance plan can avoid being tested under the general test altogether.

The final word is not yet in on the user friendliness of the cash-balance safe harbor. One issue that seems to be creating some controversy, however, is the required rate that an employer must use in projecting the hypothetical account out to a normal retirement benefit. In effect, what is required is a much higher rate than many employers currently want to use. Essentially, this is a rate that is near or is equal to the PBGC rate. What happens is that the net effect of the safe harbor rule is that many cash balance plans would be put in the position of having to pay much larger lump-sum distributions, particularly to younger employees who are separating from service, than they had intended to. This can obviously be a design obstacle to the adoption of cash-balance plans for those employers who are interested.

There is an open question about whether the IRS will require that the same rate be used outside of the safe harbor in projecting a current hypothetical account balance out to a normal retirement benefit under a cash-balance plan that is not using the safe harbor but is using the general test. Informal word from some of them is that they will require this interest rate scheme be used outside the safe harbor. They have not said that formally.

Primary insurance amount (PIA) offset plans and the new permitted disparity rules. Many employers had argued for a safe harbor for PIA offset plans under the defined-benefit plan safe harbors. The IRS rejected this. However, they did make some modifications to the permitted disparity rules which they say were intended to permit essentially more individual permitted disparities in plans that are satisfying the permitted disparity rules. Thereby employers can better design defined-benefit plans in accordance with the permitted disparity rules that more accurately replicated or approximated the individual employees PIAs. Therefore it is possible to produce better replacement benefits, or retirement benefits, that more accurately replace preretirement salaries.

Essentially, without going through the rules, what the new permitted disparity rule does is permit an individual's final average compensation to be used as the individual's integration level. And it permits separate, individual by individual, reductions in the permitted disparity, based on the relationship between the individual's final average compensation and the individual's covered compensation, or the integration level for the plan.

What this does is permit different permitted disparity amounts for different individuals, better approximating PIAs. There is a glitch, however, in the regulations. If you work through the regulations, technically there is a required reduction in one set of the regulations. There are demographic tests that have to be satisfied and there are discrimination tests. And those discrimination tests, for integration levels other than covered compensation, and other than several others that are explicitly permitted, require that so many of the nonhighly paid employees have final average pay above the substitute integration level. Those special discrimination tests, though, were designed for flat dollar integration levels. They were not designed for integration levels such as each individual's final average compensation. And what we are finding is PIA offset plans using this new permitted disparity rule cannot pass the discrimination tests. This forces a mandatory 80% reduction in the permitted disparity factor, which effectively undoes what the IRS says it was trying to do in this special permitted disparity rule for PIA offset plans.

They say informally that this required 80% reduction was unintended. However, they do not know whether they will change it. It is required legally under the regulations as the regulation is drafted. So, those of you who read the preamble to the final regulations and were pleased to see the that mock PIA offset plans would be better treated under the final regulations are likely to be disappointed, at least in the short term pending some modifications by the IRS to these rules.

Let me just mention contributory defined-benefit plans. This is another issue for those employers that have contributory defined-benefit plans, particularly step rate defined-benefit plans, where higher employee contributions are required on higher amounts of compensation. There are some pretty strict rules in the final regulations relative to the proposed regulations. You may find that in these step rate contributory defined-benefit (DB) plans that what had passed under the proposed regulations will not pass under the final regulations. So if you have these plans, you need to look closely at these rules.

Let me just quickly close with final Americans With Disabilities Act. The Equal Employment Opportunity Commission (EEOC) has recently issued regulations on the Americans With Disabilities Act. These regulations, however, are particularly unhelpful, in terms of knowing where the Americans With Disabilities Act will require or limit particular benefit designs, particularly health plans, for example, if an employer wants a cap on AIDS-related reimbursements or reimbursements for AIDS-related expenses, and a variety of other caps on mental health reimbursements and other procedures that are related to a particular illness or disability. It's very unclear about the extent to which these sort of caps will be permitted. The EEOC regulations unfortunately amount to little more than an echo of the statute and the legislative history. I think that is what happens when there is a statutory deadline on the issuance of regulations, particularly where the agency respects the statutory deadline. What you end up getting is a regulation that really just echoes the statute and the legislative history.

These rules go into effect for all but the smallest employers in July 1992. So, employers that are looking to revise their benefit plans now for 1992 need to be aware that caps on reimbursements or on procedures for certain illness-related procedures or care may well fall in violation of the Americans With Disabilities Act. So, you need to go through this analysis.

The other area that you need to be looking at, it seems to me, are the procedures for hiring, firing, and evaluating employees. There are a variety of rules on what an employer can do and cannot do in terms of hiring employees, particularly those employees with disabilities. The general standard is the employer cannot discriminate against a disabled individual who is qualified to perform the essential functions of the job. So it will be essential to look at your job descriptions to properly identify the essential functions of the job, and to make an objective assessment about whether this disabled individual can perform those essential functions. Again, echoing a comment I made earlier, the Americans With Disabilities Act, to the surprise of many, is not just a prohibition on discrimination. There is an affirmative mandate implicit in the Americans With Disabilities Act, that is, that the employer must make reasonable accommodations for disabled individuals in order to enable them to perform the essential functions of a job. So it's not just that you cannot discriminate against a disabled individual, the employer has to make reasonable accommodations, whatever that means, in order to aid the individual in performing the essential functions of the job. The EEOC regulations do not get into, in any meaningful way, what a reasonable accommodation is and what it is not. I just want to highlight this to you though, because in evaluating your hiring procedures and in your benefit plans, these issues will begin to become important as we move to July 1992.

APPENDIX A
Upcoming Lead Cases

Private sector chosen cases

1. Institutional cases

    A. Vinson & Elkins (Houston) -- normal retirement age (NRA) of 62 years, 5% interest rate, mortality loading

2. Noninstitutional commercial business and professional cases (Phoenix cases)

    A. Boren Steel Consultants -- interest-only without experience, NRA of 63 years

    B. Citrus Valley Estates (2) -- interest-only without experience

    C. Old Frontier Adjusters -- interest-only with experience

    D. Robert Davis -- unit credit cost method, NRA of 55 years, interest-only without experience

    E. Robert Stephan Ltd. -- unit credit cost method, NRA of 55 years, interest-only with experience

    F. Southwest Retina Vitreous Consultants, Inc. -- 5% interest rate and a NRA of 55 years

IRS chosen cases

1. Institutional

    A. Wachtell, Lipton, Rosen & Katz (New York) -- similar to V&E, NRA of 55 years

2. Noninstitutional

    A. Diversified Financial Services -- funding method with experience

    B. Jonathan R. Fox and Renee K. Fox/Arizona Orthopedic Institute of Traumatic and Reconstructive Surgery (2) -- no in-service distribution.