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NONDISCRIMINATION RULES

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The panel will review the final regulations on nondiscrimination and discuss how actuaries have adapted to them.

- 401(a)(4)
- 401(l)
- 401(a)(26)
- 401(b)

MR. TIMOTHY W. SHARPE: It is my pleasure to introduce the two gentlemen who have generously and courageously volunteered themselves to speak. Tom Miano is a consultant in the Chicago office of Towers Perrin. Tom is an Enrolled Actuary and a Fellow of the Society of Actuaries. Roger Siske is an attorney and partner in the law office of Sonnenschein in Chicago. Roger is the firm's director of employee benefits and executive compensation practices.

Our format for this session will be for Tom and Roger to give brief presentations on the nondiscrimination rules to bring us up to date, and then we will shift to a discussion format.

I was talking with a friend and I mentioned to her that I was going to be participating at this meeting. She asked me what the topic was and I told her it was nondiscrimination rules. She sort of laughed and said, "Who cares? They just keep extending the effective dates. What does it really matter?" I told her that reminds me of an experience I once had with the library. I had checked out a book. I believe it was *Lincoln* by Gore Vidal. If you have not read it, I recommend it. It is entertaining reading. It is kind of a lengthy novel, at least by my standards. Six hundred or seven hundred pages. By the time it was due to be returned, I had not finished the novel and the library is not that close to my house. I thought, well, I want to finish the book before I return it, so I will finish the book, return it, and pay the fine. Well, a few days later, I get a letter in the mail from the library and I open it and in big bold letters at the top of the page it said, "FINAL NOTICE. Dear Mr. Sharpe: Our records indicate that the book, *Lincoln* by Gore Vidal, has been issued to you and is overdue. Please return the book immediately or your library privileges will be suspended." So the next day, slightly embarrassed, I went to the library. I returned the book and I brought the letter with me. I gave the letter to the librarian and I said, "I am really sorry for keeping this book so long. I would have been happy to return it sooner, but this was the first notice that I received and it says final notice." Well, the librarian smiled at me and said, "I know. We ran out of first notices."

* Mr. Siske, not a member of the sponsoring organizations, is a Partner of Sonnenschein, Nath & Rosenthal in Chicago, Illinois.

With that, I want to turn it over to Tom and maybe Tom can tell us whether or not we have received final notice yet on the nondiscrimination rules.

MR. THOMAS M. MIANO: Addressing Tim's question, I think most of you probably know that the IRS did just come out with announcement 92-81 recently that we're going to talk about a little bit. I don't want to go too deep into it because it probably will be covered in a late developing session, but I think it might be pertinent to our discussion. The announcement, 92-81, came out in a proposed revenue ruling procedure that employers can follow right now. Basically it was supposed to simplify the process of substantiating compliance, which I think it is going to do for everybody. It's covering a single day snapshot testing, which could be maybe the first day of the plan year, and possibly tie into evaluation day. The second area it covers is special rules for identifying highly compensated employees. This is made easier in relationship to the single-day snapshot testing. The third thing is a three-year testing cycle if there's no significant changes or events that happen in a cycle period. And the last one is the quality of the data. It is unreasonable to collect all the data that they're talking about in this testing. You might be able to use something like the evaluation data, which will make things a lot easier. The same way the IRS in that notice said that they're still looking at the regulations and are looking for input from employers and from practitioners to help simplify this testing process.

I'm going to cover two areas. First, I'll quickly go over some of the changes from the proposed regulations to the final regulations in 401(l) in relationship to plan design features. The second thing I will do is talk a little bit about good faith compliance given that we're going to have to test sometime in the transition years of 1989-92.

What are some of the major changes that happened in the final regulations in 401(l)? There were some lay rules that sort of switched over to 401(a)(4). There were changes in the accrual and payment option rules. There were adjustments in disparity limits. There were some changes in the overall limits. The final one is separate rules for plans integrated with railroad retirement.

There are some changes that relate to 401(a)(4). Things that now are governed under 401(a)(4) are contributory defined-benefit plans, target plans, and cash-balance-type plans. It's my understanding that cash-balance plans are being tested under the defined-contribution rules. Also, our fresh start rules were expanded and now you have multiple fresh start dates, and you also have safe-harbor alternatives available for anytime in the future, given that you have passed nondiscrimination for the prior year.

One of the changes in the accrual and payment option form, which is a big one that caught some people by surprise, but the IRS said it shouldn't have, was benefit decreases for increasing the covered compensation is forbidden. I think a lot of people felt that the anti-cutback rules allowed accrued benefits to be reduced for increases in Social Security benefits or covered compensation, but the IRS has said that that's not true and that you always should have been worried about any cutback in accrued benefits from increased covered compensation. I think for most people, it's possibly an administrative nightmare. What that means is that each year when an individual's covered compensation increases, and your formula is integrated with covered compensation, the accrued benefit cannot be less than it was at any prior time. Let's say you have a person who has accrued his or her benefit on

December 31, 1991. Now you go to January 31, 1992, and he or she maybe had a pay increase, and also had covered compensation increased and there is one more month of service. The increase in covered compensation could possibly be at the point where that January 1992 accrued benefit is less than the December 1991 accrued benefit. And the employee is entitled to the December 1991 accrued benefit, which is larger.

FROM THE FLOOR: I can see that applying to final-pay plans, but that is not going to apply to career-pay plans, is it?

MR. MIANO: I don't think it would because with the career-pay plan you keep adding to it each year. That's my understanding of it. From an employee point of view just on this issue, the employee must understand that the benefits on a final-pay plan are not accruing sort of linearly. You're still going to be flat, and jump up, and be flat for a while, and then keep jumping up.

MR. ROGER C. SISKE: It could apply not only to a final-pay plan, but also to a career plan that isn't structured as an accumulation plan, as the IRS or Service calls it. You know, in a career-average plan, we take average compensation for your career and multiply it by some unit benefit formula, then the same consideration would apply. It wouldn't apply if a person accumulates 2% of the year's pay this year, 2% of next year's pay next year. It really doesn't cut across both lines where you have a career unit benefit plan.

The issue raised is, could this ever apply to a career-average plan, or would it only apply to a final-pay plan? While it more clearly applies to a final-pay plan, if you have a career-average plan that's in the nature of a unit credit plan for which you multiply career-average pay as it continually changes by a unit credit (let's say 2% a year) you'd have exactly the same anti-cutback consideration from higher covered compensation in later years with a career plan as you would with a final-pay plan. It wouldn't apply to an accumulation career plan where you accumulate, let's say 2% of this year's pay this year and 2% of next year's pay next year.

MR. MIANO: Cost-of-living adjustments (COLAs) are allowed and you won't have any adjustment in disparity if the COLA is applied to all participants and that application is parallel to Social Security COLAs. That means that if a COLA starts after age 62, its 62 and later.

Someone asked whether you could start to give a COLA to people before age 62, and I think the answer to that would be, yes, but I don't think it would be considered a safe harbor. You might have to reduce the disparity limits down to get to the point of safe harbor.

The final regulations changed rules concerning plans that use the fractional accrual rules; these are project-and-prorate-type plans. Let's use an example of 1%, a 1-1.5% step-rate formula. If you have disparity over 35 years, meaning if you accrued the benefit over 35 years, basically you have to use your step-rate formula for the 35 years. If you're going to give benefit accruals for service after 35 years, you can use a rate up and to your excess rate, in this case 1.5%. Keep in mind you used your step-rate formula for the 25 years. If you accrue disparity over 25 years

(this is something different that the IRS said), for the next 10 years, you have to use the excess percentage, the 1.5%. Then, after 35 years, you can use any rate up to the 1.5%.

There are some changes to the disparity limits. If you have a nonstandard integration level, which is different than individual covered compensation, you're allowed to interpolate between the percentages of the final regulation if your integration level is above covered compensation. You're also allowed on an individual basis to make adjustments to disparity. One or two individuals might have a benefit or accrue enough service to affect the safe-harbor formula. Furthermore, their safe-harbor limits are provided now that you don't have to worry about the demographics test. There also are adjustments for early payment. Also, the new table is applicable for all ages. You have only one set of early retirement factors and it applies to all the people. Also, if you have a qualified Social Security supplement, you can avoid reduction in your disparity limit.

The changes to the overall disparity limits were totally reorganized in the final regulations. Annual limits are applied to the combination of plans, both to the defined benefit (DB) and the defined-contribution (DC) plan. They're based on a proportion of disparity used compared with the amount that's allowed. If you have one plan for general testing, you impute disparity, and that is considered fully integrated. That means your annual disparity limit is one. So, that means if you have two plans that are integrated and you want to impute disparity, the only way you could do that is by aggregating the plans together in the general testing.

Accumulative limits are based on the sum of your annual limits. They can't exceed 35 and they apply to DB plans only. They do not apply to DC plans. So, that's basically a quick overview of some of the major changes in the 401(l) final regulations.

Next, I'd like to talk about good faith compliance for those transition years from 1989-92. Given that most likely we're going to have to do some type of testing in this period, what's the best thing to do? Good faith compliance. Back in November 1989, the IRS issued some guidelines to their field personnel concerning good faith compliance and some transition issues that basically didn't provide that much new information to employers, but it's somewhat helpful. Using this good faith compliance, employers may be allowed to continue using their plan as is until 1993.

How do some different issues and regulations concern good faith? We look at amounts tested under 401(a)(4). What's considered good faith? In the IRS's eyes, of course using the final regulations, it says its okay to use testing methodologies -- the old ones based on Revenue Ruling 81-202. There you have to determine benefits on a projected basis and group employees by compensation ranges. There are some things you have to take into account. One is the $200,000 pay cap. Also, your compensation is supposed to satisfy 414(s) and if you impute disparity, it must be under 401(l). Now, given that this new announcement came out in Revenue Ruling 92-81, some of these issues might even be considered. You might be able to use good faith for some of these issues if you can show that these are nondiscriminatory.

Good faith under past service amendments basically means there must not be significant discriminating in favor of highly compensated employees. This is similar to the final regulations. If you have a determination letter that covers prior grants of past service, then you can use that. But I'm not too sure anybody would have a determination letter for this situation, but the IRS has put that in there.

Good faith for contributory defined-benefit plans. As you know, in the final regulations, you're supposed to test if you have a contributory defined-contribution plan. In a contributory defined-benefit plan, you have to test the employer provided and the employee provided separately. But during this good faith period you're allowed to test them together if the total benefits provided by the plan and the level of the contribution are the same for all employees.

Regarding good faith for optional forms of benefits, the IRS said that you're supposed to meet the same tests as the final regulations. They must be currently and effectively available to a nondiscriminatory group. Some people think that you might be able to use some good faith there. You might not have to stay with the final regulations. For ancillary benefits and other rights and features you must satisfy a facts and circumstances test.

Let's look at 410(b) regulations for good faith. Effective for 1989, you must use the final regulations unless you're doing an average-benefit percentage (ABP) test. Beginning in 1990, if you are doing the average benefits test, you must meet the objective test under the nondiscriminatory classification test. Prior to 1989, you can use a payroll determination letter. Going further, if you do pass the objective test, then you're allowed, if you're doing the average benefits percentage test, to go out in good faith to the final regulations. Good faith there is, again, for facts and circumstances, but you must take all plans into account and an employee that does not have any benefits is included with the zero benefit percentage.

Let's discuss Section 401(a)(17) and $200,000 compensation limit. This is effective for the 1993 plan year, but during the transition years, you're allowed to apply the current compensation limit to all prior years. However, in the final regulations, you're only allowed to use the current compensation limit in that plan year. If you're doing a 1992 accrued benefit calculation, you can use the 1992 dollar limit for all your past years. Another thing is that you're permitted to use the compensation limit as of January 1 for plan years that end in that plan year. In the final regulations it's a plan year that begins in that year.

IRC 401(a)(26) says that if you have a problem with this regulation, you must retroactively amend the plan by the last day of the plan year, but under this good faith period for 1989-91 you're allowed to amend it by the end of the 1992 plan year.

What is a possible method of determining good faith given what we just talked about? Maybe you can look at whether the current division is acceptable under pre-TRA '86 law. Then see if the plan division is reasonable and acceptable under the law as modified by tax reform. Some ways you can do that are look at the actual statute, Blue Books, or relevant committee reports. You possibly don't even have to look at the regulation.

Regarding good faith, there are basically a few guidelines and I think that you should be prepared to justify your position in case of audit. And, you should consult a lawyer in a case to determine if the position has good faith.

MR. SHARPE: Roger is very active in the employee benefit community in Chicago, not only professionally, but also by teaching law courses at Chicago Kent College of Law in the Masters and Tax Program. He is also very active nationally as well.

MR. SISKE: I don't want to deal with the 401(a)(4) regulations technically. It would take a week or two and then none of us would understand what each of us had said to the other. I'd like to deal with it more at a practical level. Where are we with the regulations? What are some of the problems with them? How are you going to practically comply with them over the transition period from now until, let's assume, the end of 1993, but maybe later? What ought we be doing now? Well, first of all, I think we better look at what I'll call an attitude adjustment, which the service has had. I testified on the proposed and final regulations, both under 401(a)(4) and 401(l). The attitude then was we want you all to testify, but we've already figured out what we're going to do. So that when we talked about doing different things, creating greater flexibility, and explaining practical problems, it was pretty clear that anything that didn't fit its model was going to be ignored. There is a definitively different attitude. I recently was talking with senior IRS and Treasury people about changes that were needed because some things that everybody had agreed should be allowed weren't allowed in the final regulations. They actually listened. Not only did they listen, but they came up with some constructive ideas to achieve what we wanted even though it departed from the regulation's scheme. So, as a starting point, they are listening.

What caused an attitude adjustment? Some of you who may be from smaller towns know exactly what an attitude adjustment means and how it's brought about. It's usually something swift and painful. And the same is true here. There's been a lot of complaints. The complaints have gotten to the Hill and they've gotten to the executive branch, including the list of targets of onerous regulations that really foul up industry. As a result, the IRS is hearing more and more of the same kind of footsteps it heard when it had the Section 89 regulations revoked legislatively. It doesn't want them revoked. The IRS people put a lot of time into this area and they want to make them more workable and get rid of the worst problems. The problems they're going to get rid of aren't going to be the ones that we tell them about after they fix the regulations. They're going to be the problems that are brought to their attention by actuarial, legal, and other groups sometime between now and perhaps the next six months. Although probably things that are brought to their attention after the next couple of months are going to take a back seat.

There's a whole range of things that they may need to deal with. When will regulations actually be effective? We aren't going to see a whole package of reissued final regulations. We're going to see adjustment seriatim. There was a meeting of a number of senior people from the American Bar Association and senior IRS and Treasury people last week and at it they said just that. We're going to deal with certain things within the next month or two and we'll deal with some more a few months later. So, if they stay on schedule, maybe we'll see it by year-end, maybe we won't.

One of the problems with that is we're back in exactly the same position with a 1993 effective date for the regulations as we were last year. If we don't know what all their adjustments are until we're nearly into 1993, we have the problem that their 411(d)(6) position compounds. They've effectively said if you haven't changed your formula and something accrues under it during 1993 when the regulations are effective, and you figure out what you should have done, you've got to top everybody up. That is, you have to come up with a compliant formula and make it a legal compliant formula where everybody gets not less than they would have gotten under the noncompliant formula. So, while the Service isn't prepared to suggest that they're going to delay the effective date again, unless they get all this out quickly, it seems to me that they're going to run into the same problem of not much choice. On the other hand, we, as practitioners, don't have much choice except to have our clients ready to comply in case the effective date doesn't get extended.

In dealing with compliance, there are a number of problems. As I said, this session isn't lengthy enough to go through all of the intricacies of the regulation, but I'd like to relate some concepts. One is good faith compliance, and I noticed the last slide said, see a lawyer. I always tell people, see your actuary. None of us really knows what good faith compliance is, but I think there are some practical suggestions. I'd like to relate good faith compliance to concepts dealing with effective date timing, determination letter timing, or just a practical array of what we all ought to be doing and what the IRS might practically be doing. The service has said something fairly obvious: "If you comply with the regulations back to 1989, you'll have good faith compliance. Anything else, we'll decide when we audit you. And when you get a determination letter, it will not cover whether you've been in good faith compliance before you amended to comply with the regulations."

Let's take a simple example. We amend the calendar-year plan effective January 1, 1993; we figure out what the regulations mean, and we bring it into compliance. For the four years between 1989-92, we have a plan that doesn't exactly comply with final regulations for a whole variety of reasons. Now, what are we going to live with? First of all, I don't believe you are ever going to see an aggressive enforcement program aimed at good faith compliance. The IRS has avoided putting good faith compliance into the determination letter program because it's very hard for it to describe. At private meetings with very senior people, they've said, "You know, if we bump into something and think it's really abusive, we're going to go after you on audit, but we're not going to be out there looking for you and we're not going to instruct our agents to be aggressively looking for things we can argue." But if it looks like you're so clearly over the line that no reasonable person could have taken that position, then the IRS is going to get you.

So, what that really means is, for example, if you did something before the 1986 act and you had a determination letter, or there were published rulings permitting it, then unless there's something in the new round of statutory provisions, including the committee reports, that say you can't do it, the presumption is you can. Now, you'll have to make a lot of judgment calls on the gray areas because they're sort of the spirit of the law. If you can't find something specific, can the Service come back and say you violated the spirit? If they want to get you badly enough, and if what you did looks abusive enough, I suppose they'll make those arguments. But it seems to me that if you can support it, either by determination letter or specific rulings, or

regulations under the old law, and you can't find anything that says it's bad, then it doesn't matter what the final regulations say. You have good faith compliance. A determination letter is going to be close to conclusive of good faith. We had good faith through 1991. Now, we're getting it through 1992.

I have a series of other things that I want to tie into it. The Service came up with this rather stringent 411(d)(6) reading, the anti-cutback reading. It said you must deal with the accruals that happened when you amend. You can't ignore your formula. And they gave us the model amendments. Without going through them in great detail, there were essentially three models plus something that wasn't a model amendment; it was called alternative 2(d). My guess is alternative 2(d) is one that you're using in the majority of your plans. It might be interesting for me to know that though. Can I see a show of hands of those who are preponderantly using 2(d) as opposed to one of the other alternatives? Surprisingly a small number. Model 3, total freeze? Straight model amendment 2 where you freeze off all of the highly paid employees, not just the super highly compensated?

I suspect a lot of people are saying, we don't know what the rules are and we're just going to deal with them when we get there. Model 2(d) and the other models essentially show, you won't violate any of the rules if you keep your old formula, your pre-1986 Act formula in effect. Model 2 essentially said, keep it in effect for everybody who's low paid and 2(d) extends the old formula to everybody who's not super highly compensated. That can be rolled forward, not only from the old 1991 date, but all the way through 1992.

There are a number of things that have nothing to do with the formula itself, but don't meet the final regulations that the model amendments can be very useful for. For example, an area that's going to become a hot topic, and a lot of people haven't raised it yet, is the portability issue. Simple case. You have a corporation that has a bunch of subsidiaries. Not all of them are 80% commonly controlled. The corporation has different plans at each subsidiary and a person moves from one subsidiary to another. Under the 401(a)(4) regulations, you can't have a plan that takes into account total service. If you do, you'll fail both the safe-harbor tests because you're counting service with a different employer because the same employer is only an 80% commonly controlled entity. And you can't count compensation across lines. The Service is struggling mightily with this, but it hasn't yet come up with an answer. Now, we won't know the answer probably in 1992. What do we do? Well, there's nothing in the statute that talked about portability of benefits, and that's what this is; it's the ability to move your service so that when you get all done, if all of the subsidiaries that aren't commonly controlled have an identical plan, you'll get the same benefit from a group of plans when you add it up that you would have gotten if you stayed under the same formula with one plan.

What do you do in the interim? Do you follow the regulations and say you can't do it? Or do you do something else? Again, there's nothing in the statute. Nothing in the legislative history that says portability is bad. The Service came up with some very technical regulations that make it bad. You had a determination letter on this before, you have good faith reliance in my judgment. So the two tend to fit together. The question then becomes, do you really need to freeze off all aspects? Can you put in a new formula that you know complies with the general formula aspects of

401(a)(4) and the integration requirements of final regulations and 401(l), and also keep pieces that you need, like portability, and other provisions that the final regulations don't allow. Good faith compliance or good faith reliance will give you a great deal of flexibility in this area as a practical matter.

I think as a professional matter, a professional can't give a client guarantee that he has good faith reliance. Opinions are never guarantees. Lawyers are the first to observe it and we learned how to qualify our opinions carefully. I think although you can give your clients some practical technical/business advice, which if something's really important to him and he's willing to live with a relatively modest amount of risk, good faith reliance will cause a lot of things that are important to be able to slip by.

When you look at the areas that the service is dealing with, where might there be changes? You've already seen some of them in this strange new animal, a proposed revenue procedure. I've never heard of them before. I'm not sure whether that's like a trial balloon. You send it up and you see if it's shot. I guess it's sort of like that. They have a project on mergers and acquisitions. The rules just don't work in the mergers and acquisitions area. The recordkeeping rules don't work and the substance rules don't work. They've already said they are going to loosen that up a lot.

Probably the critical area they're going to have the hardest time with, which is probably the most fundamental problem in the regulations going through 401(a)(4), cutting across 4(10)(b), the 401(a)(26) rules, and the separate line of business rules, is the Service's absolute desire to have a bright line test, a test where you can see whether it fits within some guidelines. We have an area for which it's very tough to have one set of guidelines or sets of guidelines that allow everything, and one of the goals that many of us had in talking with IRS and Treasury is to allow a much broader facts-and-circumstances test. For example, the general test is very specific. The rate group testing isn't as bad as the rule that no highly compensated employee salary could be any higher than the worst treated low paid test that the original proposed regulations had, but they're not much more liberal. Many people have said, you know, if the average of what the high paid employees get is not any better than the average of what the low paid employees get, however you measure it, that gives a strong indication of nondiscrimination at a very practical level. There may be a whole variety of facts and circumstances, but if you don't fit in this neat array of pigeon holes that they've lined up, it ought to be allowed. I think the Service will have trouble accepting that because it doesn't think it can administer it. It's probably the only solution that will make the regulations truly workable. I think it is going to loosen up the safe harbors.

One of the most problematic things in the safe harbors, in both defined-contribution plans and defined-benefit plans, are the uniformity requirements. I mean for example, uniform normal retirements, uniform percentages of pay, uniform vesting, uniform alternative forms of benefit. When you get all done, a plan that's essentially not discriminatory still may fall outside of the safe-harbor test. What they're doing can add a long litany of things, which will be treated as uniform even though they're not. They're going to pick the people who come in with the most problems that look like they have to be solved. The kinds of problems that, if not solved, make the regulations look absurd are going to get exceptions from these various requirements.

They'll need only a few employers. It's going to be very difficult to get these changes. They're going to try to tinker and adjust and loosen the pigeon holes up a little bit rather than rearrange them unless there's a huge outcry when they finish rearranging them. Well, what are we going to end up with when this is all done? It's hard to tell. I think we'll probably see the array that I've described and if they do a reasonably good job, we'll all suffer with the regulations and they won't quite work, but they won't be so bad as to produce enough ground swell to get them fundamentally changed. The next six months or so will tell.

MR. SHARPE: I would like to throw out the first question to our panelists. The first theory I would like to address is a general test, and we have a general test for coverage rules and for benefit rules as well.

I would like to start off with a case study that was presented at the Enrolled Actuaries meeting a couple of months ago. If any of you recall, it was presented by Ira Cohen. It involved the bakery. The purpose was to make a lot of dough and the owners of the bakery were named Sleazy and Greedy. Sleazy happened to be only 30 years old, yet he was the owner of the company. The problem was that Sleazy wanted an age- and service-weighted profit-sharing plan, yet because he was only 30 years old, he could not skew the benefits the way he wanted, that is, in his favor. And so the case study showed the plan assumed for practical and benefit purposes, that Sleazy, and I think a couple of other employees, but clearly not all the employees, would be age 60. Well, it works nicely when you go from 30-60 years old. That doubled his age weighting, not to mention his benefit.

The question that I would like to direct to Tom and Roger is that this obviously was not a safe-harbor plan, but it passed the general test. Tom and Roger, what are your comments and reactions to a plan that would demonstrate such behavior?

MR. SISKE: I guess I'll be the trial balloon then. I believe that if you meet a test mechanically and can demonstrate you've met it mathematically, but when you take a look at it, it doesn't pass the smell test, no matter what you say about what his benefit is, the Service is going to act to disqualify that plan. They have enough wiggle room in the regulations. While we're dealing with our questions, I'll see if I can find the precise quote. They have words in the regulations that essentially say, when we get done, if the overall effect is that you're discriminating, we will still disqualify it under 401(a)(4). This one strikes me as one that's easy. It probably not only violates 401(a)(4), but if you tinker with it a little bit, you'd probably find that it violated 415 and a whole series of other things because a 30-year-old simply isn't 60. If you accrue his benefits as though he were 60, you're just ignoring reality.

MR. SHARPE: I am not sure how serious we were supposed to regard that example; maybe it was supposed to be an exaggeration of a general test, but I was curious about that. I do not know if any of you have the same concern as I do with that example.

MR. SISKE: Ira would not have taken the same view when he was with the Service. If you asked him that question, he would have laughed at you.

MR. SHARPE: To continue with the general test, I am curious what percentage of the plans out there you feel will rely on the general test in order to satisfy the coverage rules or the benefit rules.

MR. MIANO: There was, I think, an informal survey of about 250 or 300 at the Enrolled Actuaries meeting. I think they said that most -- 40% of the plan of that group of people were being covered by a safe harbor, and 60% were doing general testing. I think my feeling, because I work with mostly larger plans, is that if a plan has not gone to safe harbor, based on liberalizing some of the tough requirements, most of the plans will stay with general testing. What I've seen in general testing is that most plans with that you might think will not pass, have ended up passing with general testing.

MR. SHARPE: Now, that would be for coverage purposes?

MR. MIANO: More for amounts testing.

MR. SHARPE: For amounts testing?

MR. MIANO: And sometimes it seems like it's a little bit harder for coverage testing.

MR. SISKE: Tim, you know, your question about plans using general tests raises a whole series of issues. First of all, most actuaries I've talked to seem to be leaning towards the general test. On the other hand, when you sit down at a lawyers group, the lawyers seem to think that you almost have to get into the safe harbor. That may be the difference between people who have quantitative skills and people who have verbal skills. I'm not sure. The Service views it as their project will be a failure if they can't fit somewhere between 80-95% of the plans into safe harbors. They don't think they'll have a structure in which they can administer effectively if the majority are in the general test. So, unless they're loosening up the safe harbors, their system is going to be no more able to follow plans than it ever could. They're going to be as continually overwhelmed as they have been, and that thing alone may lead to some sort of fundamental change in these regulations because on that sort of premise they don't work. And I guess the observation I make is there are a lot of very weasely things in the regulation, which, with hindsight, can be read differently than you interpret them when you apply the general test. The problem with relying on a general test is your arithmetic might be right, but your assumptions of what the legal requirements are for the general test may be wrong. You can't get much of a determination letter on a general test.

One of the real important things that I'd suggest each of you look at when you're running plans to the general test is the IRS Form 5300. You design the plan, you do the work, and you delegate the 5300. Look at it carefully and make sure there's enough disclosure in it so that the methodology you used for the general test is submitted before the Service in a way that the only way they can approve the plan in complying with the general test is by concluding that your methodology is right so that at least you get a determination letter on your methodology. If you don't have that, if you just show them the arithmetic, then essentially the actuary or lawyer or consultant who's saying you are passing the general test may be assuming a much greater liability than he or she cares to have.

MR. SHARPE: I am curious. Each year, many firms conduct studies relating to actuarial assumptions and so on. Will one of the questions be whether the plan passes safe-harbor testing or general testing? The question is on the annual surveys that the consulting firms perform. Will any of the questions deal with whether the plan is a safe-harbor plan or not? Apparently not.

One more thing I would like to ask about general testing, then I do encourage you to step forward in using the general test, what do you feel are comfort margins? I mean if I pass, right on the money, out to the second decimal point, chances are that next year I may be a little bit nervous. Should we be aware of comfort margins when using the general test?

MR. MIANO: A little bit of a tough question, but I think the size of your plan also matters a little bit. I think if you have a smaller plan in which you're close and you just passed, you understand with the numbers and averaging and things like that one or two people can really mess you up. However, if you have a larger population and you feel comfortable that your assumptions and methodology is conservative, and not aggressive at all, and you're passing comfortably and you have no major changes from year to year, I can't see you failing the general test year to year.

MR. SISKE: So what if you fail the general test? The Service has a relatively unusual technique that's permitted under general testing that allows you ten-and-a-half months after the end of the year to amend your formula so as to pass the general test. And I think Tim is asking can we do the test once and ignore it for a while, and my answer is, not unless you're an insurance company selling favorable determination letter insurance. It seems to me that unless you meet it by a very broad margin, it just makes sense to run the test every year for a number of reasons. You not only need to know whether you passed the prior year, but you also need to know where you're going the next year. Once the year's over, you test it. If you fail, it's not necessarily a big deal.

If you were just over the good side of the test last year and you're just over the bad side of the rule, you can keep your basic formula intact, you just have add-on's. It's like balancing a scale. If the scale just balanced last year and it has 50 pounds on both sides and then it tips a little because an ounce was added, now that it's unbalanced, you don't have to redesign your whole formula. You need to put an extra ounce on the other side to balance again. It might be a one-year accrual directed to low paid employees or directed to the lowest of the low paid employees. When you're at all close, run the assumptions each year.

So, if you start by getting the determination letter on the methodology, assuming you use consistent methodology, you're going to be pretty safe if you know each year, just after the end of the year, where you stood and where you project yourself going for the next year. You project so you can anticipate cost increases. You check so you can put that extra ounce on for the prior year so that you don't have your plan disqualified. I don't think you can come up with a rule of thumb because we've seen some very large clients run the numbers and there are changes, for instance, they buy some subsidiaries, they sell some people, they embark on a new hiring scheme that hires older people, or younger people. The specifics of how the general test applies

can change quite radically. A turnover in work force can change it radically. Often it's hard to spot whether there's enough of a trend until you've run the numbers.

MR. SHARPE: My feeling with the general test is if I have a scale that is going back and forth by an ounce or two and I am talking about adding on a small piece to a lower paid group one year to make it pass, mathematically and theoretically that sounds fine to me. But, in practicality, if you are a human resource director and you send out some type of communication to somebody and say, this year, we are going to give you an additional benefit but then next year you won't need it, so you won't get it, then you will have all these employees coming to you asking, why they did not get the additional benefit this year? There are some emotional issues there that cannot be ignored. Maybe the answer is to treat it like we do our taxes. Once we have finished and we pass, we do not worry about it for another year.

MR. ARTHUR L. HALLETT: My question is that, as we do these tests, they are becoming much more cost effective. The general test is very cost effective and if we have comfort margins of 15-20%, we are very comfortable advising our clients. The general test covers a lot of practical issues that the safe harbors do not.

MR. SHARPE: Well, I must confess. My first reaction when I saw the general test was that the safe harbor is the way to go. Why bother with the general test. You had to have a good reason for it. For example, the client is set on a benefit formula that is not one of the safe harbors. One of the things I am curious to know is how reliable is the general test? Has anyone ever seen a plan that will not pass the general test? Art, could you summarize what you think our objective is with the general test, where do we ultimately go with it?

MR. HALLETT: I'm suggesting that the general test is going to be such a cost effective tool for our clients that they are going to ask why we even need a safe harbor.

MR. SISKE: I think in some cases your remark is absolutely correct. In other words, if you know on a rifleshot basis that you want to do certain things and they don't fit in the pigeon holes, your choice is to spend a certain number of dollars and not deliver as much of a benefit to one group as you want to and too much to another group, or spend a lot more than you want to in order to get one group up to the level you want. You're clearly rifleshooting with the general test, but I don't think it's an all or nothing. I'm not willing to say, at this point anyway, that I generally want to use the general test. I think you have to have an employer with sufficiently peculiar or sufficiently specific wishes that can only be met efficiently under a general test. If you can find a way of meeting it under a safe-harbor test, first of all, you aren't having to do the test. That's a savings. The client won't be subjected to the risk of testing, that's a benefit. And when you are done, we're going to end up telling clients, you ought to pass, but we can't guarantee it. And clients are going to say, predictably, they want certainty unless the benefits they get justify taking the risks that are inherently associated with something that's facts and circumstances.

MR. DONALD S. GRUBBS, JR.: The announcement 92-81 greatly simplified the general test for everyone, particularly on the data problems. Several weeks earlier, the Treasury had been talking about developing a simplified general test for those

plans that couldn't make the safe harbor and were the better of those plans. Does announcement 92-81 help everybody on the general testing, so that you should drop the idea of a simplified general test?

MR. SISKE: I don't think you can really judge. I think they'd like to see if it's a trial balloon. I think that the simplified general test starts being something that looks at average benefits, which, as I said earlier, they clearly don't want to do. I know, Don, you were at the hearings and you saw their attitudes. But it may be the only way the IRS is going to be able to go is to have a general test that asks whether it discriminates rather than this hyper technical approach it has taken, but I think it is going to see which way the wind is blowing and how hard.

MR. GRUBBS: I have a couple of questions on the efforts to simplify the safe harbors. You talked about things that violated the uniformity rules, but might not be too bad. Let me give an example. Would a plan that's limiting lump-sum distributions to an amount under some fixed-dollar amount. So, you only pay lump sums if it was $25,000 or less, would that be one of these harmless nonuniformed things.

MR. SISKE: These expansions of uniformity rules ought to be done on logic. They're clearly not going to be. The way they're going to be done is like those old TV shows where they had the applause meter or the complaint meter; the service has it's complaint or applause meter going and the shriller the screams, the more likely an exception from uniformity is going to be permitted. For example, what you just mentioned, inherently sounds like it ought to be nondiscriminatory. Intuitively you'd allow it, but the IRS doesn't like things that aren't uniform. They're going to yell if they don't get that as an exception.

MR. GRUBBS: Regarding expanding the safe harbors, one issue that a number of people have raised a question about is whether there would be a safe harbor for age-weighted profit-sharing plans, since you know the category plans can pass the general test if you run them. Will we have a safe harbor for them?

MR. SISKE: I don't really think you're going to see it. I'd like to tell you they will. It would be very sensible, but, they still have a mind that if there's any possible abuse, better to screw up 1,000 good cases than have one bad one slip through.

FROM THE FLOOR: Another would be a request from industry to expand the safe harbor deals with primary insurance amount (PIA) offsets plans asking that at least those PIA offsets that don't have an excessive amount of offset, maybe those that meet the two-for-one rule, or have other restrictions on them, would have a safe harbor. Do you think we're going to get something like that?

MR. SISKE: I asked that question about three weeks ago and they weren't too polite to anybody who suggested keeping PIA offsets. They don't seem terribly receptive in that area. I think it's illogical because a lot of us thought that you could keep them and just have an automatic – but if that doesn't give you what the regular rule requires, we revert to the statutory rule. And they went way out of their way to avoid giving a safe harbor for PIA offsets. I think they're looking at future changes. I mean maybe I'm cynical, but so long as you have a PIA offset plan, it's much tougher conceptually to limit integration and cut it back progressively. I think some of

the liberal thinking that's behind cutting back on integration sees this as just the first step. Once you get to disparity rather than offset, it's much easier -- disparity sounds like you're getting something you shouldn't get. And that's what they're all about and I think they're going to fight that one. It's wrong. They ought to allow it, but I think they're going to fight it unless they just get overwhelming pressure.

MR. GEORGE J. ROCCAS: I would like you to describe the types of plans where only the general test will work.

MR. MIANO: One type of plan would be a floor plan. If you have a plan that's offset by an employee stock ownership plan (ESOP) or something like that, you have to use the general test to be able to pass that in that you need to pass on a net basis. What I've seen is that plan has passed, but I would be less hesitant to say that each year it's going to pass because of the swing in the stock value.

MR. ROCCAS: Another type of plan I have seen is where the benefit accrues over a short period of time, say 20 years.

MR. SISKE: The place I've seen it the most often is where you're using plan aggregation to meet the coverage test. In other words, any time you take two plans that aren't the same, you fail the ratio test but you want to pass the ratio test rather than fooling with the average benefits test, or maybe you can't pass that either. Let's assume you want a safe harbor on a ratio test. You aggregate two or three or four or five different plans. Let's even assume they're all defined benefit or all defined contribution. There, you're almost forced by definition into a general test. So the bulk of the ones I've seen have been that type of thing.

MR. ROBERT E. DOUGAN, JR.: I just want to add a follow-up to a comment that Roger made earlier that the IRS is hoping that 80-90% of all the plans will fall into the safe harbors. I find that directly in contradiction to your adamancy and resistance to a PIA offset safe harbor. I think the test that most firms have done on reasonable PIA offset formulas have indicated that they passed the test. They're not discriminatory. They passed on wide margins and yet the IRS won't give us a safe harbor for them. A lot of clients have been actually convinced by the studies that we have given them over the years that replacement ratio studies show that the PIA offset is an effective type of formula and we are showing them now that it passes the nondiscrimination test. A lot of clients are simply not going to go away from that. I don't see how the IRS expects 80-90% of the plans to meet their restricted set of safe harbors.

I think the observation is correct if people stick with their PIA offset plans. In some ways the IRS is making a heavy bet that people will find that the replacement ratios don't have the mathematical correlation when you add retirement benefits from the pension to retirement benefits from Social Security that they would with an offset; the two just don't add up if you don't have one as an offset. They'll be close enough that people will live with it, but people won't look for perfection, they'll look for it to be reasonably close if they can get easier compliance. Now, if they're wrong and if people persuade the IRS that it is wrong, this may be one of the most persuasive cases you can make for a PIA offset form of safe harbor, but the service and Treasury have very strong philosophical views. They're philosophically opposed

to it. It has nothing to do whether it's discriminatory or not because I've seen people give them studies that show that actually the PIA offset (contrary to their view, which is it's inherently more discriminatory than permitted disparity), over time is inherently less discriminatory. But they don't care. They're philosophically opposed to it.

MR. SHARPE: There is an old adage that says, "If you can't measure it, you can't manage it." I think Roger is saying that and I think he's right. Whether the plan discriminates or not, the IRS, to me, ideally would like to have the safe harbors and enough of them so that they do not even have to test these plans. If it is a safe harbor then it is a done deal and they do not have to to worry about it anymore. Perhaps, what may happen is that if they do not get the percentages that they would like to see and many general test cases fall into the same category; for example, they are all PIA offset plans, maybe that is one of the ways that leads to the addition of another safe-harbor plan.

Can somebody answer a question regarding the cumulative disparity limit? I am comfortable with how it relates to defined-benefit plans. But I have heard conflicting views on the cumulative disparity limit, that is the 35-year fraction. How does that impact defined-contribution plans?

MR. MIANO: My understanding of it is that there is no cumulative disparity limit for a defined-contribution plan, but there is one for defined-benefit plans. Taking that a little bit further, if you have a defined-benefit plan and your cumulative disparity limit is under 35, you could terminate that integrated defined-benefit plan and then start up a defined-contribution plan that's integrated and never have to worry about cumulative disparity limits since I think the regulations sort of talk about that. If the cumulative disparity limit has not been reached, then you don't have to make any adjustments in your integration levels for a defined-contribution plan.

MR. SISKE: I can't look back through the regulations quickly enough to actually pull it out, but my sense is somewhat different and maybe it means we both should go back and look. If you had a defined-contribution plan that offered integration for a number of years and then you wanted to have a defined-benefit plan that offered maximum permitted cumulative disparity, it's my understanding that the service has said you can't do that -- you've used up part of your limit. Therefore, while you only have a defined-contribution plan, the cumulative disparity limit is irrelevant because you can't, in any single year, have disparity greater than the annual permitted for that year. If you've ever had a defined-contribution plan and you also at some time have a defined-benefit plan and both of them use integration or disparity, I believe they both enter into it. I'm troubled that I don't remember exactly how it works. But my best guess right now would be it would be a lot like the combination fraction limit under the 415 rules. The defined-benefit fraction is keyed to just a number and the defined-contribution fraction is a cumulative comparison of each year's limit to what's actually used each year. Assume you didn't use imputed permitted disparity, in which case, each year you're assumed to have fully utilized it. You have to consider both of them, but you can't, in effect, fully use defined-contribution disparity and use defined benefit on top of it.

FROM THE FLOOR: As a matter of fact, I believe that they say for defined-contributions plans you are to assume you are using 5.7% even if the plan uses less than the 5.7%.

MR. MIANO: Roger, the situation I was talking about was that you have only a defined-benefit plan and you have not reached your 35 years of cumulative disparity and then after December 31, 1991 you terminate that defined-benefit plan and the regulations, I think, say that after December 31, 1991 if a person does not participate in a defined-benefit plan, then their cumulative disparity limit is satisfied. Looking at it that way, if a person does not partake in a defined-benefit plan, they can start up a defined-contribution plan that's integrated and they don't have to worry about the cumulative disparity limits. It's only one plan.

MR. SHARPE: Section 1.401(l)(2)(c)(2)(ii) that says permitted disparity for defined-contribution plans, overall permitted disparity. In essence, for an employee who has reached the cumulative disparity limit, employer contributions must be allocated at the excess contribution percentage. I think it means if my plan provides 5% below and 10% above the integration level if this person reached the cumulative disparity limit, I have to give 10% of all compensation to him. Are you saying, Tom, that if I never reach that limit, which is 35, and I have an employee who has 34 years of service in a defined-benefit plan and I switch him over to exclusively a defined-contribution plan, that in essence he will never reach the cumulative disparity limit, thus he can remain in an integrated defined-contribution plan?

MR. MIANO: That's how I'm reading it.

MR. SISKE: I was going to say I think the point that comes out of that is that it's like a grandfather rule. But if you have both defined-benefit and defined-contribution plans, quickly turning back to the regulations, it's clear that you have to build both the DB and the DC into the cumulative disparity fraction.

MR. JOSHUA DAVID BANK: Could you spend a couple of minutes talking about early retirement windows and how, for instance, unreduced early retirement benefits can work into both nondiscrimination and say a permitted disparity? For instance, can you discuss applying, even an extreme case, the old PIA offset grandfather benefit updated for salaries and provided on an unreduced basis, or even a new covered compensation step-rate formula unreduced?

MR. SISKE: First, a broad observation and then I'll come to the specifics. I eluded to this meeting with senior people at IRS and Treasury last week. They expressed great desire to allow early retirement windows. I should have mentioned it earlier; that's one of the areas that they're intending to try to liberalize as much as they can. Now, what they'll actually do is hard to tell, but it does suggest they're going to liberalize it somewhat. Their present position, as you know, for coverage purposes is that your window eligible group has to be a group that passes the coverage rules and if it doesn't, then stop right there. The window is bad and putting it in the plan would disqualify the plan. And they've never allowed much of a mix and match concept, such as while this doesn't satisfy the coverage test, you do something else that's more beneficial for low paid employees, that won't wash it. Now, when you look at a window, the basic concept is, if you allow somebody out earlier, the amount of

permitted disparity effectively has to get reduced. They have that series of tables under the old rules that lays out how much it has to be reduced. You end up with the same thing you used to have under the old Revenue Ruling 71-446. When you have an absolutely unreduced early retirement benefit with a plan that's integrated or has disparity with the same formula, you actually have to give him more at 55 than you'd have to give him at 65. If you're using an offset concept, you can't offset as much. So, it's a strange result, but that's the result that the regulations dictate. I don't know if that fully responds to your question.