LATE BREAKING DEVELOPMENTS

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Recorder: LEONARD MACTAS

This session will offer a review of recent regulations, rulings, and proposed legislation affecting retirement plans.

MR. LEONARD MACTAS: Scott Tucker is a graduate, so far, of DePaul University, the London School of Economics, and the Indiana University School of Law. He's a Principal with William Mercer in the Washington office in something Mercer refers to as the Washington Resource Group, which is the central arm of Mercer dealing in technical issues and generally providing service on legal and related matters to the consultants in the organization. Earlier Scott was in with the Mercer consulting office in Columbus.

MR. SCOTT TUCKER: I was intending primarily to talk about the PBGC reform proposals. We'll do that toward the end, but since we're a little undermanned we'll go ahead and try to pick up what we can. First of all, and I'm sure this is no surprise to most everyone here, the IRS came out with most of the final regulations for nondiscrimination coverage. The replacement 401(a)(4) regulations came out at the end of August 1993, and then within a few days the amendments to the regulations for permitted disparity, minimum coverage, and the definition of compensation came out. Then the IRS also proposed changes to the separate-line-of-business regulation. So, other than the needed revisions for Section 401(a)(17), which is the maximum compensation limit, most of the 401(a)(4) regulations are in place. I'm not going to go into them really in much detail other than to say that in the main the IRS adopted the changes that were proposed earlier in 1993, in January with the 401(a)(4) regulations and in April with the rest of the regulations.

There were a couple of changes from the proposed regulations primarily in the 401(a)(4) area that you might want to take note of. The IRS made a significant change to the fresh start rules. I don't know if everyone's familiar with those generally under the 401(a)(4) regulations. Those are instances where you can freeze a benefit and then go forward with the accruals after that basis to do your nondiscrimination testing. It used to be that you could only index those frozen benefits according to a fraction of compensation, and the IRS changed it so that you can actually update those frozen benefits using actual compensation. That's probably the single, most significant change, I think, at least from the proposed 401(a)(4) regulations. But other than that, the IRS has not backed off its 1994 regulatory effective date in order for plans to comply. Plans are going to have to be amended by the end of the 1994 plan year to comply with the final regulations.

I do want to say a few things about 401(a)(17), mainly because of the lower compensation limit (lowered to $150,000) effective with the 1994 plan year. That happened, as you know, over in 1993. That's created some uncertainty, and the IRS

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is expected to announce revisions to the final 401(a)(17) regulations within the next few weeks, but it has made a few comments publicly that give us some indication of what those revisions might be. A representative from Treasury has said, at an American Bar Association (ABA) seminar, that the IRS is going to apply the $150,000 retroactively, beginning with the 1994 plan year. Basically, that would mean, in a final average pay plan, every year in the average would be $150,000, effective with the 1994 plan year. That's what the IRS did with the $200,000 limit back in 1989. There was some question whether it would do that or not, because if you read the current final 401(a)(17) regulations, the examples in there look like you plug in each year's limit as you go forward after you get past 1989. Some people might have thought that $150,000 was just another limit, albeit lower, but the IRS has said, no, it is going to apply the $150,000 retroactively. The IRS has also seemed to indicate that you should be able to use some of the transition rules for start dates that are in the final regulations effective with the $150,000 limit. Well, that's welcome news. I assume that you'll be able to then use the 401(a)(17) fresh start date just for the employees affected by the $150,000 limit. You can use A plus B and wear-away, and extended wear-away.

Having said that, there's really an important timing issue here. How do we decide which of the transition rules we're going to use up to the end of the 1994 plan year? But you have to probably grandfather any benefits that you want to go into the end of 1993 by the end of the 1993 plan year. And that means that some plans that are using final average compensation may want to use the current plan year limit, $235,840, retroactively for all prior years. The IRS has said that that's a good faith interpretation of the current guidance, so that you could go ahead and do that – increase the amount that then would be grandfathered. That's not great, but you probably have to take some action to do that before the end of the 1993 plan year.

MR. MACTAS: Scott, is there any likelihood that the IRS may relent on the deadline, the end of the 1993 plan year? Is there any provision for the IRS to do that?

MR. TUCKER: No, I don't think so. I think the IRS feels that it has most of the guidance out there – that there are really just the technical issues on 401(a)(17), and then it has the proposed separate-line-of-business regulations yet to finalize. Most of the proposed regulations are actually liberalizations to those changes, and the IRS doesn't know how many people are going to use separate line of business for the regulations anyway. But our best information from talking to people at the IRS is that it is not backing off the 1994 regulatory effective date. In fact, during this last go around when the proposed regulations were issued, the IRS received relatively few negative comments at the hearing on these proposed regulations earlier in the year. There wasn't the kind of groundswell for delaying the effective date that there was a couple years ago.

MR. MACTAS: Well, if the IRS doesn't delay the effective date, is it a fair presumption that, in general, the IRS will let you go ahead and do the anticutback-type approaches with the new limit more or less in the image of what the IRS was prepared to permit when the limit was $200,000 plus?

MR. TUCKER: Right. I think that's right, and the IRS seems to indicate that informally you can use the same fresh-start-date methodology and grandfather the benefits as of the end of the 1993 plan year and then adopt an A plus B approach, if you wanted to, which is primarily more favorable. So that's where we are with 401(a)(17). That's the one piece that really isn't out there yet, although I think we have a good feel for what the IRS is going to end up doing. I brought it up mainly just to make sure that people are put on notice that they needed to think about how to effect the accrued benefits in 1993 that you might ultimately want to transition in. There's a real argument that you would be able to use the $235,840 to increase your benefits as of the end of the 1993 plan year if you'd gotten into the 1994 plan year. Because effectively the statute says you can't use any compensation more than $150,000 in determining benefits even if it was for an earlier year.

MR. DAVID B. WEINSTOCK: Let's say you had a defined-benefit plan that defined your high pay as the high three-year average or historical high three-year average, and you lock into that and use the future accruals as of 1994.

MR. TUCKER: Well, I think you'd end up with a grandfather benefit as in the 1993 plan year, and then you'd have to start over with $150,000 as the maximum compensation that could be used in your plan formula.

MR. WEINSTOCK: So you're saying the accrued benefit would be grandfathered under the $235,840 as of the end of 1993.

MR. TUCKER: Right. And it's not just, for instance, final average pay plans that may want to worry about this. If there are career average plans that typically do pay updates and the sponsor was considering an update sometime next year, the sponsor may want to accelerate it and do it this year because, otherwise, the career average compensation update might be limited by the $150,000.

MR. MACTAS: Scott, there may be a subsubject of interest on 401(a)(17) among the people here. Let's get a show of hands. How many get involved in excess plans or supplemental executive retirement plans (SERPs)? There's a good enough proportion that this may be of interest. Perhaps we can take a detour.

Those of you who do SERPs now, when you do your SERP calculation and determine who you project to be in the SERP at some future date or those who will be covered under a separate unfunded plan, (people whose earnings will be in excess of the limit, which is currently $235,840 indexed by the time they retire) do you include people who are above the current limit or the indexed limit in your calculations for the SERP? In other words, we mean the employee group whom you include in the calculations for the excess plan. Is it those who are currently say over $235,840 or those for whom you project the pay will be over $235,840 with salary increases? How many do it just based on the current pay limit?

FROM THE FLOOR: Are you referring to financial accounting standard (FAS) or funding purposes?

MR. MACTAS: I mean for any company purpose, whether it's for funding or for FAS calculations. I presume for FAS calculations you're generally consistent between the

qualified plan and the excess plan -- that you're projecting all the benefits under the combined plans. Well, I take it most of you are projecting compensation and then determining on the basis of the projected compensation whether a person will be over the $235,840 indexed limit in order to include the individual in the calculation. Not so?

MS. MARGARET M. WARNER: If you are funding typically for an excess plan, you're not funding projected benefits, you're just funding accrued benefits. But for FAS typically you're valuing a projected benefit obligation (PBO) sort of number. I mean if I'm setting up a secular trust and I'm really funding benefits, I don't fund anything more than I'm actually willing to give employees. That's what I find companies doing.

MR. MACTAS: Is that the general practice among people here?

FROM THE FLOOR: I might address a couple of things. Normally on the excess plan you would value it just like you would value a regular *FAS 87* calculation and only take the difference between that and whatever you're projecting under your regular FAS limits. In a previous comment you were asking about who is covered by these plans. A lot of companies like to take the stance and define a particular group as opposed to pay levels, that is, the senior vice president above or something like that, which you can clearly do in excess benefit plans. One other observation in case we get trapped in the 401(a)(17) trap that we got caught in last time, it's probably going to be worthwhile to install a wear-away formula equal to your accrued benefit at December 31, 1993, plus a future service benefit on and after January 1, 1994, knowing, of course, that you have to limit your pre-1993 disparity to total of 35. But I think you're going to be doing your client a disservice if you don't do that.

MR. TUCKER: Just two points. He's right about the transition. You have to think about that if you want to use extended wear-away. It's also true that I think a number of nonqualified plans, maybe not the majority of them, but some of them, may not have been careful in the past as to who they included. They may simply have meant to include somebody whose benefit was limited by 401(a)(17). If that was the way the plans described the eligibility provisions, if they didn't look at those plans and perhaps amend them, then technically someone who had compensation that was less than $235,840 but more than $150,000 might be brought into the plan inadvertently as of the beginning of the year. So you just need to review your nonqualified plans and make sure that doesn't happen.

Well, if no one has any other comments on 401(a)(17), I guess we can maybe move on a little bit and talk about some of the revenue procedures that the IRS came out with just at the end of September 1993. I assume everyone knows by now that the IRS has opened up the determination letter program. That was effective October 12. All filings have to meet the new requirements in the revenue procedure. That's going to change things a little bit. There's now going to be a two-track filing procedure. You can file a basic letter, which covers all form requirements and certain core, nonform requirements like the 401(a)(26), or you can expand your determination letter request and, also, get coverage on certain noncore, nonform issues like nondesign safe harbors, general testing, average benefits test, or whether any of your benefits rights and features have passed the 401(a)(4) regulations.

The IRS has taken the position in the revenue procedure that, in order to get a letter for years earlier than 1994, you have to amend the plans to comply with the final regulations. Also, it has ended its reliance period to all individually designed plans. The reliance period allows you to amend the plan, get a determination letter, then not have to amend it again for any changes in the regulations. You have to amend it again if there's changes in legislation, but you don't have to amend it again for changes in the regulations. The problem with that is you're going to have to get the filing in by the end of June in order to get that extended reliance.

At the same time the IRS came out with the revenue procedure for determination letters, it came out with two revenue procedures affecting separate lines of business, one on the notification provisions. In order for you to be able to maintain a separate line of business you have to notify the IRS that you are. The revenue procedure 93-40 indicates those procedures. The IRS also had a revenue procedure covering individual applications for administrative scrutiny, and determination sets under the separate-line-of-business regulations as well. If you cannot pass the administrative scrutiny requirements under the regulations, then you have to have an individual application.

Another one of the revenue procedures that came out was one on the data requirements or at least the liberalization of the data requirements for passing nondiscrimination coverage. Basically, in 1992 the IRS had proposed a revenue procedure where you were going to be able to use something less than precise data as long as it was the best data available at a reasonable cost, and the data created a high likelihood that you were going to pass the test; and it also allowed you to use a snapshot day in testing your plans -- a day in which you determined the universe of employees of the particular day and then you could test on that basis. And, also, the IRS had a simplified procedure for determining how to compensate employees and also allowed you just to test once every three years. Well, basically the revenue procedure that came out at the end of September 1993 adopts all of those provisions in a final form, as well as adds some other simplifications for collecting data for separate lines of business and multiemployer plans. So those four revenue procedures are designed to help complete the package, and allow employers to be able to implement the nondiscrimination coverage regulations in time for compliance with 1994 plan year.

I don't know if anybody has any questions on any of those or not. They're mainly implementation guidelines. They're something that you'll probably have to read at the point when you do your actual testing, either in the general test or in deciding how you're going to show the plan's past coverage.

In the data Revenue Procedure, there were a couple of simplifications. One, the IRS is going to allow you to pick your highly compensated employees using almost plan-year data. You're going to be able to do that regardless of whether you picked a snapshot testing day or not, either for compliance testing or determining highly compensated employees. And you can do this, too, even if you haven't used the calendar-year election under highly compensated employee regulation. So this is going to be fairly advantageous, I think.

One thing the IRS has done, too, that's going to help out some employers, is those employers who have already amended their plans to comply with the tax reform and

have done their testing can use that as the beginning of their three-year testing. In the earlier revenue procedure and as confirmed in the most recent final revenue procedure, you only have to really test once every three years as long as you're satisfied that those results are still holding up and are good results. So what the IRS has done is say, well, if you have already done your testing, then you don't have to start over again in 1994.

I'm not really going to say anything about the two revenue procedures that had to do with separate lines of business. I'm not sure how much interest there is even yet with those. I think people are still waiting to see whether the proposed changes that the IRS proposed earlier this year will, in fact, be sufficiently flexible to be able to use separate lines of business in compliance testing. Generally speaking, those changes helped out because they allow you to count fewer individuals who spread their services among different subsidiaries, and they also say that you don't have to count nonresident aliens in your testing.

There is another series of revenue procedures, four of them, that came out the end of September, that we might want to get into a little bit. The voluntary compliance resolutions (VCR) that the IRS introduced in the fall of 1992 allows plans with an operational defect to present a letter to the national office highlighting that operational defect, proposing a correction for it and then they could get a compliance letter from the IRS blessing the correction without disqualification of the plan. The primary advantage is, you don't have the tax consequences that occur when a plan is disqualified. The disadvantage is, you have to pay for the correction. In any case, I think that was the program. It was set to expire at the end of 1993. The revenue procedure that came out recently extends the program to the end of 1994, which is good news. It also had in it additional information on how to use the program, and the IRS clarified the types of defects that you could have and use the program. For instance, in the original announcement of the program in 1992 the IRS said, if you had what it called "repeated and flagrant" defects, you couldn't come in and now you still can. Basically I think the IRS is trying to open the door a little bit wider and allow more people to come in unless it feels that people had been particularly bad with the plans or were doing something with the assets. But the IRS is trying not to push people away.

And the other thing, and this was much more interesting, is that the IRS said that you cannot use the VCR program for defects that arise out of qualification requirements that were effective on or after the 1989 plan year. Basically, that means that, if you have a tax-reform-related operational defect, you can't use the VCR program. The position the IRS has taken apparently is, you can amend your plan to comply. You have until the end of the remedial amendment period to comply so that you can correct through that mechanism. That leaves open the issue, if you have an operational defect under tax reform, how in the world are you supposed to get a letter from the IRS saying that you corrected it? The only way you can get a VCR letter is really on the tax reform defect, and it's been amended for tax reform and then the operational defect arises. So that's something that people are still trying to clarify.

The revenue procedure also provides some guidance on how you're supposed to correct some of these defects. Basically it wants you to keep assets in the plan, if at all possible, although if there's a correction mechanism that is otherwise available

under the Code like 415, then you can under 415 have some distribution in order to reduce an excess annual addition as an example. The IRS also wants you to restore any lost contributions or benefits to employees, and if there are any allocations that need to be made, you have to adjust for earnings and forfeitures. So the IRS is making it very clear that most of the corrections are going to be all-encompassing. Again, that may be one of the reasons why not a lot of people have jumped forward to use the VCR program. It's good that at least the IRS has put out the guidelines as to what it is expecting so that you can have some sense as to whether you want to proceed or not. And the other thing that the IRS did in the revenue procedure is it announced a standardized VCR program. If you have a limited number of certain kinds of defects, then you can sort of self-correct and just notify the IRS of your self-correction. It's really a minimal filing. Do what the IRS asks you to do and notify it that you've done that and pay the IRS $350, and it will send you a compliance letter. You don't get involved in any negotiations with the National Office.

There are just a few of those types of defects that the IRS has identified that you can use. If you have a top-heavy plan and you fail to make the top-heavy minimums, then you're supposed to make a top heavy minimum using the procedure. If you have a plan that has excess deferrals and you simply distribute the excess, you can use the procedure. And then if you have a plan that has excluded eligible employees and you have to make up contributions for their accounts, you do the procedure. In those instances all you would have to do is make the corrections, describe how you did them in a letter, send that to the service along with $350, and then supposedly within 90 days the IRS will send you a compliance letter and you don't run the risk of the plan being disqualified. So that's something to keep in mind in case you run across one of those types of situations.

Those are the five main revenue procedures that have come out over the last several weeks; the most recent four of them really having to do with the implementation of nondiscrimination coverage. The one having to do with using less precise data and the three-year testing cycle is especially helpful when plans try to implement the nondiscrimination coverage regulation. Are there any questions about any of those?

MR. ROBERT GOGGIN: I have a question about that three-year period for the testing. I think in your example you said that let's say you have amended your plan. It's now clear that you can use that as a beginning of a three-year period. I have two questions really. Is plan amendment really part of that issue? In other words, let's say you decided not to change a formula at all. You've done a general test and passed it, based on whatever guidance you had available a year-and-a-half ago. So is a plan amendment really an issue as such?

MR. TUCKER: Well, I think the plan is going to have to comply with the final regulations in order for you to be able to start your three-year testing cycle. It may not take an amendment, that's true. Some plans may have already complied.

MR. GOGGIN: The second part of the question is, could that test that you've done, the 401(a)(4) test, could that be based on so-called substantiation quality data?

MR. TUCKER: Sure, that's right. That's the less precise data that the IRS will allow you to use as long as you think that it's the best data available at reasonable cost

and there's a high likelihood the plan's going to pass using more precise data. And that's basically using valuation data. That's the best example to show that your plan is going to pass that general test. One of the minor changes that was in the recent revenue procedure that is probably worth noting is that, when the proposed revenue procedure came out in 1992, it was a little unclear what you had to do if a sponsor had both a defined-contribution plan and a defined-benefit plan. If the justification for using less precise data was that you didn't have it or didn't have it easily and you had a defined-contribution plan, then you had more precise data, should you be using that to do your general test? The revenue procedure that just came out said, no, that even though you have a defined contribution, that doesn't mean you can't use something more like valuation data to do the test. Again, the IRS has adopted what it proposed in 1992 and then simplified it even further, which is good. The IRS is clearly trying to make the rules easier for sponsors to live with, make the testing burden a lot less, I think. I remember a couple of years ago when the first set of final regulations came out. The overwhelming reaction, of course, was that the IRS was asking employers to come up with something like benefit certification data simply to be able to do the general test so that they could demonstrate they were nondiscriminatory, and for larger employers especially that was a serious problem. I think the IRS has gone a long way to try to mitigate some of those difficulties now with that one particular revenue procedure. I guess there aren't any other questions on those revenue procedures?

We can move on to the PBGC reform proposals unless somebody has any questions on some of the final regulations or other guidance that has come out recently. Now, this is certainly the most recent development -- so recent, in fact, that the PBGC has really yet to introduce a bill. The PBGC announced at the end of September 1993 what its reform proposal is going to look like, and this was, as you probably know, in response to some of the pressure the PBGC was getting from the Hill, specifically, Congressman Pickle, who was Chairman of the House Ways and Means Oversight Committee. He had held hearings earlier in the year on underfunding in defined-benefit plans and the long-term solvency of the PBGC, and it looked like he was about ready to move on his own bill. The administration stepped in and said it was appointing a joint agency task force to look at the issue. I think the administration is basically trying to delay the considerations a little bit, but the reform proposal that it announced is basically what the joint agency task force came up with. And so far the provision that has received the most press play is the provision to eliminate cross-testing in defined-contribution plans. Basically, the provision is attempting to attack what the administration sees as the use of age-weighted profit-sharing plans. That's the provision I think that's been written up the most. But actually the main focus of the bill is really just to speed up funding of the underfunded defined-benefit plan. The administration has decided that it can't continue the subsidies for the variable premium, which I'll talk about in a minute. The administration is going to take off the cap. It doesn't think it can restrict any of the benefit guarantees the PBGC has in place or keep plan sponsors away from increasing benefits. In the reform proposal, there also are a lot of miscellaneous provisions that are going to affect other plans besides just underfunded defined-benefit plans or age-weighted plans. The reform proposal provisions are going to affect a lot of ongoing and terminated plans, as well.

As I said, I think the key of the proposal is trying to improve the minimum funding requirements for underfunded defined-benefit plans. The proposal is going to do that I

think in three ways. It is going to strengthen the deficit reduction contribution (DRC). It is going to adopt a plan solvency rule and then also require immediate recognition of negotiated benefit increases. The strengthening of the DRC, again, is going to happen, according to the proposal, three different ways. First of all, the administration seeks to eliminate the double counting of gains in the DRC, as I understand it. I'm not an actuary, so you all have to bear with me, but currently there are gains that reduce the underfunding in the DRC and then the same gains then reduce the DRC again when it becomes a charge to the funding standard account. So the administration seeks to eliminate that. I think that's been one way in which underfunded plans have not had to make as much contributions, as much by the way of contributions as was originally intended when legislators made the Omnibus Budget Reconciliation Act (OBRA) 87 changes. The administration is also going to legislate interest and mortality for DRC purposes. Plans are only going to be able to use 90-100% of the current liability interest rate rather than 90-110% of the current liability interest rate. I don't think the administration is changing the underlying methodology for determining the interest rate. It is just capping the range. And it is also then going to mandate a mortality table. You're going to have to use group annuity mortality table (GAM), 1983 for determining the DRC.

Other changes in the assumptions from what's affecting the 1993 plan year according to the proposal might also require IRS approval. The third change the administration is going to make to try to improve funding, and this is probably the most significant, I guess, is it is going to change the DRC formula itself. Currently, for the plans that are underfunded or have a funding ratio of 35% or less, for post-1987 benefits, you have to fund those on a basis of 30% per year. I think that's supposed to be about a five-year amortization. And the administration is going to take that 30% formula and apply it to plans with funding ratios from 35-60%. So the administration is basically going to speed up the funding of those plans. And then for plans with funding ratios of 65% or more the administration is going to reduce the 30% formula down to 20%.

Just the DRC calculation shows that the administration primarily believes that what it needs to do is to speed up the funding in the underfunded plan. That's the basic solution to PBGC's long-term exposure. Anybody have any questions? Good. I'm not sure I'm the expert on all this.

MR. PATRICK WELSH: What's the effective date on those?

MR. TUCKER: Well, under the proposal the provisions would be effective with the 1995 plan year. That gets into another issue as to whether it's likely that the bill will be passed in time so that could still be the effective date. Right now it looks like it's definitely not going to get passed this year. Congress is much more enamored with health care reform than it is with PBGC, so it's not going to get passed this year, but at least under the proposal that would be the effective date.

Now besides changing the DRC there's also a change that would adopt a plan solvency rule. This would require plans that were invested in a lot of illiquid investments, something other than cash or marketable securities, to have to maintain at least three years' worth of disbursements in cash or marketable securities. And the three years would be measured against the last 12 months' disbursements.

Disbursements include administrative expenses, benefit payments, including some portions of lump sums and annuity purchases. You know, it's primarily a short-term mechanism trying to beef up the funding in plans that are invested in something other than cash marketable securities. If the plan does not meet that three-year requirement, then there would be quarterly contributions or solvency payments that would be due to the plan. To the extent the sponsor doesn't make those solvency payments, then benefit payments would be restricted, and the plan could not pay out lump sums or purchase annuities. The plan could only pay out amounts that were based on single life annuities, and that would be the case until the solvency payments were made up.

MR. DAVID S. WEAN: These additional solvency payments, would they be in addition to the minimum funding requirements and the regular quarterly contributions?

MR. TUCKER: Well, I know that the DRC formula is going to be transitioned in, but the solvency payments will not. So I think that's the case.

MR. WEAN: Will they be tax deductible?

MR. TUCKER: At least in the draft of the proposal I read, the administration didn't address that issue. I would assume solvency payments would have to be, but I don't know. The problem we have here I think in some respects is we don't have a bill yet. When the administration announced the draft proposals, it had a bill ready to draw up in Congress. Congress sent it back to the administration primarily because of jurisdictional issues with the PBGC, either because the administration's new people or whatever did not divide up the bill into the portions that go to the respective committees in Congress and since the end of September, the administration has been working to try to redo that, so nobody's seen the draft language of the bill yet. So, what we're really working off of is the draft of the proposal that was circulated on the Hill about the same time as the administration announced what it was doing. So we have some general outlines of what the proposal is, but don't have real specific answers on some of those types of questions.

MR. MACTAS: Scott, I presume the expression "only the amount payable as a straight life annuity" is intended to include qualified joint and survivor annuities as well.

MR. TUCKER: I would think so. I just picked up from what the administration used in the proposal itself, but you would think that the administration would have to recognize that as what had to be paid under the qualified plan rule.

The other change that would affect funding is an immediate recognition of any negotiated benefit increases, as soon as they were negotiated, even if they weren't effective for several years. This would mean that, if you concluded collective bargaining negotiations and you'd improved benefits for several years in the future, you'd recognize those immediately for funding purposes. That's generally supposed to be effective with the 1995 plan year, but at least according to the draft proposal benefits that have already been negotiated this year and next year and that are effective after 1994, that would still be subject to the provision. So presumably once the provision was effective, you'd have to recognize those previously negotiated benefit increases in the funding. I'm not sure that's going to make some larger employers, who are

currently going through collective bargaining, very happy. Nevertheless, I think the administration has recognized it's only the most underfunded plans that are underfunded because of those benefit increases. So those are the basic three changes to the funding requirements.

As I mentioned earlier, there's going to be a requirement that the liabilities that are in the new DRC formula will be recognized immediately. There's one exception. Any increase in liabilities because of the mandated interest and mortality is going to be amortized over 12 years. That's one concession the administration has made. The other concession is that it is going to have a transition rule that sort of limits the effects of the required increases. The increases in the DRC are going to be limited by the amount to increase the funding ratio of the plan by 3 percentage points a year through 1999 and then 4 percentage points for 2000 plan year and 5 percentage points for 2001. So that would mean that a plan with a funding ratio as of the beginning of 1995 of 50% would have to increase to a funding ratio of 53% for 1995, 65% by 1999, and 74% by the year 2001. So that could serve to limit the effects of some of these changes in the funding requirements. And then plans with funding ratios of at least 85% would have a slightly more generous transition rule. Having said all that, any plan would still be required to make the contribution that current law would have required, and it would also always be required to make the solvency rule payment. Those contributions operate independently, at least the DRC ones.

MR. MACTAS: Well, the solvency rule increase could apparently be used to help meet the funding ratio.

MR. TUCKER: Yes, you would think so. And, again, it's primarily a way of changing the mix in the assets. Presumably the administration didn't want to say that you had to go out and sell the building that was in your plan, but what it wants you to do is put in the cash to make sure you have three years worth of benefit payments there. And, obviously, for policy reasons, the administration wants to keep those plans funded on a cash basis long enough for some of these other funding requirements to kick in.

There's some good news here at least for sponsors of well-funded plans. The administration is going to drop the quarterly contribution requirement for plans that have been fully funded for current liability during the preceding year, so you aren't going to run up against that problem of making quarterly contributions only to find out that you shouldn't have made them and then have to try to get them back out of the plan. So I think that's a welcome change. Anyway, I don't know if it's the best place to put that provision, but certainly the PBGC reform proposal is being used as a vehicle for changes in a lot of areas because it's going to be probably the primary pension bill that Congress is going to consider over the next year-and-a-half, so that's in there. The administration is also going to eliminate the 4971 excise tax in a couple of situations.

The primary focus of the bill, as I said, is on funding, but it's also true that the PBGC is attempting to really expand its compliance authority and has a number of provisions in the bill to do that and I'll get into those in just a minute. PBGC is also seeking to eliminate the subsidy that's inherent in the variable premium right now. Apparently,

right now the variable premium only has about an effective premium rate of about $5 per participant for a $1,000 underfunding, for the most severely underfunded plan, rather than $9. So, what the PBGC is going to do is to take the $53 cap off the variable premium. That will be phased in at about 33% per year. In other words, phase it in over three years. But the PBGC anticipates that, for the most severely underfunded plans, the premium could go from $72 per participant to $140. And there's already been some objections to that raised by some members on the Hill, and the response back I think is that the PBGC has looked at it and said, well, on average for every $1 of premium increase that a number of the plans that might be most severely affected by this might have to pay, the corporations are paying out about $90 in dividends. So, clearly, the PBGC thinks that the money should go to PBGC before it goes to stockholders. Again, the PBGC has rejected any increase in the flat-rate premium. So, clearly, the focus of the proposal is to try to get at the plans that are underfunded rather than try to collect more money from the well-funded plans.

As I said, the proposal would also expand the PBGC's access to employer information and broaden its court-imposed remedies. The PBGC is changing the number of reportable events. It is including four new ones that would require sponsors to report to the PBGC when the sponsor leaves the control group, when a sponsor's liquidated, when a sponsor declares extraordinary dividends or redeems 10% of its stock in a 12-month period. The PBGC wants to know a lot more about what's going on with employers and their plans than it has in the past. It has had a problem in trying to get information because there hasn't really been a mechanism for it to do so, other than to write letters and ask for the information.

MR. ROBERT L. NOVAK: The number of $140 got fairly widely reported. I think it was in *The New York Times*, and I think it was subject to some confusion. As I understand it there really is no cap, that this was an estimate done by the PBGC.

MR. TUCKER: That's right.

MR. NOVAK: I'm kind of curious what interest rate it might of been done at. I guess for October, the rate is 4.80%. I'm curious if the PBGC went that low in doing the estimate.

MR. TUCKER: I don't know. The material that I read didn't really indicate what interest rate it had used to back the estimate up. I don't know. I'm sure it did studies to back up the proposal, but I just haven't seen them.

What's interesting about these reportable event filings is that, if the control group has $50 million or more of unfunded vested benefits, before the event could take place you'd have to give the PBGC 30 days' advance notice. So, again, it wants to know what's going on out there in corporate America to a much greater extent than it feels it does now. I'd be curious to see what kind of reaction that gets on the Hill.

The PBGC is also going to ask for annual nondisclosible information from certain employers who have unfunded vested benefits greater than $50 million -- where the employer is basically going to be reporting financial information about its plans on an annual basis to the PBGC. Right now the PBGC has a group that combs the newspapers and other types of government filings to try to find out what's going on,

and then, if the group members think that there's a problem, they will contact that employer. So I think this is designed primarily to make that data gathering requirement easier. But, again, that's something that may have a little bit more sympathy, I suppose.

The proposal would also affect sponsors in financial trouble. It's going to require that any liquidating sponsor be liable for underfunding in the plan as if it had terminated. If you liquidate the sponsor right now, the PBGC has to step in and terminate the plan in order to create that liability. It doesn't like to do that, so it is going to make it a liability that attaches to liquidating sponsors at the time they go out of business. For some sponsors who are liquidating and then passing the liabilities back to other members of the control group, and the PBGC is going to have it occur right when the one sponsor liquidates.

The proposal would also prohibit any benefit increases while this employer was in bankruptcy. Interestingly, there are no other real bankruptcy-related provisions in the proposal. But the PBGC has said publicly that it is still interested in bankruptcy reform. It still wants sponsors that are in bankruptcy to have to make minimum funding contributions, and it still wants to be able to serve on the Creditor's Committee. I guess the PBGC just doesn't think that the administration's reform proposal is the best vehicle to get those things accomplished.

There are a couple of provisions that are designed to affect participant communications. Plans that are underfunded and pay variable premiums would have to notify their participants as to their underfundedness and what the benefit guarantees are. They would have to do that every year. And then also the PBGC says that it's going to assume the liability for missing participants on a standard plan termination. That's good news I guess. We probably have had standard plan terminations that have ended up with several hundreds of missing participants. The PBGC finds them and doesn't know what to do with them. Should it set up bank accounts or, otherwise try to provide for the benefits? The PBGC is just going to take on that liability, because it is also going to take the assets of those missing participants. I guess that's a help to participants.

At the end of the proposal, there are a number of changes that were a little surprising because they're not directly related to PBGC reform, but they're going to affect ongoing plans. The PBGC is going to change the methodology for calculating lump sums for ongoing plans. It is going to divorce the 417(e) applicable interest rate from the PBGC rate structure, and you're going to use 30-year Treasuries instead. And the PBGC is also going to mandate a mortality table that will currently be the GAM 1983 table. This would be required for the 2000 plan year, but at least according to the draft proposal, employers could adopt that early if they wanted to, and it would not be a cutback under the Code or ERISA. So that if you currently had an interest rate that was based on the PBGC rates and this proposal passed, presumably you could amend the plan, adopt 30-year Treasuries, and then pay out what would, in effect, be the much lower lump sums, and that would not be a cutback. It will be interesting to see if that provision really gets past some of the people in the labor committees on the Hill, but at least PBGC has put it out there as a proposal.

And, also, I don't know that I'm an expert on this area, but I know that in cash-balance plans there's a problem with the interest rate that you use if you have to use the PBGC interest rate. And to the extent that you no longer have to use PBGC interest rates to calculate lump sums, that problem sort of goes away, too.

MR. MACTAS: I understand the Treasury doesn't plan to issue 30-year bonds anymore.

MR. TUCKER: A good point. Well, I guess the two parts of government ought to talk to each other then. The administration is also going to change the threshold for involuntary cash-outs, going to up that from $3,500 to 5,000, and they're going to index it. I was very surprised to see this provision in there. I'm not sure what this does to help out the PBGC, but the administration is going to index the cash-out in $500 increments and then round it down to $500 increments. The administration is also going to change the methodology for indexing the 415 limits and 402(g) limits. It is going to have the limits go up in specific increments and then round those down. For 415 the limits would only go up in $5,000 increments, and for 402(g), which is the salary deferral, limits go up in $500 increments. For instance, on the 402(g) limit, if it was $9,900 then you'd round it down to $9,500, because that's the next lowest multiple of $500. This is a methodology that I know is similar to what is being offered in pension simplification for 415, and it's also something that's currently in the statute for indexing the 401(a)(17) limits. It looks like they're trying to gain revenue at the margins by not letting the cost-of-living increases increase until you've reached these thresholds.

MR. MACTAS: Sounds more like that than simplification.

MR. TUCKER: Yes, it's much more like it. I'm not sure what the revenue figures are, but I'm sure they think that's going to raise the money for them. It's interesting that the draft of the proposal that was circulating on the Hill didn't say anything about what was the most controversial portion of the reform proposals that was then later announced and that's the elimination of cross testing for a defined-contribution plan. And that has really stolen the headlines most recently. Apparently the administration, as I said earlier, is very upset about the publicity that some of the age-weighted profit-sharing plans are getting by way of directing a lot of contributions to older, more highly paid individuals. And we haven't seen the bill language, so we don't know for sure what is being proposed, but it looks like the administration is trying to prevent defined-contribution plans from being able to be tested on a benefits basis.

Nell Hennessy said recently that the administration is going to prevent the establishment of those types of plans and that existing plans might have until 1995 to be revised. I think one of the press reports had her saying that existing plans will have until 1997 for revision, but that was apparently a misquote. The administration also said that it was taken back a little bit about how this provision might affect some larger employers, and it is willing to work with some of the larger employers who might be counting on cross-testing and see if they can further refine the proposal. But right now the administration still plans to go forward with it. There was some speculation, I think, that the reason the bill was so late in being sent up to the Hill was because the administration might have been looking at this. And our best information is, no, that it has the provision in there and it hasn't been working on it,

that the provision is going to stay in there. And the reasons the bill hasn't been dropped yet are basically because of those jurisdictional issues I mentioned earlier. So that's going to upset a number of people's planning for tax reform compliance, I'm sure.

As I said, as to the prospects for the bill, clearly, it's not going to pass this year. We received sort of favorable response from the House Oversight Committee, but Congressman Pickle has somewhat faulted it already because it doesn't seek to eliminate benefit increases. His bill, the one that he introduced in 1992 in fact, would prevent plans from increasing benefits if they were less than 90% funded unless they posted some kind of collateral, and that's an issue that he thinks still has to be addressed. This current bill would not limit benefit increases. It's going to be an issue between the administration and Congressman Pickle as to whether that needs to be added to the provision. It's a little bit too early to see if that's going to hold up passage. Rostenkowski has said that pension reform is on the table next year – probably not seriously until after we're a bit further down the road with health care reform. But, clearly, it's something that's going to create a lot of interest and activity in the Congress.

There's another piece of pension legislation that also looks like it might get some interest. Just this week, Rostenkowski said that he's going to try to schedule a markup for a technical tax bill that may include some pension simplification. The feeling on the Hill is that the legislators don't want to have a bill that includes anything controversial. They don't want to have phone calls from the constituents on the bill. They don't want to create a higher profile on any of these issues so that it becomes something that other members might want to add on some of their own bills, too. So it's not clear how much of pension simplification might get included, because, as you recall, there were a couple of provisions in that bill, the one that's already been introduced, that had created some controversy. The proposed simplification includes the repeal of five-year averaging. It includes safe harbors for nondiscrimination testing for 401(k) plans. That's a provision that the administration doesn't particularly like. Some of the people in the labor committees don't like it either because it basically means employers don't have to work as hard getting the non-highly paid to make contributions to 401(k) plans. They can simply give them a floor contribution and then not have to worry about satisfying any deferral test. So anyway, those provisions have been somewhat controversial, so it may not be that those aspects of pension simplification would be included, but there are some other things that could be. Anyway it looks like at least that Rostenkowski is going to try to move forward with some type of bill, and we ought to know in the next few weeks whether there's any chance of that or not. He certainly wants to try to do it, and the issue really is whether other members of Congress will let him do that without turning the bill into something that it shouldn't be. I think they're especially afraid that, if the bill were to get to the Senate, some of the Senators might try to use that as a vehicle to get some of their own pieces of legislation attached.

Phil Gramm, for instance, is very interested in trying to get a provision attached that would repeal the retroactive provision in the increase in tax rates. That's another piece of legislation that may, in fact, heat up this year, rather than pension reform, which is probably going to be on the plate next year. Does anybody have any

questions about either the PBGC reform bill or anything else that's going on in the Hill?

MR. MACTAS: As a matter of fact, if you have any question or any observation on a late breaking development of your own, that you'd like to let the other members of the group in on or you'd like to ask a question of Scott on, we invite you to come up and talk.

MR. ROBERT K. CALDWELL: Well, this isn't a qualification question. I would be interested if anyone has any comments or observations he or she might want to share or discuss on the recent SEC challenge of the discount rate on past disclosures. I think this could have as much impact maybe as anyone's talked about here and represents another nail in the pension coffin.

MR. TUCKER: I don't have any special insight on that.

MR. MACTAS: Where's the Coopers guy?

MR. NOVAK: It's a little bit hard for me to say, because I'm in the human resource group, and it's really the function more of the audit practice. I don't think currently any clients are being recommended to use a discount rate in excess of 7% based on available interest rates, and I guess comments made by the Chairman of the SEC are mirroring that. But other than that, really, I'm not at liberty to say anything further.

I did have a question on a totally different topic, though, as long as I'm here. Going back to the weighted changes in 401(a)(17) regulations, for a company that wanted to maximize the accrued benefits as of the end of the 1993 plan year, I'm somewhat uncertain if you said that you could use the $235,840 for all prior years or if you're limited to the 401(a). So, for instance, if a plan was final three pay, are you limited to the 401(a)(17) limits in 1993, 1992, and 1991 with regard to the accrued benefit?

MR. TUCKER: What I'd said was that it was acceptable to use the $235,840 for all prior years. The IRS has said that in its good faith memo field directive and has indicated informally that it still holds to that position.

MR. NOVAK: So then the accrued benefit could be defined as the greater of using the $235,840 for all prior years or the accrued benefit on December 31, 1988, effectively, which may be larger for some very highly paid people.

MR. TUCKER: Well, that's right. And that raises another issue, too. There are some plans that were using the wear-away approach in 1988, that may have been better off using A plus B, but they didn't worry about it quite so much because they thought compensation was going to continue to increase. And because compensation would continue to increase, then basically within a few years the grandfather would go away. But they may want to reconsider that, and if they do, then they probably ought to do something before the end of the 1993 plan year and maybe change their end of 1988 grandfather, as well.