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LATE BREAKING DEVELOPMENTS

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The panelist will focus on recent legislative and regulatory developments in the U.S.

MR. RICHARD G. SCHREITMUELLER: This session will cover all three branches of the federal government. We'll start with new rules and regulations, then go through one or two recent court cases of interest to pension actuaries, and end with current legislation. Our main speaker is Hardin Matthews, an attorney in Boston. Hardin is a partner at the firm of Ropes & Gray, where he specializes in employee benefits. He's a graduate of Harvard University and Harvard Law School, class of 1974. He's an ERISA baby who has worked with these laws and rules for 20 years. Hardin often speaks on professional programs; for example, he gives the New England Employee Benefits Council a Washington update once or twice a year.

IRS ISSUES

MR. R. HARDIN MATTHEWS: I will start with the IRS regulations on notice consent and election requirements for qualified plan distributions. On September 15, 1995 the IRS issued some new regulations under Section 411(a)(11) of the Internal Revenue Code (IRC) concerning early distributions from retirement plans. In general, the previous regulation required that a notice be given to participants at least 30 days and no more than 90 days before the distribution. Also, on the same day, the IRS issued regulations concerning the notice requirements and consent requirements for qualified joint and survivor (J&S) annuities in plans that are subject to those requirements. Those J&S regulations also require a notice to be given to participants at least 30 days and no more than 90 days before, this time, the annuity starting date, which is the first day of the first period for which an amount is paid as an annuity or as any other form.

The new 411(a)(11) regulations incorporate some prior guidance, which indicates that if people are in a hurry to get their distribution started, as many people are, and they come in for a hardship withdrawal or they just want to get their retirement benefits started, that you can start a distribution less than 30 days after giving the employer notice. To do that, participants must affirmatively elect to take an earlier distribution, and the employer must notify participants that they have the right to consider for 30 days whether to start the distribution before age 65.

The new Section 417 regulations on qualified J&S annuities also have a provision, which is not quite as liberal, that allows employers to commence distributions with an annuity starting date less than 30 days from the date they give the notice. To do that, the participant must receive the explanation, affirmatively elect to take the distribution, get spousal consent if necessary, and meet several other requirements. Participants must be informed that they have 30 days to consider the J&S election.

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Also, participants are permitted to revoke an affirmative distribution election at least until the annuity starting date or, if later, until after seven days following the time the explanation is given. The annuity starting date must be after the date the explanation is provided to the participant. However, the annuity starting date may be before the date the affirmative distribution election is made and before the date distribution is permitted to commence. I'll give you an example of that. Finally, the distribution may not commence until at least seven days have expired after the explanation was given.

Basically, there is a seven-day waiting period to start the distribution if the plan is subject to qualified J&S annuity requirements. The regulations have an example that illustrates all this: on November 28, the explanation of the qualified J&S annuity requirement is given to a participant in a defined-benefit plan who's married, terminated employment, and ready to start a benefit. Four days later, on December 2, the participant elects to waive the J&S, and the spouse provides consent. The election is a single-life annuity. The regulations say that it's all right to have a December 1 annuity starting date, just three days after the notice material was given, as long as the first payment is made no earlier than December 6—that is, the first day after the expiration of the seven-day waiting period—and the participant doesn't revoke the election before that. Payments for later months can be made the first of each month so that the payment for January can be made January 1.

There is a special rule for the purposes of the 411(a)11 notice on early commencement. Instead of timing that with respect to the date distributions commence, it can be timed with respect to the annuity starting date so that the notice requirements will coincide for that purpose and for the J & S annuity rules.

The IRS considered and rejected suggestions to expand the 90-day period—that is, let employers give notice more than 90 days before the distribution starts. Some companies wanted to publish an "evergreen" notice once a year through electronic media or otherwise. The IRS declined to let them do that. The IRS also did not give any guidance on the use of electronic media to satisfy the notice and consent requirements, but it is interested in your comments. These rules are effective September 22, 1995.

I might add in this context that the House Ways & Means Committee simplification bill includes a provision that would eliminate any waiting period following the time a notice is given, if a participant elects to start a benefit early and the spouse consents. So under the proposed legislation, there wouldn't even be a seven-day waiting period for a J&S annuity.

Let's turn now to the rules for direct rollover and 20% withholding. We recall that this came from 1992 legislation that required plans to offer a direct rollover option. That same law expanded the class of distributions that could be rolled over. It said that there is a mandatory 20% withholding tax on any eligible rollover distribution that is not rolled over in a direct rollover. It also required that plans give an explanation of the direct rollover option and tax rules.

The new regulations follow much the structure of the old ones, but with a number of refinements and clarifications. Unfortunately, there's no substitute for slogging through them if you want details. I'll just mention briefly a few things. People had asked if the

402(f) notice on rollovers and tax treatment could be posted at the place of employment. It can't; it must be provided directly to retirees.

Much of the regulation is devoted to clarifying what an eligible rollover distribution is. You'll recall that, in general, an eligible rollover distribution is any distribution that is includable in income and is not payable over the life or life expectancy of the participant and his or her beneficiary, or in a series of substantially equal payments over a period of ten years or more. The regulations clarified, in determining what is an eligible rollover distribution is when you're looking at the balance to the credit of the account, that ancillary benefits are included. The regulations mentioned qualified disability benefits and hardship withdrawals. I would also have thought, if there are whole life insurance policies with a cash value that would be includable in income, that the cash value might be rolled over by a surviving spouse. The surviving spouse is the only beneficiary who could roll over. But to the extent it was includable in income, it seems to me it might be eligible for a rollover.

The regulations clarify that qualified defined-benefit plans can receive rollovers, but a plan does not have to offer a rollover to a qualified trust that is part of a defined-benefit plan. A defined-benefit plan can always receive a rollover if it so provides, but any plan does not have to offer a rollover to a qualified trust that is part of a defined-benefit plan.

The regulations follow the statute very literally, though, and say that a plan is required to offer a rollover to a 403(a) defined-benefit annuity plan. That would be one without a qualified trust. One would think that should have been a distinction without a difference, but the statute was written to draw a line there and the regulations followed it.

My general comment is that it's good to have more rollover opportunities, but it is quite complex to administer one set of withholding rules for eligible rollover distributions and a completely different set of withholding rules for other distributions. The new regulations apply to eligible rollover distributions made on or after October 19, 1995. For early distributions, you can use any part of the new regulations and part of the prior regulations if you want to.

I have just a couple comments on things that are happening at the IRS. The IRS has promised to issue follow-up guidance on COBRA, and on loan defaults under Section 72(p). It will someday give us guidance on cash balance plans. It has promised that for some time. It's said that the IRS does plan to allow nonamended plans—plans that did not comply by amending on a timely basis—to meet the requirements of the Tax Reform Act of 1986. Those plans will be allowed to come in under the voluntary compliance resolution (VCR) program. The sanction, as it were, will be a sliding-scale payment—a lower payment if you are not as late as you might have been. The later you are, the more it will cost you.

The IRS has also promised regulations under 3121(v) for the hospital insurance employment tax that applies to deferred compensation, the 404(a) regulations for deducting contributions to foreign pension plans, and guidance on 204(h), which will say that we only have to give the notice to the people who are affected. Also, there will be regulations on the $1 million deduction limit.

Let's turn to compliance for 403(b) tax-deferred annuity plans. We don't have regulations yet. We have an active audit program by the IRS. Also, IRS examination guidelines are available to you and to the IRS agents examining these plans. Briefly, the IRS so far has focused on larger employers—colleges, universities, hospitals, and other health care organizations, as well.

The IRS auditors often come in as part of a so-called coordinated examination program. There are quite a number of issues, of which the 403(b) matters are only one. I should also say that Section 457 (c) plan issues on deferred compensation very often are part of the audit. The most common violations tend to involve exceeding the contribution limits under Section 415 (c) of $30,000 or 25% of taxable pay, the 403(b) exclusion allowance, or the 402(g) limit of $9,500.

Sometimes there's a problem in the healthcare area in which a provider either has an outside Keogh plan or is covered in a plan of a company that he or she controls, and that coverage has to be aggregated with the 403(b) contracts for purposes of applying limits. Another problem can be a wrong definition of compensation, especially where salary reductions are in effect under 403(b) and Section 125. The 402(g) limit of $9,500 overrides the higher limits produced in some cases by special election under 415(c)(4), and so certain employers can get a higher limit under Section 415 by election. Other noncompliance involves failure to comply with rules for 401(a)(9) minimum distributions.

In a new IRS program called the Tax-Deferred Annuity Voluntary Correction (TVC) program, you can voluntarily come in and correct problems with 403(b) annuities. That has not been very popular so far for a few reasons, including a sanction of up to 40% of the maximum tax liability, the cost of corrections, and uncertainty of what will be required with corrections. Just a handful of people have gone in under that program.

It's rumored that the IRS is considering a revision of the TVC program to include so-called simplified VCR program (SVP) procedures, similar to the SVP procedures in the VCR program for qualified plans. These would be common defects with a standardized correction and little or no sanction.

DEPARTMENT OF LABOR (DOL) AND SEC ISSUES

MR. SCHREITMUELLER: That takes us through the IRS. We're not going to touch on the PBGC here because that's being covered in other sessions on the General Agreement on Tariffs and Trade (GATT), but a couple interesting things are happening at the DOL. None of them involves major pronouncements such as that we've just heard about, but these are things that we need to keep up with. Let's start out with top hat plans as many things have been happening underneath the surface.

A top hat plan is a plan that's defined in ERISA as covering a select group of management or highly compensated employees. It is not the same as an ERISA excess plan, which covers amounts above the 415 limit, and ERISA has a very specific provision for that. The problem is, of course, that a couple years ago the 401(a)(17) limit got cut back to $150,000. That meant a great many employees could no longer have their entire amount of pay under a qualified plan. There has been a great deal of soul-searching about what to do to cover the excess pay for midlevel executives under nonqualified

plans. We haven't heard anything new from the government and that just makes it more interesting.

Some years back, a DOL official said informally, and it has been quoted many times, that in his view, a top hat plan that's legitimate under ERISA would mean one covering top employees who were so high up in the company that they were in a position to influence the plan design. There's really no formal guidance about who can be covered. There was an American Bar Association (ABA) meeting in May 1995. I have not heard anything more recent, but there was a dialogue and the notes were published. In this dialogue, the DOL officials said that they really did not plan to issue anything to define who could and could not be covered under an ERISA top hat plan. They found that if they tried to define this for a large employer, it wouldn't work for a small one. If they tried to define it for a small one, it wouldn't work for a large one. Being unable to construct any one-size-fits-all type of rule, they were going to let the courts make any further decisions. That might make it seem like you're home free, unregulated, and are able what you want, but that's not true. Remember, they said the courts could make any further decisions.

I've discussed this with several lawyers and they all tell me that it's possible for participants in these plans to sue the plan sponsor and say, "This nonqualified plan doesn't meet the ERISA definition of an exempt top hat plan, and therefore it should have been funded or vested or had J&S features that you didn't give me. Fix that and give me the additional benefits." If the plan has a noncompete agreement, for example, you must disregard that because under Title I you can't have one. There are some possible risks that are a little hard to measure.

What can you do about this kind of risk? You can amend the ERISA definition of an excess plan so that it will pick up amounts above the 401(a)(17) limit, but nobody is really working on that right now. It certainly is not in the cards for this year and probably not next year, so that's a slow way to fix it, but that's the ultimate solution. In the meantime, it's something of which you need to be aware.

Meanwhile, on another front, the SEC has also expressed an interest in top hat plans for the same reason. The SEC noted that these plans cover a broader group of employees than they did a year or two ago. It also noted that there's more of a tendency now to have a mirror type of defined-contribution plan; top hat plans are no longer just the defined-benefit type. Many folks are not in control of the company and are covered under these defined-contribution nonqualified plans, and maybe they have options about electing to defer pay versus to not defer pay. They may have options about using this or that equity fund, or a fund that isn't equities at all, and so there are investment issues.

The moment of truth came when employers tried to get the SEC to issue a so-called "no-action" letter, which means that your plan is fine as far as the SEC is concerned. It will not give you a problem about registering or regulating it. Well, Merrill Lynch and at least one other large employer found that the SEC would not give them a no-action letter for these reasons: according to the folks at the SEC, the plan was broad-based, involve choosing among investment risks, and the SEC wanted disclosure. So Merrill Lynch registered three plans, meaning preparing a prospectus and other steps that go with having it registered as a security. Of course, that's well outside our usual way of handling pensions.

My understanding of this process is that, for publicly held companies, such as Merrill Lynch and many others, it's not too bad. There are some forms to file, but beyond that, it's not terribly burdensome. But for a privately held company, it's a major requirement, something that would give you pause before you'd want to get into it.

So what do you do about this SEC involvement? First, you can see if there's an exemption from SEC registration rules available. Certain classes of employers and plans do have exemptions; if they happen to be very small, or are within one state, or involve very few dollars, you have a chance at an exemption. If the plan covers a large, multistate group, that probably will not work.

You can also register the nonqualified plan with the SEC. A third alternative, and this might also provide protection under the DOL top hat issue, is to split the nonqualified top hat plan into two parts. That is, put what you might call the truly top-level folks, who by anybody's definition would qualify as top hat participants, into Plan A, and the others into Plan B. Then, if Plan B gets into trouble, at least it won't spill over into Plan A, which you've isolated. That's more work than some employers may want to go through but it might be worth it for a big company.

What are the risks of disregarding the SEC? What could go wrong? Well, it's not a matter of imposing Title I rules or anything else under ERISA. It is conceivable that a court could hold that the plan really is a security under federal law, and therefore an employee who was not given the proper SEC disclosure has the right to rescind the whole deal. He or she could change his election to defer pay and demand cash instead. If he was investing in funds that lost money, he could say, "Well, make up those losses. I didn't have the proper disclosure." So there is that risk from the employer's viewpoint.

There is another risk that has been talked about if the employee does get that right of recision. Perhaps that is incompatible with the 401(k) type of cash or deferred status that you're looking for under those plans. If so, it becomes a tax trap in which the employee is deemed to have constructive receipt with unfavorable tax consequences. Again, official guidance on these nonqualified issues is not clear, and I don't believe anyone has all the answers, but we need to raise our consciousness.

There's another major DOL issue with the SEC a little bit in the act. We won't say much about it, but you need to be aware of it. In mid-1996, the DOL began a major push to try to help increase the savings rate in the U.S., which, as we know is low, both historically and compared with other developed nations. There's a good deal of support for raising the savings rate: it's politically correct in all quarters. Labor, management, and everyone else agrees that we need to promote savings. All your major lobbying groups and employer groups are behind this, and you'll be hearing more about it. Meanwhile, for many years employers have been helping employees decide when to get in the plan, how much money to save, and how to invest it. But they've always been a little concerned, even under 404(C) where they're largely exempt from fiduciary involvement, about giving too much advice. If an employer tells people to invest aggressively, for example, that might be deemed to be going too far, crossing over the line, and making the employer a fiduciary. Employers don't want to get into that situation.

Later this year, the DOL, with a little help from the SEC, is supposed to issue an interpretive bulletin about investment education. If the DOL does that well, it will give

employers and employees some comfort and flexibility to communicate on these important issues and promote savings. If it doesn't do it well, it may chill the atmosphere and discourage employers from making efforts to educate employees. The government is well aware of this problem, and so are all the rest of us who are trying to tell them what to do. We'll see how well the DOL does it. The DOL bulletin is supposed to include examples of education that are in a safe harbor mode.

UPDATED TABLES FOR 1996

I would now like to talk about three tables that relate to the CPI. Last Friday, October 13, 1995, the DOL issued its monthly update of the CPI through the end of September. That's the end of the third quarter, which is now a magic time. That date has always marked the Social Security Administration's (SSA) annual update of its program numbers. That date also will now provide the basis for the IRS to update two important sets of numbers for pension actuaries, so it's a triple-witching day for us because of the three tables. Table 1 contains 1996 Social Security factors. These are official numbers, announced by the SSA last Friday. If you call the Office of the Actuary, you can get these numbers via fax. We reformatted it, but these numbers are from the SSA. The wage base went up to $62,700. The cost-of-living increase in benefits at the end of this year is 2.6%. This table has all those other numbers that we actuaries love so much—the average annual wage and the primary insurance amount (PIA) formula.

TABLE 1

SOCIAL SECURITY (1996 FACTORS)

	1995	1996
Wage base:		
For Social Security	$61,200	$62,700
For Medicare	No limit	No limit
Old-law wage base, for indexing PBGC maximum, and so forth.	$45,300	$46,500
Cost of Living increase (payable in December of prior year)	2.8%	2.6%
Average annual wage (from data two years earlier)	$23,132.67	$23,753.53
PIA formula, 1st bend point	$426	$437
PIA formula, 2nd bend point	2,567	2,635
Max. Family Benefit, 1st bend point	544	559
Max. Family Benefit, 2nd bend point	785	806
Max. Family Benefit, 3rd bend point	1024	1,052
Retirement test exempt amount, annual, below age 65	8,160	8,280
Retirement test exempt amount, ages 65-69	11,280	11,520
Wages needed for one quarter of coverage	630	640
FICA (employee) tax rate:		
Social Security (OASDI)	6.20%	6.20%
Medicare (HI)	1.45	1.45
Total	7.65	7.65
SECA (self-employed) tax rate, total	15.30%	15.30%

Table 2 is covered compensation for 1996. The numbers are unofficial, done on a Lotus spreadsheet. All you need to do is plug in the new wage base of $62,700 and, lo and behold, you have your new covered compensation table. We've checked it with a couple other people and are comfortable with it, but it has not been announced by the IRS.

TABLE 2
COVERED COMPENSATION, 1996 (1996 WAGE BASE—$62,700)

Year of Birth	Age in 1996	SSRA	Year of SSRA	Covered Compensation, rounded to:			
				$1*	$12	$600†	$3,000
1929	67	65	1994	24,314	24,312	24,600	24,000
1930	66	65	1995	25,926	25,920	25,800	27,000
1931	65	65	1996	27,580	27,576	27,600	27,000
1932	64	65	1997	29,234	29,232	29,400	30,000
1933	63	65	1998	30,889	30,888	30,600	30,000
1934	62	65	1999	32,543	32,532	32,400	33,000
1935	61	65	2000	34,197	34,188	34,200	33,000
1936	60	65	2001	35,800	35,796	36,000	36,000
1937	59	65	2002	37,403	37,392	37,200	36,000
1938	58	66	2004	40,540	40,536	40,800	42,000
1939	57	66	2005	42,109	42,108	42,000	42,000
1940	56	66	2006	43,677	43,668	43,800	45,000
1941	55	66	2007	45,211	45,204	45,000	45,000
1942	54	66	2008	46,694	46,692	46,800	48,000
1943	53	66	2009	48,109	48,108	48,000	48,000
1944	52	66	2010	49,497	49,488	49,200	48,000
1945	51	66	2011	50,851	50,844	51,000	51,000
1946	50	66	2012	52,171	52,164	52,200	51,000
1947	49	66	2013	53,457	53,448	53,400	54,000
1948	48	66	2014	54,594	54,588	54,600	54,000
1949	47	66	2015	55,646	55,644	55,800	57,000
1950	46	66	2016	56,589	56,580	56,400	57,000
1951	45	66	2017	57,454	57,444	57,600	57,000
1952	44	66	2018	58,226	58,224	58,200	57,000
1953	43	66	2019	58,937	58,932	58,800	60,000
1954	42	66	2020	59,597	59,592	59,400	60,000
1955	41	67	2022	60,729	60,720	60,600	60,000
1956	40	67	2023	61,234	61,224	61,200	60,000
1957	39	67	2024	61,654	61,644	61,800	62,700
1958	38	67	2025	61,980	61,980	61,800	62,700
1959	37	67	2026	62,246	62,244	62,400	62,700
1960	36	67	2027	62,451	62,448	62,400	62,700
1961	35	67	2028	62,597	62,592	62,400	62,700
1962	34	67	2029	62,657	62,652	62,400	62,700
1963	33	67	2030	62,700	62,700	62,700	62,700

* Represents exact average of wage bases, as permitted by law and regulations.
† After 1993, IRS does not authorize the use of covered compensation tables rounded to $600 multiples under §401(l). Thus, integrated plans using this table are no longer safe-harbor.

Table 2 has four columns. The first is an exact covered compensation table. It is not rounded, except to dollars, and that's perfectly acceptable under the law. Then there's the column that's rounded to $1 a month or $12 a year, and it's rounded in a peculiar way. It's not to the nearest dollar, and it's one that the IRS has traditionally published. Then, over on the right side, there are $3,000 multiples. That's also one that the IRS usually publishes. Finally, there's a $600 table which, in a sense, is an obsolete table. It's not permitted officially under Section 401(l). Some plans that are not qualified under 401(l), the safe harbor, use it anyway and so for administering such plans it's a good table to have.

Table 3 has the IRS pension limits for 1996. Again, these are indexed to the third-quarter CPI now. That's a new GATT rule. We don't have to wait until January to get these numbers anymore. Table 3 shows that the limit on 401(k) elective deferrals is going up next year from $9,240 to $9,500. (By the way, just to show you that this session does include late breaking developments, that number was in *The Wall Street Journal* on page 1. Apparently the IRS issued the official numbers yesterday, October 17 [1995].)

Table 3 also shows that several other key number, did not go up because of the GATT rounding rules. These include the defined-benefit-limit of $120,000, the defined-contribution limit of $30,000, and the cap on covered compensation of $150,000. Those limits will all be the same in 1996 as they were in 1995.

TABLE 3
IRS PENSION LIMITS FOR 1996

IRC Section	Limit	1995	1996
415(b)(1)	Defined-benefit plan limit	$120,000	$120,000
415(c)(1)	Defined-contribution plan limit	30,000	30,000
401(a)(17)	Cap on compensation included	150,000	150,000
402(g)(1)	Limit on 401(K) elective deferrals	9,240	9,500
414(q)(1)(C)	HCE definition, 1st pay threshold*	66,000	66,000
414(q)(1)(B)	HCE definition, 2nd pay threshold*	100,000	100,000
414(q)(1)(D)	HCE definition, office threshold*	60,000	60,000

* Proposed legislation would change the highly compensated employee (HCE) threshold to a single amount of $80,000.

COURT DECISIONS

MR. MATTHEWS: I will talk about a case called *Spink vs. Lockheed Corporation.* For those of you who like to read cases, the reference is 60F-3rd-616. It was decided July 18, 1995 by the U.S. Court of Appeals for the Ninth Circuit. The facts of the case are as follows. Prior to 1988, Lockheed maintained a defined-benefit pension plan that excluded from participation individuals hired within five years before age 65—a maximum-age exclusion.

Mr. Spink, the plaintiff, was hired at age 61 in 1979 and because of that plan provision, did not become a participant. OBRA 86 came along in 1986 and changed the law, saying that a plan could not (1) exclude an individual for having attained a specified age, or (2) cease or reduce benefit accruals because of age. The plan

admitted Spink in 1988, as it was required to do. The plan did not count prior-year service for accrual purposes, because the plan did not count any service prior to participation. Spink demanded retroactive service credit.

Separately, in 1990, the plan was amended to offer an early-retirement window—an enhanced early-retirement benefit for those who left before normal retirement. The amendment said that to be eligible to receive the additional benefit, an employee had to sign a release for claims that the employee might have against Lockheed. Spink refused to release the claims. He said that conditioning the benefit on releases was a prohibited transaction under ERISA, because it was the transfer to or use by or for the benefit of a party in interest, being the employer, of the assets of the plan. The idea was that Lockheed was using the assets of the plan to satisfy claims that might exist against Lockheed.

The district court dismissed Spink's claim, but it was appealed. The ninth circuit reversed the district court, reinstating his claim and finding that there was a prohibited transaction, also indicating that he was entitled to retroactive service credit for periods prior to becoming a participant. The court said that denying service that the employee would have accumulated but for prior age-based exclusion from the plan results in a reduced rate of benefit for that employee. Therefore, denying credited service years that an older employee would otherwise have is unlawful under OBRA.

Now you'll note that the statute refers to reductions in the rate of benefit accrual, not the rate of benefits. The statute refers to what I would call the speedometer or the rate of accrual going off into the future, and you cannot reduce that merely because someone has attained a certain age. What you have accrued is like the odometer, your accrued benefit. The court refers to it as the rate of benefits.

In my view, the court confused the speedometer with the odometer and came to the wrong result. Lockheed's arguments concerning the effective date provisions in the statute were rejected. The court also chose not to follow the IRS proposed regulations on which the people were supposed to be able to rely in this case, indicating that you do not have to give retroactive credit.

This may involve a relatively small population, but I can tell you in plans that I or the people whom I know amend, not one of us has ever given this retroactive credit. So if the court is right, we've done our plans all wrong, and the IRS has improperly given us determination letters on those plans.

The prohibited transaction issue has wider application. This is a broad holding, looking to the use of plan assets to satisfy a claim against the employer. The analysis of the court had several steps. Let me give you, first, Lockheed's argument. Lockheed argued that the plan provision required the releases. The company administering the plan merely followed the plan provision, which was an eligibility requirement for getting the enhanced benefit. Second, the company was free to adopt an amendment requiring the releases as a condition of the enhanced benefit, and the company was not a fiduciary with respect to the making of the plan amendment. Finally, the company did not benefit. Remember that the company paid 100% of the cost of this plan, so if people were getting enhanced benefits out of the plan, that

would increase future funding requirements or reduce the amount of reversion that Lockheed might get on plan termination.

The court decided, first, that Lockheed was a party in interest. Second, a party in interest who benefits from an impermissible transaction can be held liable. That was the court's language. Third, according to the court, the only question was whether the plan amendment was a transaction that directly or indirectly benefitted Lockheed. Fourth, Section 406(a)(1)(D) of ERISA prohibits the use of plan assets for the benefit of a party in interest.

This prohibition forbids Lockheed from writing checks drawn on the pension fund to buy the releases. Similarly, this provision prohibits plan documents from providing for use of the plan funds to buy the releases; in effect, saying that Lockheed could not amend the plan to do something that was prohibited by the law. In fact, the releases cannot be characterized as an incidental benefit to Lockheed.

Lockheed filed a petition for re-hearing on August 1, 1995. The petition was denied on September 1, 1995. Lockheed has 90 days from September 1, 1995 to file a petition for certiorari. That's a request for review by the U.S. Supreme Court; the Supreme Court can choose to take the case or not take it.

The prohibited transaction result of Lockheed follows fairly closely on the heels of another Ninth Circuit case: *Case vs. Pacific Lumber*. That was an Executive Life annuity case in part, a plan being terminated with a reversion to the employer and the annuity purchase not being so solid. The district court held that in the context of a buyout of the employer, in which there was a fair amount of debt incurred to accomplish the buyout and the lender was informed that there would be a reversion coming back to the employer on the termination of the plan, there's no collateral given. That is, collateral could not be given in that the plan assets were never jeopardized by that knowledge of the lender that there would be a reversion coming back. The court nevertheless held that in doing the borrowing and informing the lender of the reversion, and giving the lender whatever assurances that were given concerning the availability of that money after the plan termination as collateral or security for the loan, that, too, was a prohibited transaction. I guess the message in the Ninth Circuit is to be very careful with what you do with plan assets.

I'll mention briefly a third case: *Scott vs. Administrative Committee of the Allstate Agents Pension Plan*. This is a district court case in a small district of Florida and involves a 204(h) notice. Allstate Insurance attempted in March 1989 to amend its plan to freeze benefit accruals after January 1, 1989. This was done by using the IRS notice that was out at the time, permitting suspensions of accruals pending the finalization of the nondiscrimination regulations.

The plan under the IRS notice is, I believe, later amended. The plan was required to give notice to participants by the end of the 1990 plan year. The participants later filed suit, challenging amendments that reduced the rate of benefit accruals by 1.5% and increased the retirement age from 63 to 65. That, I guess, is the ultimately amended plan as compared with the plan as it was before 1989. The participants claimed that the plan failed to give timely notice of the amendment's effective date, which is one of the requirements of a 204(h) notice.

The court found that the plan was not amended until November 1991 and that the plan administrator violated 204(h) by not giving proper notice. The court also found that communications given to participants between early 1989 and the spring of 1991 were inadequate under 204(h), because they did not clearly communicate that the plan's accrual rate was suspended or frozen. The notice was not actually given before the end of the 1990 plan year. Therefore, the plan lost its right to freeze benefit accruals as of January 1, 1989. The amendments were found by the court to be not effective earlier than 15 days after the giving of notice, which happened, according to the court, on April 15, 1992.

That is one of a number of unpleasant cases that are developing concerning 204(h) notices. The price tends to be fairly high. The plan just continues to run at the higher benefit level that it had before, and the employer is stuck with the bill for that. The message is to be careful with 204(h) notices; give notice if it is required.

PENSION SIMPLIFICATION

I will talk a little about the pension simplification legislation that's in Congress. A number of provisions in the House Ways & Means bill would simplify life, to some extent, for those of us who work with pension plans. I really don't have time to go through them in any detail, but I can tick off a few that I think are more significant.

The definition of a highly compensated employee would be simplified. It would basically be someone who (1) earns more than $80,000 indexed or (2) is a 5% owner. The infamous family aggregation rules would be repealed.

Section 401(a)(26) would be repealed for defined-contribution plans; that is, it would only apply to defined-benefit plans. That would mean that defined-benefit plans would have to cover 50 employees or 40% of all employees, with the special rule that if there are only two employees, both of those employees must be covered.

There would be design-based safe harbors for purposes of 401(k) testing. These have been proposed for a while. In one alternative, the employer contributes 3% of pay for all nonhighly compensated employees. That will buy the employer an automatic pass under 401(k). The second model is that there's a dollar-for-dollar match on the first 3% of pay contributed, and $0.50 per dollar on employee contributions, going from 3% to 5% of pay. Five-year averaging for lump sums would be repealed and so would the $5,000 death benefit exclusion.

The income tax treatment of pensions that have after-tax money would be simplified in a manner similar to what the IRS now allows for lifetime payments. You basically look up the age of the participant in a chart at the time the benefit is starting, and see a number, such as 150, in the chart. You take the benefit and assume that the after-tax money is paid out over 150 months, if that were the example, and the basis recovery is spread out over that period.

The 401(a)(9) minimum distribution rules that require that benefits start at age 70.5, even if the employee is still working, would be modified so that the distribution would not have to start as long as the person is still employed, unless the individual is a 5% owner of the employer. In general, if the payment is delayed, there would have to be an actuarial increase in the benefit to make up for the delay.

There are simplified plans for small firms—firms with 100 or fewer employees. The latest acronym I've seen on that is in the Senate bill being marked up today by the Senate Finance Committee. There is a new small plan called SIMPLE, very similar to the so-called nest proposal from the administration.

The 401(k) plans could be maintained by tax-exempt organizations under the Ways & Means bill, including Indian tribes, and also by state and local governments as long as they do not have a Section 457 plan. I guess those that were eligible to maintain 403(b) plans could also continue to have 403(b) plans. So, subject to limits, one could have both 403(b) and 401(k) plans.

There is a change in the House Ways & Means bill to the GATT interest and mortality assumptions that must be used for computing lump sums and certain other benefits. Under section 417, specifying minimum lump sums, you have the choice of amending now or waiting until basically the year 2000 to amend.

At the moment, you don't have a choice under the Section 415 limits which impose the new GATT rules right away for the purpose of determining maximum lump sums. Under this provision, the new Section 415 treatment will not apply until you make your plan amendment adopting the GATT rules. If you've jumped the gun and already amended your plan to pick up the GATT rules, you would have a year to reverse the change, in which case the new Section 415 rules would be deferred until you make your permanent GATT amendment.

Dick Wickersham of the IRS just said a few days ago that with respect to the 403(b) salary reduction agreement rules, the requirement of one agreement per year and the other restrictions are a dinosaur. This legislation would do something about that. It would allow multiple salary reduction agreements under 403(b) plans. Interest deductions on corporate-owned life insurance would be restricted.

Actuaries have told me that they dislike provisions on 415(e) calculations. That section would be repealed under the Ways & Means version for limitation use beginning after 1996.

There would be a helpful change in the determination of leased employees. The historically performed test would be replaced by a control test.

Another proposal is that the Social Security retirement age would be allowed to be used as a uniform age for purposes of nondiscrimination testing.

Many of you probably have heard about the provision in the House Ways & Means bill on reversions. This provision generated a certain amount of hyperbole. It's not that often that the president comments on a piece of legislation. The president made this comment: "How can we forget? Just last December I signed a bill," and that's the Retirement Protection Act, "to save the pensions of 8.5 million American workers and stabilize the pensions of 40 million more. Do we want to go along with the congressional budget plan to let corporations go and make the same mistake all over again and allow corporations to loot their pension funds legally?"

Martin Slate of the PBGC says this measure threatens unprecedented damage to pensions. It is open season on pensions. Labor Secretary Robert Reich said, "If Congress enacts this change to the tax code, we are going to see raids on pension assets that will make the train robberies during the days of Jesse James pale in comparison."

The provision under the House bill, as many of you probably know, would affect employers having defined-benefit plans with excess assets. Excess assets are defined—to simplifying it a little bit—as the plan assets minus the greater of the accrued liability or 125% of current liability. That's as of the 1995 valuation or, if less, any later valuation. An employer would be allowed to transfer those excess assets to itself and use them for any purpose.

There would be no reversion excise tax at all, a complete waiver of the reversion excise tax for transfers that occur before June 30, 1996. There would be a 6.5% excise tax on transfers that occur prior to, I believe, the end of the year 2000. There would be regular corporate income tax on the reversion and that is what produces a fairly large revenue estimate, something in excess of $10 billion over a few years. That makes this provision hard to take out in that revenue must be found to replace it.

The provision does require that participants be vested in their accrued benefits, and I believe that includes people who have left within one year. It does not require termination of the plan or annuitization—that is, buying annuities—for benefits that are accrued. As I mentioned, there is a lot of controversy over this provision and there will continue to be.

The bill to be considered by the Senate Finance Committee also contains a reversion provision. This one is more limited. It would permit the transfer to the employer, provided the assets are used to pay for "qualified employee benefits," defined as qualified retirement plan benefits, accident and health benefits, disability benefits, educational assistance, or dependent care assistance. They'd have to be provided under plans that cover a broad group of employees and are subject to regulations under the IRC and ERISA.

The same amount of transfer is permitted as in the House bill, with excess assets defined the same way. Vesting is also required under the Senate provision. The amounts transferred would be included in the gross income of the employer, with one exception: there would be an excise tax on the amount of the transfer. There would be no limit on the number of transfers that could be made during the year. However, if you receive a transfer and don't use it for qualified employee benefits, the employer must return it to the plan. Amounts returned would not be includable in gross income, but would be subject to the 20% excise tax on reversions. No deduction would be allowed for the returned amount. This proposal would apply to taxable years beginning only through the year 2000. I'm sure we'll see much more discussion about that in the press.

I'm now going to talk about veterans' reemployment. A provision in the House Ways & Means bill, and I believe only in that bill, would provide some technical corrections, allowing plans to receive contributions and to grant benefit accruals in accordance with the Veterans Law without being disqualified.

The Veterans Law, as most recently amended, is effective, I believe, in December 1994, as far as the plan provisions go. Returning veterans have reemployment rights under federal law and are entitled to be treated as if they had never left, in some respects. They must be given service credits under defined-benefit plans and that, I think, has been the law for a long time. But with respect to defined-contribution plans, the employers must make whatever contributions would have been made while the veteran was in the service if the veteran instead had continued working at the same pay.

If the plan had offered the opportunity for 401(k) elective deferrals or employee contributions, when the veteran comes back, the plan must offer an opportunity for the veteran to make, as it were, make-up contributions. When those are made, they do not fall into the Section 415 limits and other limits for the year in which they're paid. Instead they relate back to the years when the employee was away. A plan is not disqualified merely because those contributions are made, even though if you looked at them just in the current year, they might exceed the Section 415 limit, the 402(g) limit, and so forth.

There is a time limit for the returning veteran to make these contributions: the lesser of three times the period that the veteran was in the service, or five years, whichever is less. When retroactive contributions are going in, there's no requirement of interest to be credited on those when the employer puts in extra money or extra matching money. If the employee contributions are matched, interest does not need to be added.

The last topic I have, which is also mentioned in *The Wall Street Journal* today, is the source tax bill. For some time legislation has been pending in Congress that would restrict or prohibit states from taxing income received by nonresidents that is attributable to income earned in the state. The most commonly heard-of situation, I think, is in California. If you work in California and retire to another state, California will seek to tax all or part of your retirement income as it's paid to you in the other state, even though you're no longer a resident of California.

Massachusetts has a similar provision with respect to nonqualified benefits. If you work in Massachusetts and retire to New Hampshire and you're receiving nonqualified benefits, Massachusetts will seek to tax the nonqualified plan benefits. This legislation, which is being considered currently in Congress, as introduced by a representative from Nevada, would prohibit states from taxing this sort of income.

There are various versions of the legislation. Some people believe that only qualified plans should have this special treatment and that nonqualified benefits should not. Others believe that it's OK to have a rule such as this, but there needs to be a dollar limit. As you can see, this gets to be complicated for a plan administrator if some of the benefit is subject to the source taxation and other parts are not. Other versions of the legislation would treat different distributions differently; for example, state source taxation would be prohibited only if the amount is paid as an annuity rather than as a lump sum. I guess we'll just have to stay tuned and see how that one turns out.

MR. RICHARD Q. WENDT: I have a question on the surplus reversion. No mention has been made about the effect on the funding standard account credit balance. Is it possible to take money out of surplus and not change the credit balance?

MR. SCHREITMUELLER: I'm not sure how it works on the funding standard account. Maybe one of our experts in the audience could address that, but I believe the idea is that you would have to repay it over ten years. It's in the nature of a loss.

MR. DANIEL M. ARNOLD: Just briefly, could you review the timing on the simplified pensions? What is the process and when will the decisions be made?

MR. MATTHEWS: Congress will have to decide on several proposals if it decides on any of them. As I said, a bill was introduced in June. There was an administration proposal also in June. There's this Senate finance provision. This is all going into the budget reconciliation legislation. Under the current schedule, the government will have to shut down November 13, 1995, if Congress doesn't agree on this legislation. This is one part of a much bigger legislative package.

We don't know what will happen. The House and Senate versions will be different. It will have to be ironed out in the conference committee. I should say generally the pension simplification provisions that I talked about are in the bill that was approved by Ways & Means and is likely to be included in the House bill.

There is not a comparable set of provisions in the Senate finance mark-up being considered today, so we don't know what will happen. It will go to a conference committee, and those provisions might be included or they may be changed in the conference. I think the answer is that we should know something more by the middle of November. It's possible that we'll have another continuing resolution to keep the government going a little longer, in which case the thing may be delayed again. I think we should have a good idea this fall as to whether this will happen.

MR. FIELDING LEWIS: I'm curious to know if the guidance and the regulations that were just published on consent and election requirements provide any relief for distributions that are triggered purely on the basis of a phone call through a voice response system.

MR. MATTHEWS: They provide no guidance about voice response systems. The government was asked to provide guidance on new technology, but it took the comment and declined to give guidance. Something has to change. The world is changing and the IRS will have to change. I think it is just concerned about making sure that people actually get the proper notices and that the consents are valid. My own view is that there are security measures so that one can be very confident that you're getting a good consent, but it's a little harder to be sure that people actually read a notice that you gave them.

MR. WILFRED L. THORNTHWAITE: Hardin, regarding the *Lockheed* case, I've seen oftentimes that there is a release when lump sums are paid to people leaving the plan. Does this prohibited transaction decision in the *Lockheed* case impact that type of release?

MR. MATTHEWS: Well, as I see it, if you want to be safe, don't put a provision in the plan that requires a release. If you want a release, get it through some other means. If you want to avoid the problem, I believe the plan, just needs to offer the benefit unconditionally.

I've heard people say that if an employer has an unfunded severance plan on top of other benefits, as a condition to get that benefit you might be able to require a release. The idea is that there aren't any assets of the plan so there cannot be a prohibited use of plan assets. I think employers will, one way or another, try to get these releases, but they can't condition qualified plan benefits on them.

MR. SCHREITMUELLER: There are some very strong feelings on both sides of this decision, and it may not be the final word. Some of the objections that we've heard from Washington insiders note that every plan is for the benefit of employers. Why else would they have a plan? You can't move without doing a prohibited transaction if you follow this logically. We're not sure where this is all going. Hardin has indicated how you can stay out of trouble in the meantime.

MR. MATTHEWS: If you don't live in the Ninth Circuit, you're a little freer to choose not to follow this decision. You act a little bit at your own peril, but there are those who believe this decision is inconsistent with the notion that when an employer amends a plan, it is acting as a settlor and not as a fiduciary and therefore should be free to put this kind of provision in the plan. We don't know whether the Supreme Court will choose to hear this case, but I'm reasonably confident we haven't seen the last word on this.

FROM THE FLOOR: Will you accept a question on the DOL interpretive bulletin 95-1?

MR. SCHREITMUELLER: Is this about the safest available annuity?

FROM THE FLOOR: Yes, that's the one.

MR. SCHREITMUELLER: Go ahead.

FROM THE FLOOR: The bulletin says that if an employer doesn't have the expertise in-house to determine the safest available annuity, then it must go outside to get the advice. Many annuity brokers are generally not willing to give the advice because it puts them in a fiduciary position. Also, it could potentially be a conflict of interest with their brokering. Where do you go to get this advice?

MR. SCHREITMUELLER: My firm is in the business of giving such advice. I'm not sure how many others are. I've heard of some that aren't. This a difficult area, and it's still shaking down as to who will be doing this kind of consulting and who won't, but there are firms that do this.

MR. JEREMY GOLD: You can check financial ratings of insurers from rating agencies. These include Moody's, Standard & Poor's, Duff and Phelps, and so on, who rate insurance companies.

MR. SCHREITMUELLER: Right. The DOL bulletin, though, is very careful to warn that you may not rely on those rating agencies. This is consistent with the DOL's legal position in some annuity cases in which the employer said, "But, these were top-rated insurance companies," and the DOL said, "Sorry, that's not good enough."