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Who Wants Yesterday's News?

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Recorder: RICHARD G. SCHREITMUELLER

Summary: The panel will discuss retirement benefit-related developments of recent months. This would include statutes, court cases, and guidance provided by relevant agencies: IRS, PBGC, and Department of Labor (DOL).

Mr. Richard G. Schreitmueller: For most of the session we're going to talk about the Small Business Job Protection Act that was enacted in August 1996, and all the wonderful things it will do for us in the pension world. After that we'll briefly discuss the government figures that were updated for 1997 recently.

We'll have a little time for questions and comments at the end. I know we have a number of experts in the audience. I need to make a disclaimer on behalf of both us panelists and everyone else present: whatever we say here represents only our personal opinion.

Now let's introduce David Weingarten, who is our main speaker. We're very happy to have him. Dave journeyed here from Washington D.C. where he is a partner in the law firm of Sanders, Schnabel, Brandenberg & Zimmerman. Dave is a 1975 graduate of the University of Chicago. He was with the PBGC from 1975–82, working on regulations under Title IV of ERISA and helping draft the Multiemployer Pension Plan Amendments Act of 1980. In the law firm environment where he

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is now, Dave's extracurricular activities include teaching an employee benefits course at Georgetown University, plus many other writing, speaking, and teaching assignments, including three presentations at the Enrolled Actuaries meetings. Dave will emphasize the effects of the new law on single-employer corporate pension plans, then I'll cover the provisions affecting other kinds of plans.

I will start out by giving you an overview of this law, which has been called pension simplification. The new and simpler rules are a little more helpful for 401(k) plans than for defined-benefit plans, but defined-benefit plans were not entirely ignored. For 401(k) plans, we have simpler design elements, nondiscrimination rules, and 415 limits.

Changes in rules for benefit distributions are of interest to executives particularly. Reporting and disclosure rules have been fine-tuned a bit. And those of us who have been studying this law for a couple of months might say that they made a good start, but left many problems for another day, including a great many open questions and issues. Either we'll get prompt guidance from the government, or we'll have to do some good guessing in the months ahead.

In the personal retirement planning area, this law has several unwelcome things that help pay for the good parts. The folks on Capitol Hill were trying to keep the budget from getting further out of control, and did a few things to raise money. One was to repeal five-year averaging tax treatment of lump sums in the year 2000. Also, they took away the tax-free feature of death benefits up to $5,000, with an immediate effective date. If you haven't died already, it's too late. And there's slightly less favorable treatment of after-tax contributions than under the old rules.

On the other hand, there's quite a bit of good news. During a three-year window, 1997 through 1999, the 15% excise tax on excess distributions is being waived as a revenue raiser. That's the only reason they're doing it. Those of you who are lucky enough to have a distribution big enough to be affected are probably busy running spreadsheets and sharpening your pencils because it's not at all clear what you should do. It depends on the situation.

A second change that's extremely popular with those of us who want to make things simpler is the repeal of the 415(e) combined-plan limit. We're going to have to wait until 2000 for that to happen, and hope they don't change their minds in the meantime.

Another change affects spouses whose earnings from employment are little or nothing. In the past, they've had an opportunity to contribute essentially $250 to an IRA, and that's being raised to $2,000.

Other pension features we'll cover are the Uniformed Services Employment and Reemployment Rights Act (USERRA). I call it the rehired veterans makeup benefits, because someone who left employment for military service and came back would get benefits.

Another way the law raises revenue is by increasing the rate of tax to 10% on prohibited transactions. There's also a change in the multiemployer plan vesting rules. And there's a bit of forgiveness available on liquidity shortfalls, where the IRS may now waive the excise tax for late payments. A very controversial legal issue was or is getting resolved for insured pension funding contracts. Also a number of small changes affect governmental plans, nonprofit employers, and church plans.

When other pension laws are enacted, often there aren't many decisions for employers and employees to make. Under this law, they'll have to make many decisions, so that creates good work for those of you in the consulting field. There's opportunity to fine-tune your 401(k) and defined-benefit plan designs. There are not only new methods of nondiscrimination testing, but also new options to choose among them. There are new issues on reporting, disclosure, and employee notices where things may have to change in the near future. There are personal retirement planning issues of great interest to top executives, giving us an opportunity to be more visible. We'll need many employee communications about changes that are happening. And don't forget the changes in internal administrative systems, where this all must be made to happen if the programmers have spare time in between reprogramming for the year 2000. That's our overview. Now I'll turn it over to the one who knows what all this means, David Weingarten.

Mr. David Weingarten: First, let's talk about the 401(k) rules in general because there are many good things for 401(k) plans. Number one, for those of us in Washington with tax-exempt organizations as clients, 401(k)s are now available to them again, as of 1997. You might recall that after the Tax Reform Act of 1986 (TRA), tax-exempts didn't have 401(k)s. Plans were frozen out of that market. There's much discussion with association clients about how to coordinate many 403(b) programs. I think Dick will talk about that later on.

A second important item is the change in the highly compensated employee (HCE) definition we will talk about, which should make life easier for people doing testing. Also for 415(c), the compensation definition is important. People who have 401(k)s and 125s, and end up in a situation where the lower-paid can't be successful in putting away as much as they want in the 401(k), will violate the 25% of compensation or $30,000 rule. There's going to be some relief in 1998, a big help.

In doing the testing, there's the ability to look at prior year results for the nonhighly compensated, and use those for the current year. There's also a new method to distribute excess deferrals that's intended to be fairer to middle management people, those earning, let's say, $80,000 and above. Rather than taking the excess deferrals out of their own accounts, they are taking out of some higher paid people.

There are also special rules on how to run the average deferred percentage (ADP)/average contribution percentage (ACP) test for those who don't have an age 21 and one-year service requirement. There's some ability to do special planning in the year 1999 when there will be the new safe harbors that we're starting with here.

For many years, there's been a controversy in the simplification legislation which, as you all know, has been pending for some time, with many participant groups claiming that safe harbors would destroy the system. They would create no incentive for employers to educate lower-paid people to put money away in these programs. We ended up with some sort of compromise where in 1999 there will be design-based safe harbors to avoid the ADP/ACP testing. There's nothing more unpleasant in the first part of the year than to have to be talking with a client about refunds, giving money back, calculating earnings, redoing reporting, and how to explain to senior people in the organization why it didn't work out. These safe harbors are designed to avoid all of that, and they're expensive.

I think the open question is whether people will embrace these safe harbors, or whether the cost is too high. Three percent contribution is for all employees, all nonhighly compensated at least, to be more specific, if you want to limit it. Or, alternatively, a match of 100% of the first three, or 50% of the next two. It has to be 100% immediate vesting for dollars used for this test, and the 401(k) normal in-service withdrawal rules apply. You can't have a stated event withdrawal after 60 months of participation, or two-year-old money, or what have you. These are fairly strict and expensive rules.

It's interesting that after-tax dollars are not subject to these safe harbors. They still have to be tested. So if you have a program where there are some after-tax dollars going in, maybe some analysis is necessary of where you will be if you adopt these safe harbors. You could use matching dollars above and beyond these minimums to satisfy the 401(m) test that will apply also to the after tax. The matching component has a similar sort of rule. The match there can't be in excess of a 6% cap. You could play games with how you structure this. It doesn't literally have to be 100% of the first three, but you have to end up with a match of 4%.

Next, we'll talk about using prior year's data. This is a 1997 change, and you get to use the 1996 results. It's interesting that the highly compensated group is going to change between 1996–97, and there are some questions being raised about precisely how you do this. If you have a new plan for a tax-exempt, for example, the first year you could use 3%, or you could use the first year's results to figure out how much the highly paid could put away. There's an election process on whether to use the current year or the prior year, and IRS approval may be necessary to change.

There are open questions on this. What do you do if you change the nature of your program? What if you add after-tax dollars to your program? What if you change the rate of match? So there are some interesting questions about what people will want to do, and whether it makes sense. The theory is that if you know what your maximum is for a year, you could control the behavior of the highly compensated. That may or may not be a good theory.

Next, we're going to talk about the highly compensated definition. There's a choice in the definition for the $80,000 feature, whether or not to apply the top-paid group rule that we have under current law. The IRS has come out with limits, as Dick mentioned and the limit is still $9,500. The $150,000 went to $160,000.

We have clients who contribute 6%. With the pay limit at $150,000, they managed to get to $9,500, which I was told was an actuarial rounding rule, I didn't quite understand it. But maybe with a $160,000 limit, they'll be able to get to $9,500 with a 6% rule. It's interesting that the IRS Exam Guidelines lend some support for that rounding rule.

Let's move on to some of the other changes, like giving back excess-defined contributions. It's a very strange process. The leveling approach that we're used to under current law, where you figure out the pool of excess dollars based on leveling, starting with the highest percentage and working your way down, I think, is still in effect. What's different is that once you determine the dollar pool, it's then allocated not to those people whom you started with, but it's allocated based on who has paid the highest dollars into the plan. If you go back after you go through the process, you'll see that, if you ran it again, you wouldn't pass. And there's some discussion about whether this is what Congress really intended on how it works from the methodology. But, again, it's designed to take excess contributions out of the pockets of the more highly paid in the highly compensated group.

There is also a special rule that will come in 1999 under the coverage rules. Currently, there's the ability to desegregate the plan for people who haven't met the one-year and age-21 rules, and treat them for coverage purposes as though they're separate programs. Now, we'll be able to disregard the nonhighly compensated who are under one year and age 21; that's the 1999 change.

Next, we have the new definition of an HCE. This is not only important, of course, for the 401(k) rules, but it's also important for minimum coverage purposes. It's important in a defined-benefit plan for the top 25 highly compensated. It's more important than just in the 401(k) context, of course. Under the current rules, there always had to be at least one HCE. Under the new rules, there isn't necessarily one HCE because you don't have to include the highest-paid officer.

In fact, the rule no longer looks at officers, and no longer looks at the 20% who are making over what was $100,000. It's now $80,000, and the top 20% is elective. You look at the prior year. Again, the thought is that you could do some planning if you're able to look at the prior year. The IRS has been struggling in this area on how to simplify things. There were special rules in 414(q) to simplify for large groups. The IRS put out its own simplified method, and now we have Congress's attempt. There are still 5% owner rules based on current year and prior year.

There's some question about how much of this needs to be in the plan document. For the 20% rule, I think, even under current law, there's some discussion about whether you need to make that choice in the plan, or whether you can make it outside the plan. Whether it's a choice that you could vary from year to year is still a question.

Next is my favorite, family aggregation. I'm very happy to hear that this rule is gone. This is one of those rules that no one seems to like, and everyone seemed to think it needed to go. In fact, the IRS regulations, in large part, reserved this. They had many very interesting rules on aggregation for ADP/ACP. But this is a tremendous break on the defined-benefit side, not having to aggregate compensation in the $150,000 or $160,000 limit.

I don't know that it's mainly for small employers. The thought is that smaller employers may be more likely to see some of this family aggregation. The rule applied to 5% owners and the top ten paid employees, so there was limited applicability in big companies. But this is where people have tried to allocate the $150,000 limit between the spouses, and that was never a good division. Now we're out of that, which is a good thing.

Next consider leased employees. The IRS has been struggling with how to deal with abusive situations, how to deal with leased employees, how to deal with affiliated service groups. The 414(o) regulations and other regulations have been withdrawn on abusive situations. And, after much discussion, the new leased-employee rule relates to the primary direction or control of the worker. We still have the rules that you have to be in full-time employment for a year, that you have to have an agreement with a third party organization. There's still the question of common law versus independent contractor versus leased employee.

The Microsoft case decided in the Ninth Circuit recently shows us all that the plaintiff's bar is still very interested in looking at who's covered under these programs and it is trying to make sure that the classification of employees is correct. Part of this legislation has rules on worker classification. And the IRS finalized some of its procedures and rules on worker classification.

Leased employees had "historically performed in the same field of employees" rule. We had clients who wanted to argue that, even though they were in the engineering business that leased engineers that were not in the same field. We had other people who wanted to be fairly aggressive on that. Now we have a rule, but I'm not sure how much clearer it is, it's still vague. But there's a question of direct supervision of the recipient, and whether the individual is performing services in a manner dictated by the worker as the test.

Again, the IRS says that it is going to look at abusive situations. It is not going to want to see situations where there are groups of highly paid engineers under the plan, small groups of nonhighly paid under the plan, and a large group of nonhighly paid leased employees. This is an area in which there is some relief, but it's part of the developing area, I think, in looking at the nature of who's covered by these programs.

We now move away from 401(k) plans into the more hearty nondiscrimination rules on testing. We have a new rule giving some relief in the (a)(4) testing for uniform Social Security Retirement Age (SSRA). That may be some help with subsidized early retirement benefits, or joint and survivorship (J&S) annuities, and how those are available.

Next we have changes in 415 limits. I was saying earlier that one of the areas that was a help for the 401(k) plans was the 415(c) definition of compensation. And, as Dick mentioned earlier, the 415(e) rule being repealed in the year 2000 is a big positive change. There will be a number of people who are happy about this; especially small employers who, it is hoped, may rethink whether they do or don't want to have a defined-benefit plan.

We have many clients who terminated their programs and have struggled with the combined limits and what they're able to do to go forward, and there needs to be more discussion of this. I take it that the 2000 date is driven by revenue concerns as compared to many of these other rules we were talking about, which are effective immediately in 1997.

There are transitional issues that involve the rules under the General Agreement on Tariffs and Trade (GATT), as the 1994 legislation is known, and we're going to talk about them in more detail. Many plans were not amended to put in the 415 changes for GATT, and yet the plans are being administered based on those changes. There's some question about what you do if you were rolling along in 1995–96 and trying to implement the law expecting the plan to get amended. There's an issue about whether you can anticipate the repeal of 415(e) in 2000. My impression is that the IRS is probably saying no, but I'm not sure that I have seen that.

What about retirees getting an increase in 2000? Many of you have clients with a mix of plans, so they may have some nonqualified programs, and, to the extent that people are restricted by 415(e) or otherwise, maybe more of the money is coming out of the nonqualified plan. I think there's a question of, when we get to the year 2000, what the mix is and how people adjust. It may even be possible that employees got too little because of some of these limits. I think some IRS guidance is needed in this area to sort out how we transition.

Let's go back to the 415(c) limit for 401(k) plans. The deduction rules in 404 are interesting. I didn't see a comparable change to the 415 change that's effective in 1998 to add back the before-tax dollars. In the past, we had the problem, number one, in voluntary compliance resolution (VCR) that lower-paid people were putting away more than 25% of net compensation. Now, in 1998, the problem gets solved by the ability to add back the section 125 and the 457(b) or 401(k) dollars. But for 404, we still have the issue of whether it's net or gross.

The IRS had issued a private letter ruling a couple of years ago, nothing more definitive, seeming to say that the deduction was based on net pay. On the 401(k) side, that seemed to make perfect sense. On the 125 side, it was maybe a little less clear. But there is no fix in 404 like there specifically is in 415. We had some clients recently looking at trying to improve their match and what have you, and running these sorts of tests and getting involved with this issue. So you may want to think about what happens in 1998.

You may have clients who want to redesign their 401(k) as a result of this rule. Many employers are trying to back into the 25% of net, or 20% of gross, and trying to schedule the maximum 401(k) as compared to the match by design, trying to avoid having a problem. You may get many questions, I suspect, from people who want to open up to nonhighly paid employees, especially, the ability to increase the maximum 401(k).

Let's get back to the GATT assumptions. There's the ability to undo 415 amendments to comply with the December 1994 Retirement Protection Act changes. And there are some interesting questions about what people ought to be doing from the 415 side versus the 417(e) side in calculating benefits. We have clients who have gone ahead with changes on the 417(e) side, but haven't literally amended the plan on the 415 side. What do you do if you haven't amended the plan and you've made payouts? What if you go back within the one-year period and decide to undo what you either did formally or did informally? How do you do that if it's informal? What do you do for people who are owed money? You paid them too little. What if you paid some out of the qualified plan and some out of the nonqualified plan?

The goal was to try to have the year 2000 as the effective date for both the 417(e) side and the 415 changes, but I think there's some important transition rules to look at. Other interesting issues that we'll talk about are the 15% excise tax, how some of these effective dates will line up with the 415(e) repeal and these GATT assumptions, and the 15% excise tax with some delayed effective dates.

Next, we'll mention early retirement adjustments, being able to go back to the greater of 5% or the rate in the plan, rather than using the 30-year Treasury rate. These are for lump sums, let's say pre-age 62, where we're uncomfortable, so this is going to be a help. But, again, it raises questions about revising calculations that have been made already.

Next is benefit distributions, one of the more interesting areas, where there are many unresolved questions such as in the 401(a)(9) minimum distribution rules. The IRS's proposed regulations have been out there for some time, and the IRS has an active regulation project to try to finalize those rules. There's always been many questions, at least in my mind, on the defined-benefit side on how some of these rules work where people leave in the year they hit their required beginning date. Are they owed a minimum? How do you determine the minimum?

This may be a pension simplification, but I'm not sure how much we're helped by some of these rules. The new rules literally say that you don't need to continue to start people on the April 1 following age 70½ if they're still working except for 5% owners. These rules don't apply to IRAs. We're going to have a different set of rules for IRAs, the old rules.

We also have some interesting transitional rules. What do you do with the fellow who started payments as of his required beginning date a few years ago who's in a defined-benefit plan, and he's been getting payments? You can't stop the payments without going back to the people and getting their approval. We have some plans where there are no offsets for continuing accruals for prior distributions. There doesn't seem to be much point to go back and ask the fellow whether he wants to stop getting money.

There's a question of precisely how the effective date works if you have a defined-contribution plan and someone is 70½ this year. Is the person subject to the new rules, meaning the person doesn't have to start? Or is the person subject to the old rules, meaning the person is owed a payment for this year? There are many interesting issues, and much controversy about how this works. One of them is 411(d)(6) and cutback issues for plans that may be written in such a way that people have the right to get payments. Also, there are issues of whether changes need special consent. So this is an area where, it is hoped, there's going to be a great deal of early guidance from the IRS.

One choice in the defined-benefit area, once we get into these new rules, is going to be whether we want to continue to start people, or whether we want to give an actuarial increase. The actuarial increase is written in such a way that, if someone hits age 70½ and retires in a subsequent year, it literally seems as though the actuarial increase is from age 70½. If the person hits 70½ and leaves that same year, it literally reads as though there is no actuarial adjustment. Presumably, the plan assumptions are used for actuarial increases, but that's not crystal clear either.

Next, let's talk about excise taxes on excess distributions. One of the wonderful inventions of the TRA 1986 was additional taxes so you couldn't get too much or too little. On the too-much side, the 15% excise tax is being waived. This is while you're living. It doesn't affect the death tax, the excess accumulation tax, and it's for a three-year period, so there's a three-year holiday. It's interesting that currently many people having this situation had more than $562,500 back in 1986 and made grandfathered elections. They need to look at their options to see whether it's to their advantage to take advantage of this excise tax holiday during these three years.

Normally, if you use the five-times rule to get to the $775,000, you have to elect five- or ten-year averaging. But we're going to talk about how five-year averaging will be gone by the year 2000. So some of the older notions of lump-sum distributions are retained solely for this purpose of the five times limit. Again, in a death situation, we still have this problem of being subject to this tax. The tax, again, applies to distributions not only from qualified plans, but also to IRAs.

We have some tradeoffs and whether you do or don't want to take advantage of the new rules. Perhaps you could use five-year averaging before the year 2000, and use the five-times exemption one time only after 1999. Perhaps that isn't crystal clear. Or you may want to take advantage of the chance to not have the 15%. If you're under 59½, you have to watch out for the 72(t) penalty of 10%. You also have to think about the tax-deferred compounding of earnings on the money that's sitting there.

One issue that runs throughout the discussion is whether a person is better off taking the money, paying the tax, and then dealing with it, as compared to allowing the money to compound and deferring it. The general rule has always been to defer taxes as long as possible. These tax breaks are Congress's attempts to raise some revenue. And the question is, who wants to take advantage of this and pay their taxes and move forward?

Five-year averaging is the other important part of the equation. That's gone in the year 2000. For many years we've been waiting for five-year averaging to go. You have to be 59½ by the last day of 1999, meaning that you were born by June 30, 1940. We still will have the ten-year averaging rule. People who were age 50 by January 1, 1986, will have the ability to take ten-year averaging and use 1986 rates, and maybe capital gains rates on the pre-1974 portion. But now Congress is getting rid of what was one of the, in theory, important advantages of having large lump sums in defined-benefit plans.

Let's talk about the planning issue of how to handle this. There are some reasons to take money out of plans in these years, perhaps, without taking all the money out. You could set yourself up for down the road, to lower the possible 15% tax, or to lower the minimum distributions under 401(a)(9) going forward. The money that comes out doesn't count against the grandfather amount. The way it's set up, you first use your nongrandfather amount with a 15% excise tax, so that's a good thing. It's also interesting to think how to coordinate the 415 and 417(e) changes that don't have to go into effect before 2000, but could be adopted earlier. So there's some coordination issues between 415(e), the excise tax, and the GATT rules.

Moving along to death benefits, 101(b) of the Code has had a $5,000 death benefit exclusion. There's no planning left to do here. This rule is still effective for people who died before August 20; they get a $5,000 exclusion. There may be some issues going forward, such as how to make it up to people. But basically, this is something to be aware of.

The IRS, in its direct rollover rules and what have you of a year ago, spent much time on what plans should be doing in terms of withholding or giving choices for this $5,000 rule. And many of us have built into our forms this sort of analysis in death situations on what to do, with no withholding, no rollover, it's not taxable. So people might want to be looking back at how they're handling death distributions for this change.

Regarding after-tax dollars, the IRS has put out a simplified method on how to figure out the return of your investment in the contract for contributory defined-benefit plans which, of course, the 1984 regulations billed anyway. But this new rule tries to set forth statutory ways to allocate monthly payments to basis, and it doesn't apply generally if you're 75 or older. It says you take the nontaxable portion. To figure that out, you look at the total investment in the contract over the number of payments based on age, and you figure out the proration.

If there's a lump-sum piece plus an annuity piece, the lump sum is treated as though it was received separately before the annuity starting date, and that affects the investment in the contract. The effective date is November 18. So employers need to go back into their systems and deal with people on 1099R reporting on what's taxable and what's not.

Next we have the 30-day waiver rules. The IRS has come out with a temporary regulation trying to deal with the 30-day waiver rule. There was a model amendment a couple of years ago that was mainly on the defined-contribution plan side, allowing participants to waive the 30-day notice and get immediate distributions. On the defined-benefit side, frankly, we haven't had many clients who have been interested in being under that time pressure to try to go through the process in less than 30 days. And yet, the IRS and Congress seem to think that there are people who would like to do it in as little as seven days. So if you give out a special tax notice of rollover consequences, the 402(f) notice, lo and behold, you could have a seven-day period instead of a 30-day period. And, in fact, you could start payments after the annuity starting date retroactive to the annuity starting date.

It's interesting to me how many people are really going to want to take advantage of these rules. Many things need to be said in the administrative forms, like the 30-day waiver rule on the defined-contribution side, to tell people what they need to know.

Next, consider model IRS wording. Rather than model language, sample language is supposed to be issued by the IRS by the end of the year. The PBGC recently issued a booklet on qualified domestic relations orders, and the DOL has interpretive authority. So the IRS is talking with those people about what language to put out. You'll remember the General Accounting Office did a report a while back criticizing forms that plans are using to get consents. You'll note that in standardized VCR one of the popular problems is failure to get special consent, or to get consent on a form that tells the participant or the spouse enough information.

It will be interesting to see the IRS language. I don't know whether it will be one-size-fits-all or modular, like your couch. As an aside, it's always interesting to see what the IRS thinks is sufficient. The president's portability proposals are being implemented by some IRS revenue rulings and proposed regulations. We're not going to talk about them directly. But for those of you who didn't see that a couple of weeks ago on the rollover side, there are some examples of what the IRS thinks is the minimum due diligence before you can accept a rollover, so that, if you accept it in good faith and there's a problem, you could spit out the money with earnings. And you might be surprised to see what the IRS thinks are minimum requirements. Some of my clients would never in their wildest dreams have thought it was as complicated or cumbersome as it is for conduit IRAs or not direct rollovers. So it will be interesting to see what the IRS thinks needs to be done in some of these qualified J&S annuity forms. Similarly on a qualified domestic relations order, which is generally the wild west where almost anything goes. It will be interesting to see what happens now that PBGC has put out a booklet and the IRS comes out with language.

Our next change to discuss is on IRS penalties. It's an attempt to have more uniform penalties. And on the rollover notice, the special tax notice, the 402(f) notice that IRS put out many years ago, in theory, we would like to have it update to comply with some of these changes. If you don't give out that notice, the IRS raises the ante in terms of trying to get you to comply. Also, the IRS is interested in 1099R compliance.

I had a conversation the other day with some of the 1099R people in the IRS National Office and, I confess, after reading the 1099R instructions and the client reading them, we went to the IRS people, and my understanding of the English language is evidently flawed. They are very technical forms and there's much more emphasis on reporting and cross-checking, and the IRS looking at what people are really doing on reporting.

The last item I want to talk about is USERRA. October 1994, there were some changes in the law that didn't go into the code and make conforming changes. Unfortunately, as a result, we've been in limbo with these rehired veterans' makeup benefits. The rule is basically that rehired veterans have to be treated as though they had always been there. That's easy to say, but it's hard to understand when you get to specifics.

The IRS issued a model amendment a couple of weeks ago that is just one sentence, saying that it's going to comply with 414(u). Another sentence, if you have loan rules, says that there could be suspensions while people are in military service. For many years plans have been crediting service for people in the military. What these rules do, when they refer to some other acts, is to try to go through some of the details. There's the opportunity for a veteran to come back and repay before-tax dollars over some period of time—three times the period of service up to five years.

What isn't crystal clear is mechanically how you do that. There isn't a notice out yet. Maybe the DOL is working on a notice to tell people about these rights. What if someone was rehired, but is gone now? I think there are many practical questions about people returning from active duty who have come back into plans. There's no obligation to go back and give them lost forfeitures that occurred while they were there, or to give them lost earnings before money goes into a defined-contribution plan. But there are many administrative issues for those of you who will go beyond the one sentence in the plan and try to figure out how this works.

Mr. Schreitmueller: We've been through the main things that affect single employer pension plans. Now we're going to talk about some of the odds and ends in this law.

First is the 10% tax on prohibited transactions. That rate, since ERISA went into effect in 1974, has been 5%. If you do a prohibited transaction and get caught, you pay 5%. Presumably, you'll fix it, and that will be it. But that rate now is up to 10%. If you have clients with prohibited transactions, you'll be interested.

Another change is one that doesn't directly affect qualified plans. Spouses are going to be interested in the expansion of the IRA deductible limit by $2,000. Presumably, the couple between them is earning at least $4,000, and so that sounds pretty good. However, in the fine print, it says that this change phases out. You can have the whole $4,000 if the combined income is up to $40,000, but then it phases out. If your income is over $50,000, you lose the spouse's $2,000. So it's only for low and moderate income families.

Next, consider multiemployer plan vesting. Historically, since ERISA began, multiemployer plans have had ten-year vesting. They are finally getting the vesting rules that were enacted for single employer plans in the TRA of 1986, basically five-year vesting with a couple of alternatives. It phases in fairly quickly—either at the plan anniversary in 1999 or, if the bargaining agreement ends sooner, in 1997–98; then this rule will come into play at that time.

Next, consider liquidity shortfall. Is anybody in the audience affected by this liquidity shortfall funding rule? Not many people are affected by liquidity shortfall. You know who you are if you have one. We won't dwell on it, but this is something for under-funded defined-benefit single employer plans. Under GATT, companies have to do some very quick catching up on assets if their assets are below three years' payout, subject to a number of adjustments. You have to do it almost instantly even though the numbers are not available almost instantly. Congress is now saying that the IRS can show leniency if employers aren't able to do this quite so instantly, and not hit them with an excise tax of 10% for not paying the shortfall within 15 days after the magic date. That seems reasonable. Let's hope the IRS, for the handful of plans that are involved, does show some leniency. That rule is retroactive to 1995 when this liquidity shortfall came into play.

The next change has to do with insured pension funding contracts. This has been a very strange situation that has developed ever since ERISA was enacted, because there's some wording that's not entirely clear in ERISA about the status of certain insured plan funds that are invested in a general account of an insurance company. Are the insurance company assets also plan assets and, thereby, subject to the fiduciary rules? Or is the contract itself considered a plan asset and, therefore, what goes on inside the insurance company is not really a fiduciary matter for the plan?

In 1975, the DOL put out interpretive rules that said, no, these are not plan assets, no problem, no hangups with prohibited transactions or other things. You just keep doing what you were doing before ERISA. And then, the Supreme Court surprised a lot of people in 1993 in the *Harris Trust* vs. *John Hancock* case where the Supreme Court said, that's wrong, and it never was right. Everybody has been doing it wrong since 1975. That caused quite a bit of consternation.

After much soul searching and lobbying, Congress put a rule in this 1996 law that says there will be some relief for the insurance industry. The DOL will have to issue some new rules, but they generally will not have a drastic retroactive effect. The retroactive effect, my reading of it, is that it won't change things much. It may change things quite a bit going forward, in theory, but I don't know that many of these insured pension funding contracts are being sold anyway. So, as a practical matter, this should resolve the issues along the lines that the insurance industry had suggested and cause fairly minimal disruption compared to some of the worst-case concerns after the Supreme Court decision.

Next, let's get into governmental plans, nonprofit employers' plans, and church plans. There are a number of very minor provisions; at least, for those of us who work more on the corporate side, they seem very minor. I'll touch on some of them.

First, let's discuss governmental employers. The principal changes involve the 415 limits, where they've cleaned things up a little and recognized that there aren't too many millionaire employees, at least not legally, on the government payrolls. So they're eliminating this 100%-of-pay rule, which causes some problems for defined-benefit plans, and they are liberalizing the limits for certain survivor and disability benefits.

There is an important change going in for tax-exempt nonprofit employers, and for Indian tribes. Up to now, tax-exempt employers couldn't sponsor 401(k) plans. For a while, they could, and there was some grandfathering. But now, the door is wide open, and any tax-exempt employer can have a 401(k) plan. For this purpose, Indian tribes are deemed to be tax-exempt employers, so they get the same deal. That creates much opportunity to do two things for nonprofits and Indian tribes. First, to sell them on a 401(k) plan and, second, to do some consulting about the differences between a 401(k) and a 403(b), and perhaps a 457. There are all sorts of little differences, plus and minus, so you can do a lot of useful consulting.

Church plans have a number of small changes. First off, there are some tax breaks for retired ministers and for foreign missionaries.

One thing I found interesting is that the law refers to ministers. My firm has a Catholic archdiocese as a client, and that client is very interested in these changes, because as far as the tax code is concerned, priests are considered ministers. Ministers is a generic term, minister of religion, as opposed to a Protestant minister.

For ministers who are not retired, there are some changes in the rules about coverage. Ministers can be covered more easily under certain kinds of plans.

Finally, let's discuss nondiscrimination rules. There's a change in the rule about highly compensated employees. And, perhaps more important down the road, the IRS is given the authority to issue safe harbor rules so that religious and church personnel will not have to deal with some issues. I don't think anyone is too worried about the churches making off with many tax benefits here.

Next, we get into Section 457 and 403(b) plans. This is the world of tax-deferred annuities and deferred compensation. Primarily, this is for governmental and tax-exempt employers. There are some fairly complex rules about who is eligible for what. But they have done some simplification here in the IRS rules. In particular, for 457 plans you can have an excess benefit plan over and above the 415 limits without dealing with any 457 limits that would otherwise apply. In other words, if you happen to have a highly paid employee in a governmental plan and that employee runs into the 415 limit, you can put in an excess plan and it's fine. Go up as high as you need to fill in the missing amount.

There also are some administrative rules which, without getting into much detail, conform 403(b) and 457 plans more to the world of 401(k) plans. These three more or less separate sets of rules for 401(k), 403(b), and 457 plans are coming closer together in a number of ways. You almost have to be a specialist in the field to track exactly what's happening here. But the three kinds of plans are definitely becoming more like each other in their eligibility rules and some of the administrative nuances.

A very important rule for 457 plans grew out of the Orange County bankruptcy in California a couple of years ago where there was some money held on behalf of 457 plans for employee accounts. It turns out that it's really not their money, it's the county's money. And when the county goes bust, the employee accounts money goes with it. That bothered a few Congressional Representatives, and they've put in a new rule that says Section 457 plan assets have to be held in trust. And, of course, whenever they say in trust, it could be an insurance company contract. That's always treated in a parallel fashion, so you can read that into it if you like.

There are transition rules. Existing 457 plans have a couple of years to conform to this, until 1999. In the meantime, you'll probably find some 457 plans wanting to move ahead with this change, although there are a few technical issues to resolve.

There's a special new benefit for volunteer firefighters and emergency medical personnel. You can give those people a tax deferred benefit up to $3,000 a year under a 457 plan. It's an anomaly because usually you're allowed to defer a percentage of pay. These are unpaid people, so how do you do that? That's why this rule is in the law. You can defer the $3,000 even though there's no pay involved.

Finally, for 403(b) plans, a number of small administrative changes are bringing them into line with 401(k)s. One thing that's happening is the $9,500 limit is being indexed so that some day it will go up to $10,000, and march on up, instead of just staying at $9,500 as it has for so long.

Let's move along to SIMPLE plans. It's a small-employer product. If you have more than 100 employees, you can't have one. Or if you have a qualified plan of some other kind, you can't have one. What do you mean by 100 employees? These are people who earned at least $5,000 in the prior year. There are transition rules about what happens if you grow past 100 employees, but we won't get into that.

As far as employees earning $5,000 are concerned, there's also a rule that the employees must be eligible after they've been on board for two years with that amount of earnings. The service can be broken. You don't just look back to the last two years. If the individual happened to be with the firm in some earlier year, that would count, too.

SIMPLE plans have two separate sets of rules. The plan can be a 401(k) plan, or it can be a group of IRAs, with different rules. Another important point is that salary reduction simplified plans (SARSEPs) are repealed at the end of 1996. You can't put in any new ones. Some practitioners feel that a SARSEP is a better deal, so hurry up and put one in while you can. If you already have one, it's grandfathered; you can keep it, but the door shuts at the end of 1996.

Let's get into a few details of SIMPLE plans, which are defined-contribution plans. Contributions have a number of rules you need to know if you get into this. Employees may elect to put in up to $6,000 a year, and that number will be indexed. Employer contributions are a bit more complex. It's a little like your 401(k) safe harbor where, under the first rule, employers are allowed to match the first 3% of pay contributed dollar for dollar.

If they use that rule, then there's a special rule if they are using the IRA-type plan, which is intended for an employer who may have a cash-flow problem. You don't always have to match the whole 3%, you can match just the first 1% if you want to, but you're only allowed to do that two years out of every five. It means the employer has a little less of a commitment. And that becomes an advantage of the IRA-type plan if you're trying to choose between that or the 401(k) approach.

There's a whole other contributions track you can go onto. Instead of matching, you just put in an automatic 2% of pay for everybody, and that fulfills your employer contribution requirement. You have to put in exactly that amount of money, no more and no less. The tradeoff for no nondiscrimination rules is you get a cookie cutter approach. You do it this way, or you don't do it at all.

Another feature of SIMPLE plans that will be popular with employees, but perhaps not with employers, is that all money that goes in is 100% vested from day one.

A few special rules that affect SIMPLE plans are worth knowing if you'll work in this area. There are no nondiscrimination tests or ADP/ACP tests to worry about. You can forget about top-heavy rules. By statute, those rules do not apply to SIMPLE plans. And that gives people who favor these plans something to talk up.

SIMPLE plans get a little more complicated on reporting and disclosure. The 401(k) approach gets the full ERISA treatment. For IRA-type plans, there's only a couple of fairly easy things you do, and having done those, you've met your requirements for reporting and disclosure. You file a government form, and you give the employee an account statement once a year about how much money is there, and how much has gone in and out—just a transaction statement for the year.

Fiduciary rules for SIMPLE plans are interesting. Under a 401(k)-type plan, you typically would be dealing with the 404(c) rules, or else the full ERISA fiduciary rules if you don't meet the requirements for 404(c). But in an IRA-type plan, it's like any other IRA. The employee is the captain of the ship, and whatever investment the employee wants is fine. The employer is not a fiduciary. The employer is merely making the plan available.

Finally, let's discuss early withdrawal penalties. There have been some problems under SARSEPs where employees were enrolled in them as a gimmick to get the plan in, not done in a serious way. The idea was that the 10% penalty was not very harmful. It didn't hurt much and was a price you paid for having the plan installed, but then you pulled most of the people out. For SIMPLE plans, they've tried to close that loophole by upping it to a 25% penalty during the first two years, which is intended to keep people from playing games.

Another important issue is whether SIMPLE plans will prove to be popular. Some money managers and insurance companies say this is really a good deal; they'll sell many of them. Others are not so sure. Some consultants have said they won't recommend SIMPLE plans, especially the 401(k) version. Opinions vary, and people selling SIMPLE plans may not have as much competition as they thought.

This new law has many consulting issues, many ways you can help clients and keep yourselves busy. On 401(k) plan design, down the road you'll have an opportunity to use the design-based safe harbors. It's nothing you can do right now, but it's something to keep in mind because if you do something that's incompatible with it, you may wish you hadn't. You may want to move in that direction so that when it becomes available in a couple of years you'll be able to use it.

There's a small issue about contributing for highly paid employees during disability. That might be an easy change to make when you're amending a plan.

There's another issue, a social issue, an opportunity to cover people who are under age 25 and one year of service because they don't count toward your nondiscrimination testing. If you want to have something that appeals to employees when they're first hired, that's something that you could consider for 1999.

On the defined-benefit side, there are also a few new things you can do. You will have some flexibility about deferring the change to GATT assumptions. Nobody is very sure how this works. We didn't understand all the GATT assumptions in the first place, and now it has become quite a bit more complex because you have some options that are not entirely specified. We're going to have to figure out what is meant.

You also have an opportunity to defer commencement of benefits past age 70½. Here's another one that's problematic. No one is sure about a number of administrative issues, and there's an option for those who are now over 70½. We have to figure out how to offer that option and what it all means.

There are consulting opportunities with the SSRA under a defined-benefit plan. One thing you can do is reduce early retirement benefits more than you have been for people whose SSRA is 66 or 67. It's a chance to save money by taking away benefits if the employer wants to do that.

Another way you can use the SSRA change is to increase the permitted disparity, if you have an integrated plan, or increase the imputed permitted disparity, if you have a plan that's subject to a general test. Either way, you are allowed to discriminate a little more in favor of highly paid employees.

Finally, we have this change in the $5,000 death benefit, and some employers are moving it from one pocket to another because of the change in tax treatment.

Another set of consulting issues gets into nondiscrimination testing. Should your clients use this 20% rule in the HCE definition? If you have a very highly paid group, that can be an important rule. What about using the look-back year data for nonhighly compensated employees? You may want to try it both ways and see which is more favorable. Again, you have nothing to lose by using the SSRA in your testing.

Employers also might want to review the status of their leased employees. The testing is a little different, and there are still plenty of unanswered questions. But, as Dave said, in light of the Microsoft decision, some of these issues about the status of employees are becoming more important. And now that we know the IRS limits for 1997, you can start running some tests on a trial basis and see how the numbers come out.

Other changes involve reporting, disclosure, and notices to participants. We're expecting sample IRS wording before year-end. And then it's a question of do you want to use the IRS wording, or to try something else? I think quite a few employers will use the IRS wording just because it's tested, and the employers are not going to have to be concerned about whether it works. A couple of other recent IRS announcements are coming along also about J&S and rollover notices.

In this new pension law, personal retirement planning is one of the most immediate and most interesting areas. We have all sorts of consulting opportunities here, where you can run spreadsheets based on age, retirement date, and amount of pension. The desirability of using this three-year window can vary quite a lot depending on the particular circumstances. It's very much driven by the facts of each case. At the very least, employers would want to notify the individuals that there are some changes here. I suspect they would find out anyway, but it doesn't hurt to notify them. Beyond that, your clients are probably going to want to give at least some advice to individuals about what happens if they do this or that. You could do some very extensive consulting on that, and I think many of you already have.

This law creates other opportunities in employee communications. All the changes have to be communicated, and much of them have to be tailored to the individual employer about how it wants to announce these things, and what they mean for the company's employees.

Important changes are needed in internal administrative systems because all sorts of plan features are being changed. The USERRA changes probably won't affect many employees, but when you get into the changes for rehired veterans, they just don't fit into the normal way of doing things, so you're going to have to reprogram. We have new treatment of after-tax contributions. We've had to do some work with that before, explaining to retirees what their tax status is on the benefits they're getting.

Nondiscrimination tests are going to need reprogramming quite a bit. And the age 70½ benefits are, too, although it's a little early to know exactly what we're doing. But it's a major change, especially if you get into the options for people who are now over 70½, and if you're doing the actuarial increase. The Section 415 calculations are going to be much simpler when we get into repealing 415(e). In the meantime, there are a number of small changes. And finally, we have changes in the procedures for qualified J&S and qualified domestic relations orders.

The Small Business Job Protection Act's benefit provisions have many open issues and unresolved questions. I really appreciated this recently after working with two Washington lobbying organizations. The Association of Private Pension and Welfare Plans has just submitted to the Treasury a preliminary list of open issues, 14 pages of questions, and we had a three-hour meeting discussing it with the Treasury. Also the ERISA Industry Committee has a list that ran only to eight pages, but many of them were different items, and ERISA's list used smaller type.

The technical questions cover a wide range of things. The idea of this exercise was to help the Treasury and IRS people set their priorities about what is urgently needed and what can be put off a little while. You can look for a lot of guidance from the IRS. It's having a tremendous amount of dialogue with industry and other groups as to what it needs.

Before we open this up to your questions and comments, I want to spend some time talking about the IRS pension limits for 1997. Those limits were announced officially just recently. The $120,000 defined-benefit plan limit is going up to $125,000. The $150,000 pay cap goes to $160,000. The other key limit of $9,500 for 401(k) deferrals stays at $9,500.

What's interesting is that you can see where the limits are going to go next year. The first number is $125,000, and another 1.4% of inflation will get you to the next multiple. That's about half the annual inflation we've been getting. So it's an almost sure thing that the $125,000 is going to $130,000 at the end of 1997. At the next couple of numbers, it doesn't figure that we'll get that much inflation, so they probably will not go up.

Then we have the $9,500 limit. You can put your money on that one because it's almost there now. Virtually any amount of inflation would get you to $10,000. And finally, the $80,000 HCE number is probably going to take two or three years to get up to $85,000. Those are the key limits, and the same information is shown for the other limits down below.

The official numbers from the Social Security Administrationannounce the new wage base of $65,400. That was not in any of the news reports. It was not announced by the media at all because the government press release focuses on what gives you money, not what takes money away, namely the 2.9% cost-of-living adjustment. The press release went on about what that 2.9% does for benefits. But, from a technical viewpoint, we care more about the new wage base.

The updated numbers were announced recently by the Health Care Financing Administration for Medicare Parts A and B. It also has our calculation of the new PBGC maximum for 1997, $2,761.36. That's done by a simple formula, and we're quite sure we're right.

Mr. Michael Scott Bost: I want to ask about the $150,000 limit and repeal of family aggregation. For prior years, do you have any indication from the IRS whether that's retroactive, or is it just a fresh start going forward if you've had family aggregation apply in the past few years?

Mr. Schreitmueller: That transition is interesting. I haven't seen any details on it, but it certainly is prospective, and there's been nothing to indicate that you could change it for prior years.

From the Floor: As you indicated, the Indian tribe change is getting lots of attention. Is it really clear in the law that the Indian tribes can move money from a 403(b) to the 401(k), that is, all the existing assets? Is that spelled out, or is that a matter of interpretation?

Mr. Weingarten: I don't know about Indian tribes in particular, but generally I've always thought there was a problem with moving money from 403(b)s to 401(k)s. I didn't think that was doable. Maybe Dick knows whether there's something in the new law about it.

Mr. Schreitmueller: You'll see this covered in our outline of the law under Section 1450(b). It says money that's been in a 403(b) contract for an Indian tribe can be rolled into a 401(k) plan.

From the Floor: So that seems to be a special exception.

Mr. Schreitmueller: Right.

Ms. Claire L. Wolkoff: I wondered if you had any feel for whether the IRS is going to extend the effective dates for tax-exempts and governmental for the 401(a)(4) regulations beyond January 1, 1997?

Mr. Schreitmueller: First of all, I should say that you're welcome to ask questions that are outside the scope of what we've covered. We seem to be broadening it here, and that's fine.

I keep hearing rumors that the IRS is going to do that. I would bet the people who are starting those rumors are right. I find it hard to believe that the IRS is going to crack down on governmental plans, but they like to keep us guessing. That's my opinion.

Mr. Weingarten: I have heard the same rumors. I haven't seen anything on it. I think in the tax-exempt community, there are a lot of people who represent tax-exempts who are suggesting to the IRS that it not postpone it. If the IRS wants to draw a distinction between the government plans and the tax-exempts, that the IRS can do. But we made that argument when the IRS went from 1996 to 1997 and what have you. From our point of view, we'd like to move forward in the process with the tax-exempts.