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Pension Simplification: Defined-Benefit Plans

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Summary: Can pensions be simplified? This panel discusses the major effects of the Small Business Job Protection Act (SBJPA) of 1996 on defined-benefit plans emphasizing:

- *415 limit changes,*
- *nondiscrimination issues, and*
- *taxation of distributions*

Mr. James A. Hughes: I'm a consultant with Towers Perrin in Minneapolis. Ethan Kra is the chief actuary for U.S. retirement plans for William M. Mercer in their New York office. The topics we will address can be grouped into required distributions, the taxation of distributions, changes to Section 415, and a handful of miscellaneous topics. Ethan will cover the first two, and I will cover the last two.

Mr. Ethan E. Kra: I'd like to explain why we really needed pension simplification. Whoever thought that the rules were simple? They started out simple. We had one set of rules called Employee Retirement Income Security Act of 1974 (ERISA) and things were moving along smoothly. Then Congress came along with things like the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984, the Retirement Equity Act, the Omnibus Budget Reconciliation Acts, (OBRA) the Consolidated Omnibus Budget Reconciliation Act of 1986, the Tax Reform Act 86s, and the Technical and Miscellaneous Revenue Act of 1988. OBRA included the General Agreement on Tariffs and Trade (GATT) and the

Retirement Protection Act. What did we end up with finally? The idea for pension simplification came along. This is something that had been bantered around in Congress for a while. Many of the professional societies and trade associations had been pushing for it, for example the Association of Private Pension and Welfare Plans and ERISA Industry Committee.

What were some of the real difficulties we had? Some of you may have heard the story about how 1.25 = 1.4. For those who were not at the enrolled actuaries (EA) meeting of our 20 anniversary of ERISA where Ira Cohen explained to us how we got to this, let me share it with you.

In 1973-74 ERISA was being debated and was in committee. The Chairman of the House Ways and Means Committee was Wilbur Mills. During the hearings, there was an acting chairman. A congressional staffer went through a long presentation about how much we should allow in the defined-benefit world and how much in the defined-contribution world and you shouldn't have to pick one or the other. You should be able to do both, but not take full advantage of both. They had done a very complex analysis and come up with the conclusion that if you're going to take some from column A and some from column B, the right proportion was 1.25 and the acting chair of the House Ways and Means Committee said, "I agree—1.4." The staffers weren't going to correct him. They went through the entire presentation again and described how 1.25 was the right answer. "You're right—1.4." Now no staffer ever made his or her career by correcting the acting chairman of the House Ways and Means Committee, so they wrote 1.4 into the statute. They had intended to correct it when they did technical corrections as part of TEFRA. Then they realized that would hurt the lower paid people, so what they decided to do was leave 1.4 for the lower paid, 1.25 for the high paid, and that's how we got one of our famous complexities of the Internal Revenue Code (IRC)—1.4 equals 1.25. With that we'll go on to some of the descriptions of what were fixed.

Required Distributions 401(a)(9). The regulations are so simple that they haven't been able to finalize them. They're still in proposed status. They will no longer be required, but we have a number of questions such as the effective date, the actuarial increase, etc. It was so simplified that we were able to put together a multipage letter, send it to Treasury and the IRS with all the questions raised, and they haven't been able to figure out the answers to tell us how to administer this. They're no longer required, correct? Not exactly. They're still required for certain people, namely 5% owners. You'd better know who your 5% owners are. In many companies that's a simple question. Ownership is trivial. I know one of my colleagues sitting in this room has to do a major project every year to determine the 5% owners. In some situations it may be complex.

The new rule is effective January 1, 1997. Simply, if you're 70.5 before 1996, you might still be under the old rules, or maybe not. We'll come to that in a moment. The plan may, but is not required to, stop in-service distributions if the payments commence prior to January 1, 1997. This applies to people who attained 70.5 in 1995 or earlier. If you don't do anything, they will continue in pay status as if nothing changed. However, you must amend your plan to allow these people to elect to suspend payments and continue under the new rules starting January 1, 1997. The plan has the option, not the requirement, to give people the option to suspend. Those who attained age 70.5 in 1996 will have no "required" distribution because beginning January 1, 1997 there are no required distributions. However, any distributions they received during calendar year 1996 will be deemed to be required distributions under the old rules. If somebody turns 70.5 in 1996 and collected anything in 1996, then up to the 401(a)(9) nonrequired distribution, it is deemed to be a required distribution which means no rollover or no mandatory withholding. Anything above that is subject to rollover and mandatory withholding. Anything after that will depend on how it's paid out.

In deciding whether to do mandatory withholding, remember that required distributions are not able to be rolled over and not subject to withholding. Nonrequired distributions are able to be rolled over and are subject to withholding. How do you determine whether a distribution made in 1997 or any subsequent year falls into one category or the other? If it's not a required distribution, you could say that it could be rolled over, so there is required withholding. Remember that the rollover rules do not apply to distributions that are made as a series of periodic payments extending over a period of at least ten years. If the person starts collecting an amount which would otherwise meet the rules of minimum distributions, there is no rollover opportunity because it falls under the category of a series of periodic payments expected to go at least ten years over the lifetime of the individual.

Plans are required to give an actuarial increase for any post-age 70.5 payments not received. The defined-contribution plan actuarial increases really don't make sense. I think everybody will acknowledge that the actuarial increase means you just continue to give investment earnings and you don't decrease it for any mortality, which you wouldn't do any way. On the defined-benefit plan, there are a number of questions. Which actuarial basis should be used? For what period do we calculate the actuarial increase? How do you determine the benefit if the person gets an actuarial increase? How much be paid to avoid giving the actuarial increase and how do you calculate some of the other pieces?

Which actuarial basis do you use? Let's start with that. If I give an actuarial increase, how do I determine what basis? Is it on a GATT basis? Is it on a Pension

Benefit Guarantee Corporation (PBGC) basis? Is it the plan's actuarial factors? Will the IRS come up with factors? Remember, the IRS has issued many mortality tables and interest rates for various purposes, but the IRS has given us no guidelines. That's a tough one.

The next issue is offsetting for the value of benefits accruing. Can a plan still offset the post-age 70.5 benefit accruals by the value of in-service benefit distribution? When I started paying in-service distributions under a defined-benefit plan for people who continue to work past age 70.5, under the Age Discrimination in Employment Act of 1967 (ADEA), I had to continue benefit accruals. I was permitted to offset the accrual during any calendar year by the value of the benefits received during that year. Must plans now provide for both the actuarial increase and the continued accrual of service? In other words, is it A plus B or is it the greater of A and B? For the period from age 65 to age 70.5, under the various regulations, you had to give the continued benefit accrual. If you failed to give the suspension of benefits notice, you generally would give the greater of the two. You didn't give the sum of the two.

For what period must the actuarial increase be determined? I've heard many people say, "I don't want to deal with this problem of actuarial increase. We're just going to administer the plan the way it was before the Small Business Job Protection Act (SBJPA)." They're going to start paying April 1 of the calendar year following the attainment of age 70.5 and without actuarial increases. How many people think that's acceptable? Here's the problem. The wording in the statute is "in the case of an employee who retired in a calendar year (notice the word retired; doesn't say commences benefits) after the calendar year in which the employee attains age 70.5 there will be actuarial increase to take into account the period after age 70.5." Note it does not say after the April 1 of the calendar year following the calendar year of attainment of age 70.5. It says after the period after age 70.5, in which the employee was not receiving any benefits under the plan.

Let's now look at a few examples. An employee attains age 70.5 February 1, 1997. The employee retires and starts collecting May 1, 1998. This employee retired in a calendar year following the calendar year of attaining age 70.5. Therefore, that employee is entitled to an actuarial increase for what period? If I read the statute literally, I would say it's the period of February 1, 1997 to May 1, 1998 or 15 months—not for one month.

The next case is the person who retires on April 1, what would otherwise have been the required starting date—April 1 of the calendar year following the calendar year of attainment of age 70.5. Under the old rules, this person retired right on schedule. The required distributions start on the benefit commencement date—it's the retirement date. A reading of the statute says this person gets a 14-month actuarial increase.

Another example is a person who turns 70.5 February 1, 1997, and starts collecting three months later. Why did it take three months to do the paperwork? They may have had to get the salary history from the warehouse. It may have been a career average plan or it may have taken time to get the joint and survivor notice and the spouse to sign up and do the election. The person starts collecting within the same calendar year, but actually retires April 1 of the next year. The statute would seem to imply that starting April 1, 1998, that person would get a three-month actuarial increase.

As a final example, a person still commenced on June 1, four months after the attainment of age 70.5, but retired in the same calendar year on December 1. Since the person retired in the same calendar year as the attainment of age 70.5, the literal reading of the statute says no actuarial increase. The difference between employees three and four is they started collecting the same date, but one of them continued to work for an additional four months, and as a result, got the actuarial increase on some earlier period. This is simplification.

How much must be paid to avoid the actuarial increase? Remember, it says in the statute “take into account the period in which the employee was not receiving any benefits under the plan.” If we pay a dollar a month, is that adequate? I would not want to take that case to court. That would seem to be abusive and egregious. Should we pay regular benefit? That's clearly appropriate. Perhaps what would be adequate would otherwise be a minimum distribution under 401(a)(9). There are no regulations. We have raised the question with the IRS. I think that they will not give us the dollar amount. I believe that it is a fair guess that the minimum distribution may be a safe compliance. I can't give you a guarantee.

They're no longer required, right? We can tell anybody who turned 70.5 in 1996 that they won't get any benefit—it won't even be offered to them until they retire. Is that right? Is that fair? Do you think you're going to be able to get away with this? What about 411(d)(6)? The IRS and Treasury have raised the issue that the entitlement to the benefit on the April 1 following attainment of age 70.5 for a defined-benefit plan is an optional form of benefit, a 411(d)(6) protected benefit with respect to the accrued benefit at the date you entered the plan. Under 411(d)(6), the Secretary of Treasury has a right to waive protection. There are two schools of thought. One is they should declare it's not a benefit, right, or feature. The other is they should waive the 411(d)(6) protection and plans will be allowed to remove it. Many elderly groups are not willing to throw in the towel that easily. They're talking in terms of giving 411(d)(6) protection to anybody who is 65 by

January 1, 1997, and giving relief for people below that. That's one of their ideas to which we reply—is that going to really make it go away? I thought this was simplification. We were supposed to be able to get rid of this complex problem and now they're saying no. We're going to leave it with you for another five, or six, or seven years and after the turn of the century, it will go away. Is that what they really meant by simplification?

Plan sponsors want to have something simple that they can tell all their employees. What I'm going to do is, for anybody who is over 65 on the cut-off date, I will mandate that we will require everybody to get the required distribution so I can just say—here's your check. I don't want to go through all the problems of trying to give people the choice. There's a school of thought that might be an age discrimination violation because now you're forcing people to collect their pension on account of age. I can't force them to take it. I can't prevent them from taking it. I have to give them a choice and anytime I give a choice, I have to give them all the information necessary to make an informed decision; otherwise if they make the wrong decision, they'll come back and sue me as plan administrator. Who's going to come up with that communication? Has anybody seen any good communication to the average plan participant who is now age 71 as to how to make a decision about the actuarial increase, which I can't define because I don't know what assumptions will be used, what period will be paid, or whether I can offset against benefit accruals or immediate commencement? How do you make an informed choice when the rules aren't even out there? This is going to be a tough one. All you can do is administer until the regulators give us some guidance. We hope they will be reasonable.

Let’s move on to the taxation of distributions. What we had was a repeal of five-year income averaging, a suspension of the excess distributions tax, a repeal of $5,000 death benefit exclusion, and simplified basis recovery rules. Let's go through those in more detail.

Five-year income averaging has been repealed with a delayed effective date of January 1, 2000. You still can do a phantom election after that date for purposes of 4980A, the excess distributions tax. If you get a lump sum after January 1, 2000, there is no income averaging in general. You'll pay ordinary income tax, but if it otherwise would qualify as a lump sum distribution, you can elect to have it treated as a lump sum distribution solely for getting five times the annual exclusion from the excess distributions tax. It was $750,000 last year, I think it's now about $775,000, and it will be indexed. There is still a grandfathered ten-year income averaging and capital gains treatment for people born prior to January 1, 1936, but other than that, there will be no income averaging.

Mr. Hughes: I just wanted to mention that the change Ethan mentioned makes possible another strategy. This only makes sense after the distribution tax comes back. You take an in-service distribution and bring your account balance down to the $775,000 as indexed. You would take that money and roll it over to an IRA. Then when you have a triggering event such as retirement, you can take the $775,000 out, and you are allowed to use the five times limit to avoid the distributions tax. You couldn't do that in the past because the initial in-service distribution would have precluded you from using income averaging and you needed to use averaging in order to have the five times limit. That chain has been broken by SBJPA, and now this is a viable strategy for the future.

Mr. Kra: The old rules said that if you did a rollover of any distribution in-service that you would not be able to get the income averaging with respect to any future distribution from that plan, and effective January 1, 2000, that hook has been removed. You now can have a $1 million account balance, take a distribution of $350,000, whether in-service or, after termination, a partial distribution, roll it over to an IRA, and then in the subsequent year be able to make this phantom election.

Mr. Hughes: That's not a valid strategy for people eligible for the ten-year averaging.

Mr. Kra: Right. The excess distributions tax 4980A have been suspended for the three-year period of 1997–99. It's a tax suspension and effectively there is no tax for three years. That was marked up as a revenue raiser by the congressional budget office and treasury. The expectation was that people would run out, take tremendous distributions from these large accounts, and pay the income tax to avoid the 15% excess distributions excise tax. Whether that will take place depends on the individual. It does require very careful tax planning as to whether it makes sense. There is no suspension of the excess accumulations tax, even though during this three-year period there's no 15% on excess distributions, if the money is taken out while either you or your spouse is alive. If the money is still in the account after the demise of both the participant and the spouse, the IRS collects the 15% excess accumulation tax, which combined with federal and local estate and federal and local income taxes can drive the effective marginal tax rate well into the 1990s as a percentage of the amount of money involved because the 15% excess accumulation tax is not deductible on either the estate or the income tax return. This requires careful planning. There is a rule of thumb that if you think that you're going to have to take the money out within the next ten years and pay the 15% excess distribution tax, then it pays to take it out during the three-year window. On the other hand, if you think that you can leave the money in the tax-qualified arena for at least a period of ten years and then take it out under the distributions tax as opposed to the accumulations tax, then it pays to leave it in the tax-qualified arena.

You get the tax shelter for 15 or 20 years depending on the age of the individual and pay the excise tax. The value of the tax deferral more than pays for the 15% excise tax. On the other hand, if you think it's going to come out as part of the excess accumulation tax you want to get it as quickly as possible.

Also, the $5,000 death benefit exclusion has been repealed. It's a small amount, but effectively these are two ways of the IRS extracting money from the deceased.

Taxation and distribution. The exemption from income of the first $5,000 of the employer's sponsored death benefit has been repealed. It simplifies determination of taxable income. This could have been either a distribution of a death benefit from a pension plan or it could have been accumulated vacation pay or anything else from the employer. The employee communications which you've given employees over the years has to be updated because it is already effective for anybody who died after the date of enactment, August 20, 1996.

There's a simplified method for taxing annuities from qualified plans. It does not affect nonqualified annuities. It only affects qualified annuities. We have a distinction in the method of calculating the taxable portion of annuity distributions depending on whether it's a qualified or nonqualified annuity. If you work for an insurance company and have to do these calculations because you sell both kinds of annuities, make sure that your systems are properly reprogrammed. It simplifies with determination of the exclusion ratio, and in most cases, increases the amount that's immediately taxable. It also gives you a chart which, based on the age of the individual, gives you the portion that will be tax-free depending on the annuity basis.

Mr. Hughes: I want to discuss some of the changes that were made to 415. The first one we'll talk about is 415(e), the combined plan limit, which is going away after January 1, 2000. Is this the plan year or the calendar year? It's the limitation year, which so many things in 415 are tied to.

What do we do for funding? Are you allowed to anticipate this in your valuations for this year that eventually benefits will not be subject to 415(e)? The answer to that is no. You have to wait until the 2000 valuation, and at that time, you will probably need to recognize it as a plan amendment as you do with 415(b) dollar-limit increases and 401(a)(17) limit increases.

One possible exception to this is if you have a union plan where the collective bargaining agreement specifically calls for changing the plan documents to allow benefits to be paid under 415(e). The 412(c)(12) requires the actuary to recognize those benefit improvements in the term of a collective bargaining agreement. What kind of a union plan has 415(e) problems? A pilot's plan is one example where they do run into those problems.

What do you do for your *Financial Accounting Standard (FAS) 87* valuations? The answer depends on if there is a substantive commitment to pay the maximum benefits available out of the qualified plan. It probably makes sense to anticipate that in the year 2000, benefits will no longer be subject to 415(e) and anticipate that in your *FAS 87* valuations.

In the area of paying benefits, if you have somebody who terminates now and this benefit is limited by 415(e), are you permitted to increase that benefit in the year 2000 once the provision goes away? We don't have anything specific, but this probably will be allowed. You should make sure that there is an explicit provision in your plan document for that.

Another issue is what if you have a Supplement Executive Retirement Plan (SERP) which is picking up the excess benefits and you have to pay Federal Insurance Contributions Act tax. Can you anticipate that in the year 2000 the excess plan will pay a lower benefit? I think the answer to that is yes.

Mr. Kra: I would agree because the only prohibition is in 412. The 3121(v) has no prohibition on anticipating future legislative changes, especially because this has already been legislated. It's just a delayed effective date, so I think it would be reasonable depending on what the document says will occur.

Mr. Hughes: I think the last question for 415(e) is—will the repeal actually happen? Many people think that because it is a revenue loser, that in 2000, if the budget projections are not as rosy as they are now, maybe 415(e) won't go away. That's a possibility. The other thing to look at is that the small business lobby is highly in favor of this provision and Congress may not want to do battle with them again or even deal with the intricacies of pension law.

Mr. Kra: The pressure to remove this was very high because for the larger plans, the estimate was that the cost of complying with 415(e) was a large multiple of the revenue involved. When a number of us met with staffers, we gave a description of a larger automotive company that may have two or three people affected by 415(e) but they have to track everything. They said, “Why don't you just track the chairman of the board or those three, four, or five people who are affected by 415(e)?” The question came back, “The problem is we don't know which 22-year-old engineer we hired this year is going to be chief executive officer (CEO) 42 years from now. If you can tell us which one of those engineers or masters of business administration (MBAs) we just hired will be the CEO 35 or 40 years from now, we'll track him. Since we can't tell, we must track all the engineers."

Mr. Hughes: Another change that was made was the ability to repeal within a one-year window which expires August 20, 1996, the provisions for adopting GATT assumptions when adjusting 415 limits. Let's talk about how that works.

You are allowed to go back to the old pre-GATT rules on 415 up until the year 2000 effective date. When GATT came out, they said you have to adopt the GATT provisions for 415, but for paying minimum lump sums under 417, you don't have to adopt that until the year 2000. Plans had to operationally comply with the 415 provision starting in 1995. Some plans amended for that and you now have a one-year opportunity to repeal that amendment.

One question is—what if you have already adopted an amendment where you're going to pay minimum lump sums under GATT in your plan? Are you permitted to repeal the 415 amendment and wait until the year 2000 to adopt for 415? I've heard some differing opinions on this. I believe that if you have already adopted this for minimum lump sums, then you don't have the option to repeal it for 415.

Another provision that was made was to simplify calculations for reducing 415 limits for optional forms or for early retirement. Revenue Ruling 95-29 put forth the rules for calculating lump-sum limits. You had to first reduce the dollar limit for early retirement using the statutory factors—the 5/9%, 5/12% to age 62. If you were to reduce to an age earlier than age 62, you had to do one of two things. You had to use the 5% and 1983 Group Annuity Mortality (GAM) unisex mortality table if you were going to a benefit form that is not subject to 417(e). If you had a benefit form that was subject to 417(e), you had to do a different kind of early retirement reduction. You had to use the GATT interest rate rather than 5%. In each case when you do this reduction you are comparing the plan's early retirement reduction to the IRS specified reduction. Once you reach that early retirement age, you then had to make an optional forms adjustment. There again you compared the IRS specified factor to the plan's factor. The IRS specified factor depended on whether you were going to a 417(e) form. If you were going to a 417(e) form, you had to use the GATT interest rate. If it was a non-417(e) form, you used 5%.

Let's look at the calculation of a lump sum. We're going to assume that the plan's mortality table is the 1983 Individual Annuity Mortality (IAM) female table and that the plan's actuarial interest rate is 5%. The GATT interest rate is 7%, the GAM 83 unisex table is still the applicable mortality table and we're paying a lump sum to a 55-year-old. Let's discuss the calculation as described under Revenue Ruling 95-29.

We first reduce the Social Security retirement age of 65 down to 62. We knock off 20% and we end up at $100,000. We have to do a reduction using the plan's factors, and the GAM 83 unisex, GATT interest rate and take the lower limit. In this case, it's the GAM 83 (7%) which is the lower limit, and we end up at $53,375. The third step is to turn that into a lump sum. Again, we use the plan's lump-sum factor, the GAM 83, and GATT interest rate lump-sum factor and we take the lesser. In this case it's the GATT which is the lesser and we end up with a limit of $630,000.

SBJPA changed this. Step one is identical. In step two, we're going to use the same reduction that we would use if we were going to a non-417(e) form. In that case we compare the plan's factors to GAM 83 (5%). GAM 83 (5%) is the lower number in the comparison and we're down to $59,000. Step three is identical. We're going to a 417(e) form, so we use the GATT interest rate and compare the plan factors. This time we end up with a lump sum of $699,000.

What if my plan doesn't pay lump sums like this? What if my plan says, we'll take the immediate annuity available and apply an immediate annuity factor. What if I have a deferred annuity factor applied to an age 65 benefit? We think it's reasonable in that case to go through the calculation of our second example. Use the plan's early retirement factor which you would use if you were going to pay an immediate annuity. For the lump sum, use the plan's interest rate, mortality table, and do the calculation that way.

You can manufacture an immediate lump-sum factor by taking your deferred annuity factor and dividing out your early retirement factor. To the extent that the early retirement is subsidized, that will come out of your 415 limit and lower that 415 limit.

What happens during the period of January 1, 1995 to the date these changes came about? What do you do if you've already paid benefits and you go back and make any changes? What if you paid a lump sum out of the qualified plan and you realize that if you go back and make these changes retroactively, you could pay more? I think it's possible to do that. What you want to look at is, was there a SERP that picked up the excess? Then if you paid more out of the qualified plan, can you get the money back from the excess plan? I think that has to be looked at on a case-by-case basis. One thing you may want to avoid is trying to condition the additional benefit being paid out of the qualified plan on the repayment of the SERP benefit.

What about annuity benefits? If you paid out annuity benefits and are continuing, you do have the possibility to raise annuity benefits. If you're paying SERP annuity benefits, you could possibly get the money back by going to future annuity payments and reducing them. That gives you a little bit more flexibility.

Mr. Kra: I have one comment on the whole issue of plans that were adopted versus plans that were operating in compliance with GATT rules and had not actually done the amendment: what do you do with the back people, etc? The Treasury and IRS have been asked for guidance on some of those questions. It's obvious that guidance is critical to being received before August 1996 so people can make informed decisions in designing plans. Unfortunately, we have not seen anything come out.

Mr. Hughes: We want to cover some of the miscellaneous topics that we feel are appropriate to defined-benefit plans. Until SBJPA, multi-employer plans always had the ability to have a ten-year cliff vesting schedule. They are now restricted to the same rules as single employer plans. Those rules basically state that the plan's vesting schedule has to compare favorably with one of two statutory vesting schedules and they have to compare favorably in each and every year. The two schedules are the familiar five-year cliff vesting or the three- to seven-year graded vesting schedules. This provision is generally effective for plan years beginning January 1, 1997 or at the expiration of a collective bargaining agreement; in any case, it must be no later than January 1, 1999.

There was a change made to nondiscrimination testing under 401(a)(4). Plans that define normal retirement age as Social Security retirement age can now deem that as a uniform retirement age. Some plans who would otherwise be a safe harbor plan, still had to go through some initial testing steps because they're at a nonuniform retirement age. This should allow those plans to get through the testing more easily. This also covers subsidized early retirement benefits and joint and survivor annuities. These will now be deemed to be uniformly available to all participants. This provision goes into effect after December 31, 1996.

We also saw a change to the leased employee rules. Just to review, leased employee rules basically assume that this is not a common law employee. If the employee does qualify as a leased employee, you need to include them in your nondiscrimination testing. The idea is you want to fail the leased employee test and get these people excluded from the nondiscrimination testing. To be deemed a leased employee you have to satisfy three criteria: (1) the employee has to provide services to the recipient organization pursuant to an agreement between the leasing organization who is the technical employer of the leased employee; (2) the employee provides services on a substantially full-time basis for at least a year; and (3) the employee is under the primary direction and control of the recipient organization. It's this third one that was changed by the SBJPA. The old criteria stated that the services performed by the leased employee were the type historically performed by employees of the recipient organization. This change looks more to the reality of the relationship and is more uniformly applied across industries.

In making this determination, some of the factors which are determinative include can the recipient direct when, where, and how the services are performed by the leased employee. Can the recipient direct who will perform the services and say "I want my former employees which I spun off to this leased organization to perform them." Does the recipient supervise or establish the order in which services are performed? In other words, are you the supervisor of these leased employees or is the leasing organization providing the supervisor? This is a situation where, if you do have a lot of leased employees, you may want to look at how you structure the agreement in order to fail this leased employee test and be able to exclude these employees from your nondiscrimination test.

We had a couple of changes to 415 for government plans. Government plans are no longer subject to the 100% of compensation limit. The limit for single employer plans is effectively the lesser of the dollar limit or the 100% of three-year average compensation. For government plans, it is now just the dollar limit.

Another provision, that's retroactive for a few years, is more a clarification than anything new. It states that certain disability and survivor benefits are not subject to the reductions for early commencement for the ten-year phase. Regulations have already stated that qualifying ancillary benefits are not subject to 415.

Another provision that affects government plans is that they are allowed to have special early retirement reductions. These are codified in 415(b)(2)(f). At the time this came in, government plans were given the option to elect to waive these special early retirement factors in exchange for grandfathering the accrued benefit. The accrued benefit can be taken as the early retirement benefit. They now have a three-year window in which to retroactively revoke that. That's going to be a complicated thing to look at. You may be paying benefits retroactively and, of course, it will affect future retirees.

The IRS was also given authority under SBJPA to waive liquidity excise tax under 412(m)(5). The waiver could be granted if the plan sponsor establishes to the satisfaction of the IRS that the shortfall was due to reasonable cause, not willful neglect, and that steps have been taken to remedy the shortfall.

SBJPA also made some changes to the annuity start-date rules which Ethan will cover.

Mr. Kra: This problem started when an employer was doing an early retirement window and people were not going to get the pink slip until a few days before they would actually be out the door. A number of these people were eligible for early retirement, so they wanted to allow these people who were getting a pink slip on August 20 to be able to start collecting a pension check on September 1. But then they ran up against the required joint and survivorship requirement rules that you could not write the first check before a certain cooling off period had expired. Then you get to the annuity starting date rules and you put it all together. In fact, the IRS and Treasury were saying it was illegal to make retroactive payments; you could not have a retroactive annuity starting date. If the person were to find out on August 28 that they were being let go, it was illegal to cut the pension check effective before October 1, even if you had instantaneous calculation capabilities. People were going around in circles trying to solve the problem. The answer given by one of the Treasury staffers was, “You have a lot of high-priced consultants. Let them figure out how to get around it,” as opposed to saying, “We should really be able to solve the problem.”, or there was a legislative way of solving it.

The other way of describing the problem was—your senior executive has good counseling and planning. He's retiring July 1, so he gives the notice to the Benefits Department sometime in May. They do the calculation workup. They get all the forms and paperwork to the executive and spouse by June 1 so they have a 30-day period to make the joint-and-survivor election. The paperwork comes in and the July 1 check is cut. An employee, on the other hand, comes in on June 30 and says, “I've had it up to here with my foreman. I quit. I'm retiring effective tomorrow.” Then you have to tell the poor guy, "You forfeit your July pension check because you didn't give us enough notice to give you the 30-day notice for you and your spouse to make an appropriate election." So the executive, with proper counseling, had no forfeiture and the employee lost his pension check for a month. This solution states that if a participant is no longer employed, you are permitted to retroactively impose the annuity starting date to a date no earlier than the termination of employment. If the employee comes in on June 30th, and says, “I'm retiring effective tomorrow,” you might not be able to cut the check for some period of time to allow for a cooling-off period of joint-and-survivor notification, but you're permitted to make the check retroactive. The Treasury and IRS have given a shorter than 30-day time period and subsequent guidance, but still there is a cooling-off period for the joint-and-survivor election. What you now have is a situation where the individual will come, you'll do the calculation, you'll give the required notice, you'll allow the cooling-off period for the joint-and-survivor waiver or election and then you'll be able to make the benefits retroactive. In fact, what you might even be able to do is cut an interim check during that period and then do a true-up based on the final election. Effectively, we call this simplification, protection of the employee.

Mr. David M. Lipkin: Mr. Hughes, when you calculated the lump sums both ways you said, we're going to use the plan rates to determine the early retirement benefit, but we're still going to cash out on GATT. I just want to clarify that this is only be for a plan that has adopted GATT and that you could have yet one more equation, for SBJPA without GATT that might have a lump sum of say, $800,000.

Mr. Hughes: Right, there is the pre-GATT rule. If you decide to repeal and wait until 2000, then there is a different set of calculations. In that case, the IRS specified rate reverts back to the pre-GATT rules, which have a reasonable mortality table that should be specified in your plan document.

Mr. Kra: In this case that would have been 5% on the IAM 83 female table which would have given a larger number. That's the pre-GATT rule through December 31, 1999.

Mr. Donald J. Segal: I'd like to follow up on David's question, regarding the same issue with respect to what the SBJPR repeals of Section 415 said. A careful reading of the statute shows that it repealed only the interest rate and not the mortality, which would imply that in this particular case we just talked about, if you used your plan interest rate, that is IAM 83 5% to do your adjustment, it just seemed to have repealed the requirements to use the GATT interest rate, but it didn't repeal the GATT mortality.

Mr. Kra: What we're saying here is that the revenue ruling said to use GAM 83. GATT mortality and GATT interest are used in steps two and three. The legislative change was, once you're into the post-GATT era, step two will use the plan's interest rate as part of that calculation or 5%, if it's greater—it will still require the GATT mortality table. During the period from January 1, 1995 to December 31, 1999, if you elect under SBJPA to use pre-GATT rules for 415, then you would get step two at IAM 83 female 5% and step three at IAM 83 female 5%.

Mr. Segal: That's the point I'm trying to make. The repeal, the pre-GATT rules changed only the interest rate, not the mortality. Basically, they screwed up when they did the amendment. The amendment only changed the interest rate. GATT put in a reference to a required mortality table. That reference didn't change in the amendment.

Mr. Kra: You're not only talking about the early retirement calculation. You're talking about step three as well.

Mr. Segal: Yes.

Mr. Kra: You're saying that even if you don't adopt GATT, you're still required to use GAM 1983?

Mr. Segal: That's what the repeal said. Read the language very carefully. I don't know whether that was the intent because everybody was always focusing on the interest rate. Our legislators in Washington focused on the interest rate and didn't do anything about the mortality basis, which was part of GATT. I think we're probably in a position where we don't know. A literal reading of the law as it now stands would mean, you're still required to use GATT mortality when you're doing all those adjustments. However, it would seem, if the intent was to go back to pre-GATT, they should have repealed the mortality provision also. Who knows what we'll get in terms of guidance because—to quote some famous IRS actuaries—the law is the law.

Mr. Kra: Don, would you expect any guidance before January 1, 2000?

Mr. Segal: Maybe in the absence of future legislation, yes. Otherwise, that would be a good one to duck.

Mr. James A. Marple: When you talked about the inability to project the fall-off of 415(e) in the year 2000, I'd like to find out what cite you're using. It seems to me that you're relying on the age old inability to project 415 limits and future changes. Is there something else I'm missing?

Mr. Kra: Really two things. One is the Treasury and IRS have said that that is their position, IRS and Treasury. Second, if you look at the legislation, and I will grant you that revenue estimates in the back of a tax bill don't exactly hold as a major source of citation in court cases, it clearly shows congressional intent. If you look at the revenue estimates in the bill, it's clear that they show a major revenue cost in the year 2000 and nothing before that for this repeal which indicates that they do not expect that the repeal of 415(e) will be reflected in any of the funding calculations during 1997–99.

Mr. Marple: I'm just remembering the small plan audit witch hunt and reading the court cases that favored our side of the story which was that there's an obligation to make sure the funding's there. Granted, there is not a lot of sentiment for the people who benefit from this change ultimately in Washington, but the potential is there for the wrong events to occur such that the money won't be there.

Mr. Kra: A plan that's amended in the year 2000 to repeal 415(e) could easily see a significant increase in liability and generally the rules are that those will be funded over some period of time. Benefit improvements aren't funded in small plans in one year. If it's a large plan, you can get unfunded current liability immediately. In the small plan arena, you don't get that.

Mr. Segal: I'd like to raise a different issue. Jim, when we were talking about the elimination of the excise tax on the excess distributions, you suggested a strategy. Basically, take a lump sum out now because it's not subject to the excise tax, reduce your remainder to below $750,000, or so and roll it over now. The theory then is, at the point when you finally do retire, the remainder will be below the threshold and therefore will not be subject to the excise tax. What are you going to do with this remainder? If you have to combine the two, the two may still be characterized as defined-contribution money. If you take it out of your IRA and your plan together, might you still be subject to the excise tax. Are you assuming you're going to?

Mr. Hughes: You would take out the second one.

Mr. Segal: Take out and pay your income tax on it, apparently.

Mr. Kra: Right, to avoid the excise tax. Generally, you want to do some careful modeling for any client that's doing some strategizing on the timing, the type of investment, the interest rate, and tax brackets. Will the person be in a higher bracket or a lower bracket in the future? How will the tax-sheltered monies grow? What will be the relative health of the individual and spouse, if there is a spouse? Is the spouse going to be your beneficiary or are they intending to give money to the children? How does it fit into the picture of the rest of the estate plan? It's not a cut-and-dried issue as to whether you want to take money out during this window. There are many strategies. There have been some sessions given at the EA, Society, and Conference meetings where there have been substantial data given just on the question of modeling and how exiting of the funds of the qualified arena and showing that paying excise tax sometimes reduces greater overall wealth. This is opposed to trying to avoid it because of the added time period of the sheltering of the tax. It's something that you have to look at very carefully. You don't just take a quick rule of thumb and say that's the answer.