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Technical Concerns: Late-Breaking Pension Developments

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Summary: The one thing certain in our business is change! The presenters discuss recent developments, especially in the U.S., that are not being covered at other pension sessions. This session identifies areas of change that may affect your clients and helps ensure that you are giving your clients up-to-date advice.

Mr. Donald J. Segal: I'm a senior vice president with the Segal Company in New York. Joining me on the panel are Ethan Kra, chief actuary of retirement at the New York office of William Mercer and Company, and Mark Wintner of Stroock, Stroock, and Levan, LLP. Mark is a partner specializing in ERISA.

We'll discuss a number of IRS releases and court cases that have happened recently. The opinions presented here do not necessarily represent those of the sponsoring organizations, our employers, or the presenters themselves.

I'll start with a few of the IRS releases. The first one is Announcement 98–1. We're being very careful to define what kind of a release it is. There were four releases numbered 98–1 this year—an announcement, a revenue ruling, a notice, and a revenue procedure. Announcement 98-1 proposed examination guidelines for the IRS agents auditing plans. These are guidelines for sections 412 and 404. It's interesting reading. Actually, it's not a bad document. It might even be used as sort of a training mechanism for your own employees because it presents some things very nicely. They didn't get it 100% right, but it was fairly good.

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The next one I want to talk about is Notice 98–1 on the new rules on nondiscrimination testing for cash and deferred arrangements. This is a follow-up to the Small Business Job Protection Act (SBJPA), which amended 401(k) and 401(m) to allow you to use prior-year's data in doing your testing. I'm presuming everyone knows what average deferred percentage (ADP) and average contribution percentage (ACP) testing is, so I won't define it. Nor will I define highly compensated employee. This notice tells you how to implement the law that permits you to use prior-year testing in doing your current year ADP testing. Basically, you use the prior-year's ADP percentage for your nonhighly compensated employees in determining what your highly compensated employees can contribute this year. I'm not going to go through all the details of any of these releases because each one of them would probably take a full session. I'll just hit the primary points.

The notice also covers how to handle a planned coverage change if there has been a merger or spinoff. It talks about the use of qualified nonelective contributions (QNEC) and qualified matching contributions (QMAC) in meeting the test. I would say the most important thing is that in order to be counted as a QNEC or QMAC, the contribution must be made by the end of the testing year. For example, if you're testing for year 1999, the 1998 QNEC and QMAC must be put in by the end of year 1999 in order for you to recognize it when doing your testing. It sort of makes sense. The only caution there is to be careful that you could produce a 415 violation in doing so, because if the contribution was actually made in 1999, it counts against your 1999 allocation for 415 purposes. They don't make it easy for us.

There's a first-year rule for brand new plans. What do you use for the look-back year? You have a choice of using 3% as the nonhighly compensated percentage for the first year or you can use the current-year percentage. Use of the current-year percentage for the first year doesn't commit you to be on the current-year method. The notice also covers how to change from a current year to a prior-year testing method. You really have the option of being on current year or being on prior year. You can't switch back and forth more often than every five years. You must have been on one method for five years before you can switch to the other one.

There's a rule against double counting of contributions, which is effective for 1998. For example, if after you put in QNEC in the year 2000, which was to apply to that year and would enable you to pass the test in 2000, it doesn't mean when you're looking back from 2001 you can say, I can count that. The example given in the guidance is that if your ADP percentage was 4% in the year 2000 and you needed an extra 1%, you put in a QNEC to bring it up to 5% in order to pass the test; then in 2001 when you go to look back, you use 4%, not 5%, as your nonhighly compensated percentage. They don't let you double count. It makes sense. The

plan must specify the testing method. You've got to say what you're doing, so, basically, if you're changing, it's a plan amendment.

Then there's notice 98–2, which was nice and simple. Notice 98–2 was to determine the tax-free and taxable portions of annuity payments. This is a simplified method. It's effective for annuity starting dates after December 31, 1997. They had, basically, put this in the 1996 tax law and said, depending on the age of the annuitant, you just took your basis (typically, the employee contributions without interest), and divide it by the expected number of payments. That is your nontaxable portion for each payment.

The law changed in 1997 to recognize joint survivor annuities so if you have two beneficiaries, they extended the table to include combined age of annuitants. This is effective, as I said, for all annuity starting dates after December 31, 1997. The original table, which was basically just with the single lives, was effective for annuity starting dates after November 18, 1996. The IRS recognized that some people did not meet that starting date. Many people thought it was January 1, 1997, so they put in a special transition for those annuity starting dates between November 18, 1996 and January 1, 1997.

One thing to note about this is that the amount of the nontaxable portion of the annuity payment remains constant even if you, for example, have a 50% joint and survivor benefit. So if the original annuitant dies, the payment drops to 50%. The nontaxable portion does not drop to 50%. It remains the same dollar amount even if there was a postretirement cost of living adjustment (COLA) that took effect. The nontaxable portion is expressed as a constant dollar amount.

The next one I'll talk about is the regulations under 417(e), which isn't all that bad. That's a cute one. These are final regulations. We finally got some final regulations that are meaningful. As most of you know, Section 417(e) was changed. There's a new applicable mortality rate and a new applicable interest rate. The mortality table is the 1983 Group Annuity Mortality Table (GAM), 50/50 male and female. The applicable interest rate is the annual interest rate on 30-year Treasury securities.

The proposed regulation came up with two new terms—the stability period and the look-back month. They changed those terms in the final regulation. They actually liberalized them. This final regulation was really an improvement over the proposed regulation, so let's note that for the record. The stability period can be on calendar month, one plan quarter, one calendar quarter, one plan year, or one calendar year. Now, this is a change. Originally, it was just calendar month, calendar quarter, or calendar year. But what about the planning year?

The look-back month didn't change. The proposed regulation added the first, second, third, fourth, or fifth full calendar month preceding the first day of the stability period permitting an average interest rate. This was a change from the proposed regulation. Under the old regulation, you had to choose what your look-back month was. Now, you can average. You can select two or more consecutive months from among the first, second, third, fourth, and fifth. So in case you didn't rely on one point in time, you could use an average, which is another improvement in the final regulation.

This particular regulation applies to all forms of benefit except for nondecreasing life annuities. An annual benefit that decreases during the life of the participant merely because of the death of the survivor annuitant (for example, reducing to not less than 50%), is not considered a violation, so there's an exception for a qualified joint survivor. A cessation or reduction of a Social Security supplement or qualified disability benefits is considered an exception to this. Everything else is subject to the 417(e) mortality and interest rates.

Some questions have come up recently. For example, if you have a lump sum. I think it's clear to everybody you use 417(e) rates. The question came up, if you're paying it out over ten payments, (i.e., you're giving them a ten-year certain annuity), do you have to use the 417(e) interest rate to determine the amount of each payment? The answer is yes, because that is not in the form of a nondecreasing life annuity. Other plans sometimes permit you to take 25% of the benefit as a lump sum; the remainder is taken as a life annuity or as a qualified joint and survivor annuity. Can you qualify for the exception or are you now subject to 417(e)? You are subject to 417(e), because the former payment is not in the form of a nondecreasing life annuity. There is relief under Section 411.

From the Floor: What if the payment was just a refund of employee contributions with interest?

Mr. Segal: These rules apply to the employer-provided benefit, in general. If the plan permitted the employee to withdraw his contributions with interest at retirement, I think that would be considered a nondecreasing life annuity.

It's okay to refund the employee contributions. If the remainder was in a qualified joint survivor annuity (QJSA), you're okay. There is 411(d)(6) relief to the extent that if you're merely replacing the PBGC rate with a 30-year Treasury rate, you don't have to put any 411(d)(6) protection in the plan. If you change the look-back month to the first or second month prior to the payment date or through your stability period, that is not is considered a violation of 411(d)(6). There's a technicality. Typically, your PBGC rates are set on the first day of the month—it is the rate

for the first day of the plan year or the first day of the month in which payment is made. But your 30-year Treasury rates are the prior month rates, so your January rate is the average of December. So they're basically saying you could pick December or November where you had a January 1 PBGC rate and you wouldn't have to put any transitional provision in your plan.

If you do not have this, in other words, if you were changing from monthly to annually, you have to put in a one-year transition from the effective date of the amendment where you will give the participant for one year the greater of what you would have gotten using the old date or the new date, or the greater of one or two months prior to the old date or the new date. If you had a plan that said they get the more favorable rate between the PBGC rate or 7%, then you can't just go blithely to 30-year Treasury rates in order to get the transition relief or the 411(d)(6) relief. You have to say 30-year Treasury rate or 7%. If you want to take away that 7%, you have to go through the one-year transition.

Mr. Ethan E. Kra: I'm going to cover a few items, one of which is not actually a governmental guidance, but something we get from abroad—International Accounting Standard (IAS) 19. Why do we even have to worry about IAS? Every ten years there's a Governmental Advanced Technology (GAT) round of negotiation on international trade. The last round was the Uruguay round. It started in 1991 and culminated, at least in this country, with the General Agreement on Trade and Tariffs (GATT) legislation. In that negotiation, they covered quite a myriad of issues.

One of the issues that was tabled in the 1991 round was international trade and professional services. That will be reexamined as part of the next round starting in the year 2001. Accounting services are among those that will be on the table. That will affect us indirectly, because actuarial services relating to accounting transactions, such as *FAS No. 87, FAS No. 35, FAS No. 88, FAS No. 106, FAS No. 109, FAS No. 112*, *FAS No. 123,* etc., will all be part of the issue of the extent to which each country will set its own accounting standards and the extent that they will be internationalized. The SEC will weigh in on that, the Financial Accounting Standard Board (FASB) will weigh in on that, and I'm not going to try to claim that I have a crystal ball as to where that will end up. We should be cognizant of the IAS as they develop and comment on them to the extent that they affect us.

What are the differences between *IAS 19* and all the *FASB* rules that we've come to know? The key ones are that for *FAS No. 87 and FAS No. 106* there will be a fresh start. If the assets are greater than the Post-Retirement Benefit Obligation (PBO), you will reset your accrued or prepaid. If the PBO or the accumulated post-retirement benefit obligation (APBO) is greater than the assets, you will recognize the difference either immediately or spread it over five years. It will be a total fresh

start, effectively wiping out your accrued or prepaid and replacing it with something else.

Plan amendments. The amortization will be through the vesting date, so to the extent that the plan amendment is already vested, there will be immediate recognition of expense. There's no such thing as a market-related value. There is no 90-day prior to the date of the financial statements for the measurement date. The measurement date must be as of the fiscal year-end.

There is a cap on the prepaid pension asset, and how much you can effectively expect to be able to utilize given the current corporate structure, such that it may be limited to recognizing no more than the assets that will cover the expected postretirement benefit obligation (EPBO) or the present value of benefits (PVB).

A multiemployer plan is supposed to be allocated to the individual contributing employers if the information is available. The presumption is that the information would be available. If the information becomes available, the employers will have to take their lockable shares of the *FAS No. 87* and *FAS No. 106* liabilities directly to their balance sheets. There is no additional minimum liability, and amortization of gains and losses are over all participants—not just those expected to get benefits. That's a slightly more rapid amortization schedule, in general.

Companies may have to deal with *IAS 19* in their international operations. It's not clear to what extent they'll affect U.S. operations, at all, but it's something that we should be warning clients about.

Mr. Robert M. Katz: My understanding is IAS 19 is applicable immediately for 1998 plan years. Is that correct and, if so, are you keeping two sets of books—one for U.S. purposes and one for international purposes?

Mr. Kra: The issue is the effective date. My recollection was January 1, 1999, but we could check on that. As far as keeping two sets of books, that will depend on the extent you're required to issue audited financials in different jurisdictions. If you're a U.S. parent, do the foreign subsidiaries have to comply with local accounting rules or can they defer to the U.S. rules? If you're a foreign parent with U.S. subsidiaries, you may have the same issues. To what extent do you issue U.S.-audited financials or do you only issue financials for the parent company? Other items that may come to bear is, in which countries are you dealing with the equity markets or the capital markets, and to what extent do you have to issue financial statements that comply with the requirements of the various capital markets? The answer as to whether or not you have to keep two sets of books will depend on a particular company's situation and to what extent different jurisdictions will give

reciprocal recognition to the other jurisdiction's rules. And I think that will develop over time.

Mr. Segal: Ethan, has there been any indication from FASB as to whether they would accept an *IAS 19* determination?

Mr. Kra: We haven't seen any indication yet that the SEC or the FASB will accept *IAS 19* as a standard for U.S. domiciled companies. There may come a point where foreign companies comply with their local jurisdiction's accounting requirements and to the extent that those requirements are very similar to *IAS 19*, they might be able to limit their disclosure to *IAS 19* disclosures even though they're issuing American Depository Receipts (ADRs) or, otherwise, tapping into the American capital markets. That might put pressure on the SEC and the FASB to allow *IAS 19* rules for American companies to the extent that American companies feel IAS would be better.

However, I don't see the pressure coming primarily from *IAS 19*, but there's a package of rules. *IAS 19* is not a rule in isolation. It's part of a package of IAS, and our understanding is that a company either adopts them as a package or not. You just can't say, well, I'll pick and choose and cherry pick that this IAS is more attractive than FASB, so I'll use this one over here, but FASB is more attractive over there, so I'll use FASB over there. It's going to be an all or nothing thing. We don't think that *IAS 19* will be the driver; it will be the rest of the package.

Moving onto Revenue Procedure 98–10, automatic approval for change in funding methods. This expands the automatic approvals under 95–51. Let's look at a few examples. On asset valuation methods, you can now use up to a five-year smoothing of the difference between actual and expected investment return where the expected return is based on market value and not on actuarial asset value. That one I will admit surprised me, because my understanding of the reasonable funding regulations was that a reasonable funding method is one in which there will be no gains and losses if every assumption is exactly met. In this situation, if you exactly meet the expected return based on the plan's actuarial value of assets, you will generate the investment gain or loss for spreading. So I was surprised with the result, but that's what has been published. You're allowed to do it with or without a fresh start.

They gave another alternative on the five-year smoothing of capital appreciation realized and unrealized that we had in 95–51 in which you can do a fresh start and then blend into the five year, smoothing over a period of five years. In that method you would do a fresh start for year one, and then in year two you would do a two-year smoothing, year three and four, and then a five-year smoothing. The original

revenue procedure seemed to give you a one-year look back as your fresh start, and we believe that may have been unintended, so this revenue procedure gives us a pure, fresh start blending into the five-year smoothing method.

There has been a change in software, where the maximum differential between the old and new software is not more than 2% of the net charges to the funding standard account. That's quite good, except for the fact that you may have certain plans where the net charge is negligible because of offsetting items. And in those situations, even though the difference in liability may be less than 2%, the difference in liability may be a fraction of a percent. You may not get automatic approval, so be very careful. This automatic approval is only where the net charges change by less than 2%, not the calculated liability amounts.

There has been a change in actuary. They did liberalize the 5%. It now applies not to net charges, but to each of the normal costs, the accrued liability, and the actuarial asset value. They put a fix in that the change base now will deal with the reconciliation account. That had been ignored in 95–51.

Another item, which they apparently have now given us, which they had refused in the past, was that the anticipation of collective bargaining increases can be a 30-year base instead of a ten-year base. To get this back to 1995 it would require refiling your Schedule Bs with amended Form 5500s back to 1995. This one was somewhat frustrating in that at least one major firm did send an application into the service for, specifically, this approval on a class basis and the check was returned; they would not even consider it, and now we get it as automatic approvals. The four-year clock on the next automatic approval does not start when you're using any of the special approvals.

Let's move on to Revenue Ruling 98–1. This is one of the four 98–1s. This is an update of 95–29. It's a 415 guidance reflecting the Small Business Job Protection Act (SBJPA). After 95–29 was promulgated, many in the profession had written in comments to the service requesting that the future guidance and updating of 415 issues be in the form of proposed regulations subject to public comment. This was the guidance that was issued to update 95–29 with relation to code Section 415. It was issued in the form of a revenue ruling with no opportunity for public comment and no requirement for the service to respond to any specific comment.

Revenue Ruling 98–1 reiterates that the form of the adjustment must be separately adjusted for early retirement and then adjusted for the lump sum. In adjusting for early retirement, you only use the plan factors or 5%. You don't use GATT. This change, which was part of SBJPA, must be used for any benefit calculations after August 20, 1996, the effective date of SBJPA. So if you did any 415 calculations for

lump sums past August 20, 1996 based on the prior published guidance in 95–51, you must go back and recalculate. There is no delayed effective date. Effectively, SBJPA repealed the IRS position of 95–29 in this part of the calculation as of the SBJPA effective date, and there is no delayed effective date on going back.

So you adjust for early retirement using the plan's factors or 5%, then you adjust for the lump sum based on the immediate annuity compared to the lump sum, and compare that to the GATT immediate lump sum factors, so you have to be careful. There are a couple of items in this guidance that you can get caught up on if you're not careful.

If you have subsidized early retirement that is only applicable to the annuity form, but the lump sum is based on the deferred annuity to age 65, the 415 limit for a lump sum is severely reduced because you get a double effect of the cutback. What you do is reduce the early retirement benefit based on 5% and GATT mortality. You then compare the lump sum you get versus the annuity using the plan's factors. Let's say the lump sum is a factor of five at age 55, whereas you have totally subsidized early retirement, and totally unreduced early retirement and so you get a factor as an immediate annuity factor of five using plan factors. So you have to cutback the 415 limit for the early retirement using 5% and GATT mortality from age 62 back to 55, after cutting it back from 65 to 62 using the statutory 80% factor, and then you cut back, once again, because you subsidized the early retirement, you have to cut back on the lump sum. Second, if you have a subsidized early retirement to age 62, but not below, there is a cliff dropoff in the 415 limit at age 61. This is a very dramatic cutback, and you have to be very careful about these.

You can delay the final implementation date to any given date up to the end of the 1999 plan year. Participants have a freeze date, which means any date between January 1, 1995 and the final implementation date. And you can have different freeze dates for the old law depending on different classes of participants. The only thing you have to be careful about, and it usually doesn't apply to most plans, is that if the non-highly compensated employees (NHCE) are affected by 415, then they would have to get the better of all the possibilities or you'd have to do nondiscrimination testing. Very few NHCEs ever get affected by 415, although you may have a few situations between now and 1999 with 415(e) or in situations primarily where individuals have had large 401(k) sums in the past. We used to have 125 salary reductions on nonhighly paid that were affected by 415(b), but that seems to be going away now that we've redefined the 415 compensation.

The guidance does, specifically, permit the A plus B approach, which was in the Congressional legislative history, but not in the statute of the SBJPA, so that you can

put in a benefit that says, I will pay the old rules up to the freeze date and then the new rules going forward (as opposed to a total freeze wearing away).

Mr. Bruce E. Binzel: You said that 98–1 was effective going back to August 20, 1996. What about the plans that have terminated or received favorable determination letters on their termination?

Mr. Kra: The guidance does not address those situations. One item that we often have is that a plan must always be administered in accordance with its terms. If you have a determination letter that often provides comfort. It would be extremely difficult to go back to terminated plans and now address future guidance. I mean, Mark or Don, do you have a comment on that?

Mr. Segal: I would just respond that you should have a policy of don't ask/don't tell.

From the Floor: Very handy.

Mr. Wintner: I would agree with both of you, but I think if you have the ruling, you don't have a whole lot of exposure if somebody comes forward.

Mr. Kra: If you have a determination letter, you administer the plan in accordance with its terms. The plan sponsor might have the ability, if they wanted to, to try to reopen the issue if they wanted to give additional benefits to someone. How it actually would get through, I think, would be a matter of going to the service and trying to work that through. But I think the service would have a tough time coming back and retroactively disqualifying your plan once they gave you the determination letter and you followed all of its terms.

The coordination of 415 and 417(e) on the different implementation dates that you could have, let's say, adopted 417(e) January 1, 1995 with respect to GATT and now how do you deal with it if you're delaying on 415, the key is that in calculating the benefit prior to the 415 limitation, you must follow the plan's provisions which includes any 417(e) amendments that you've put in. So it's a backdoor way of getting in 417(e) to apply to at least part of the calculation.

Mr. Wintner: We have about ten announcements and notices, and 13 cases, and about 30 or 40 minutes, so we'll race a bit. Let's start with the various notices and rulings.

First, is IRS Notice 97-75. If it starts with 97 maybe it's not quite late-breaking, but we've expanded the notion to pick up late 1997. In this notice the IRS gave

guidance with regard to some specific questions arising from the SBJPA amendments to Section 401(a)(9). Specifically, this changes all but 5% owners. The general commencement date now has to be age 70½ or retirement, whichever is later, as opposed to the old rule which was age 70½ whether or not the person worked past age 70½.

The IRS addressed some specific issues in this notice. As we'll see later, they both have been active in other areas involving 401(a)(9). One item that they hit was the requirement that there be an actuarial increase in a benefit when a participant reaches age 75 and his actual beginning date, if that beginning date is going to be later than 70½, because under SBJPA and under the plan he continues working past that age.

Other than noting, in effect, that there was this actuarial increase, the only significance of the notice was to confirm what one would have suspected—that while there is a parallel requirement for an actuarial increase under 411 for anyone working past normal retirement age, you have to apply both actuarial increases when you reach the point where both increases are going on at the same time. They are not cumulative. In effect, you can reduce the 411 actuarial increase by the 401(a)(9) actuarial increase. That is true whether or not you're using an actuarial increase or an additional accrued benefit adjustment under 411.

With regard to the required beginning date for an employee who reaches age 70½ prior to 1997 but retires after 1997, the notice confirms that the required beginning date will be determined under SBJPA. In effect, the person may have two different required beginning dates, one with regard to his pre-1997 benefits and a second required beginning date with regard to his post-1996 benefit.

Let's say an employee is given the option of ceasing his benefits. Let's also assume that the notice confirmed what the IRS had said earlier which is that you could, indeed, give an employee that option. Then the employee can, in effect, suspend the benefits with a couple of caveats. First, it's subject to any QDRO. Although, the IRS didn't quite say, the implication is that if there's a QDRO and a portion of the benefit is being paid under the QDRO, you simply continue to pay that portion. There is no similar option to suspend the QDRO benefit, certainly, not on the part of the participant and by implication not on the part of anybody.

Second, you do have to coordinate this suspension or interim period with the various joint and survivor consent requirements, and the notice gives you a few ways in which to do this. First, it indicates that the plan has to decide whether it's going to be under a rule by which following the period of suspension there is no new annuity starting date and a second set of rules if there's going to be a new

annuity starting date and the plan has to decide. If the plan is going to treat the suspension as just that, a suspension, and there will be no new annuity starting date upon your later retirement, then no spousal consent is required in order for the employee to elect to cease or stop benefits.

Later the benefits commence. Again, there is no spousal consent requirement for recommencement, assuming that the benefits are going to recommence in the same form or with the same beneficiary, or if there's going to be a new form, but the spouse gave a general consent at the time of the original annuity starting date, or if the spouse at the time of the original annuity starting date gave a specific consent and is no longer married to the employee when benefits recommence. That is fairly technical. You would have to advise your client to go through it, but the gist of it is if there's not going to be a new annuity starting date, the employee can make that election without consent and, in most cases, can recommence without consent.

If the plan, on the other hand, is going to say that when benefits begin again there is a new annuity starting date, then although no consent was required to suspend, all of the usual rules will have to be applied at the new or second annuity start date. You'll have to go through all of the consent requirements. The notice points out that, in that case, if there is a death between the date in which the benefits cease and the new annuity starting date, that all of the usual preretirement survivor annuity provisions would apply. So preretirement death and survivor annuity benefits would flow from that.

Curiously, the service didn't address what happens in the first alternative if there is no new annuity starting date, or if benefits are suspended. What happens if there's a death during that period? Despite the silence from the service, common sense would tell you that you would simply apply whatever survivor annuity benefits there are under the form elected and go from there. However, common sense is often misleading and perhaps further clarification would be helpful.

The notice also addressed whether or not a plan allows an employee to stop benefits. As you know, that's permissible but not required in the situation where he's working past December 31, 1996 and past age 70½. If there is an actual distribution, because benefits are not suspended, distribution of those benefits are not required and, therefore, at least in theory, could be an eligible rollover distribution. Recognizing that employers may be surprised to see that's the case, there's one-year relief that for any such distributions during 1997. That applies in cases where employers would have thought that they would have been required distributions under the SBJPA law, and therefore they would not have given 401(a)(31) rollover rights with regard to such benefits.

Therefore, it might have been eligible that the plan will not fail to satisfy 401(a)(31) if there's good faith reliance during that 1997 transition year. However, that reliance ceases January 1, 1998. It's a practical matter given the prevalence of lump sums. It may not matter in too many situations. But if you have less than ten-year installments, you'd better check and make sure that you're treating it properly.

Last, the notice indicates that a plan may continue to use the SBJPA law if it wishes; and, therefore, requires that benefits start at 70½ or at least by the April 1 following 70½. That in and of itself is not so unusual, although most plans are going to switch over to SBJPA. Many plans said they were tired of going back and forth every five years when Congress changed its mind, and although they didn't like the 70½ rule to begin with, they might as well just stay with it. That's a minority, but it is endorsed by the notice, however, to create a complication where perhaps none was necessary.

The notice goes on to say that if a plan has the 70½ rule, notwithstanding SBJPA, then for purposes of 401(a)(9) and for the 401(a)(9) rules, which require that for purposes of determining minimum distributions and whether or not benefits have commenced before death, the plan rule will govern whether or not you have a designated beneficiary in place at age 70½ and will govern whether or not benefits commence before or after death. So, in that case, the plan rule will apply. Somebody who continues to work to 75 and thinks that they have until 75 to make that designated beneficiary designation, they would not under this notice where the plan continued to use the pre-SBJPA mandatory rule.

To further complicate things, although in this case it would seem to be a relief to the employee, they will apply the actual SBJPA rules for the purposes of the 50% excise tax under 4974. Notwithstanding the fact that the plan continues to use the pre-SBJPA 70½ rule, the service will split the difference. It will use the plan rule for determining whether or not you have a designated beneficiary, but will use the statutory rule to determine whether there's a 50% excise tax.

Since there is a lot of interest in the 401(a)(9) and SBJPA area, the service had two other pronouncements during the same period. There's a proposed regulation to 401(a)(9). Actually, this was not triggered by SBJPA, but rather a more general 401(a)(9) issue. There has been increased use of trusts as beneficiaries with regard to various defined-contribution plans in order to stretch out the deferral inherent in plan benefits as much possible. The use of trusts is quite useful in many cases.

The 1995 proposed regulations had indicated that you could use the trust as long as you had designated beneficiaries of the trust, and those individuals would be treated as the designated beneficiaries under 401(a)(9). Among other things, however, it

required that the trust be irrevocable and that copies of the trust be furnished to the plan administrator. It was pointed out by many people that the irrevocability requirement, in particular, was very troubling to participants and seemed to serve no purpose. The requirement of providing full trusts, perhaps, years before any death was not substantively important, but was a pain in the neck to everybody.

Noting that it still has to be a valid trust, the IRS has proposed to change the proposed regulations so that it be sufficient that the trust become irrevocable upon the death of the participant. It also eased up on the requirements of providing a full copy of the trust, however, it indicates that: (1) the participant must give the plan administrator certifications of who the designated beneficiaries are, (2) that the trust is available upon request or demand, and (3) that full copies will be provided at the suitable time. There's a requirement that the plan be given a copy of the trust within nine months of the participant's death.

Prompted by 401(a)(9), at the beginning of June 1998, the service amended 411(d)(4) to give 411(d)(6) relief to plans that may want to eliminate the old age 70½ from their plan. This goes back to the service's concern that notwithstanding SBJPA, about the change in 401(a)(9). It did not directly authorize the elimination of what used to be a plan provision. Benefits ought to commence at 70½ even if you continue working. And what would now, in effect, become an optional form of benefit under post-SBJPA with regard to employees other than 5% employees.

Regulation 411(d)(4), which in its final form is more helpful than some of the interim announcements the IRS had made last year. They do indicate that they will allow sponsors to eliminate the age 70½ distribution option without being in violation of 411(d)(6). There are a couple of conditions. First, it applies only to employees who attain age 70½ after 1998 or after the year in which a plan amendment eliminating the age 70½ option is adopted. The IRS stated that they, clearly, did not want to take away an option from people who may be very close to age 70½ and who may have been planning on the old pre-SBJPA rules as giving them an entitlement to continue to work and draw down benefits at the same time.

The regulation also indicates that if you're going to eliminate that 70½ option and, again, it's permissive, you don't have to, so then you must preserve to the employee who continues to work past 70½ the ability to elect any other option at his later required beginning date, which he could have elected at age 70½. They also make clear that doesn't necessarily mean that you are preserving old rules, but simply that you can't say that somebody who works past 70½ and, therefore, defers his benefit will have a more limited choice under the plan than somebody else who retires at an earlier age. Finally, the plan amendment eliminating the adoption must be adopted within the remedial amendment period for SBJPA.

Turning to changes to the proposed regulations under Section 72. This is proposed Regulation 1.72(p)–1 regarding loans that are deemed distributions. The proposed regulations in this case are from 1995. What was issued in January 2, 1998 is really an expansion on an issue that was left open by the prior proposed regulations. Again, these are not final regulations. These are simply proposed amendments to regulations themselves, which remain proposed some 15 years or 16 years after the 72(p) was added.

I'm going to assume familiarity with the basic Section 72(p) treatment of loans and the situations in which they can become deemed distributions and, therefore, taxable. What the amendment to the proposed regulations addressed was two or three issues flowing from that. First, it indicated that in a situation where an employee has failed to repay a loan, perhaps initially or through a default the loan, of course, continues to be a loan and, therefore, continues to accrue interest. The IRS indicates, in these proposed regulation modifications, that interest will not be additional taxable distribution from the plan. So if you owe the plan $20,000, you're now in default. You have $20,000 of taxable income, and you continue not to pay them for some time. The $20,000 is accruing interest, but that interest is not additional income to you as a result of a deemed distribution. To put it another way, it's not a deemed distribution.

The proposed regulation also makes it clear that both the original amount, the delinquent loan, as well as interest accruing on the loan will be treated as an outstanding loan for purposes of applying 72(p) limits. So simply by ignoring it until sometime in the future when the plan gets around to doing something, either by collection or by offset, you do not sweep the boards clear in terms of having a fresh $50,000 or 50% allotment for any new loan. It's considered outstanding. As long as it's outstanding, that has been taxed to you.

The modification to the proposed regulation also indicates that if you do repay the loan, either in part or in whole, following it having to become a taxable, deemed distribution, that will give you a basis, if you will, or an after-tax contribution into the plan for purposes of determining any future tax results. Therefore you won't get taxed twice. Fortunately for the employee, however, the regulation also makes it clear that repayment, although it will be considered an employee contribution for determining his future tax results, is not a contribution free to 401(m) or 415. It's a simply a repayment of a loan for those provisions.

Next is Revenue Procedure 98-22. Because this one could take half our session, I will not delve into the content other than to note that the IRS, in effect, consolidated all its various remedial correction programs into what is now called the Employee Plans Compliance Resolution System or EPCRS, in case somebody needed a new set

of initials. This was announced in March. It is important, first because it made these programs permanent. Number two, it sort of put the cap in the Voluntary Compliance Resolution (VCR) and self-correction programs into a single envelope. Although they continue to have different features, they also share some common elements and, therefore, it makes the administration easier. Third, the sanctions are more moderate than they were before—at least the maximum sanctions. Fourth, there continues to be, as there was before in the individual programs, an emphasis on voluntary correction and reasonable restitution for the plan. Again, the emphasis is, wherever possible, to put the plan back in the situation it would have been if not for the error. There are specific methods of correction. The revenue procedure recognizes there are general or safe harbor methods and that other methods may do.

Next is Notice 98–24. This one is also purely helpful to the employee and is common sense. It goes back to an old rule, which has been hanging around for decades, concerning the tax treatment of net unrealized appreciation on employer's securities that are distributed from a plan. If the securities were purchased with employee contributions as after-tax contributions, or were purchased with employer contributions and are part of a lump-sum distribution, then to the extent these employer securities are distributed in kind, as may be the case with an employee stock ownership plan (ESOP) or other defined-contribution plan, any net unrealized appreciation (the difference between the cost to the plan and the value at the date of distribution) can be excluded from income upon distribution.

So the plan either received a contribution in kind or cash and went and bought stock on the open market when the stock was worth $10. It's now worth $15 at the date of distribution. That net unrealized appreciation applied is not taxable in those situations and, furthermore, under a decade-old law that net unrealized appreciation would be treated as long-term capital gain. It is eligible for whatever the long-term capital gain rates were under the old rules whenever it was sold. So if it was sold one day after distribution or two years after distribution, it inherently had long-term capital gain potential. Any further appreciation after the date of distribution say, for example, that goes from $15 to $17 by the time you sell it for example that incremental $2 of post-distribution appreciation will be short term or long term depending on your holding period from date of distribution.

Last year, Congress changed the rules with regard to long-term capital gain. In effect, Congress introduced a mid-term capital gain rate such that, if you hold an asset for 12 months, and then a long-term capital gain rate, which is now 20%, it could be lower in the future. It also is lower for lower-income people if you hold it for 18 months. This notice simply noted that they will treat that appreciation inherent at the point of distribution as having been held for 18 months. It will

therefore give you the benefit of the lowest capital gain rate upon subsequent sale. There's no change to the notion that any further appreciation will depend on how long you hold it. They also noted that starting in 2001 there is further reduction for certain assets held for more than five years. They said that this notice can be relied on by taxpayers until 2001 or until such time as they give further guidance, depending upon whichever is later.

Revenue Rule 98–21 and Revenue Procedure 98–34 both deal with an issue concerning transferrable stock options, which is not usually an issue we deal with at these sessions and one I will only touch on. This is an estate tax or a gift and estate tax issue. Over the last two years executives have become increasingly entranced with the notion that by transferring stock options when they have a very low value, you can have a low or no gift tax at the point of transfer. Hopefully, if the stock takes off and, of course, everybody's used to an ever-upward market over the last ten years, then any appreciation will have been shifted to the next generation.

There's a dichotomy here between the income tax treatment. It does not shift the income tax results. Upon subsequent exercise of the option, the executive, employee, or director, if it's not an employee, will still bear the income tax consequences because you cannot assign income tax ahead of time. However, for gift and estate purposes, you can have this shifting over to the next generation. Part of the issue is whether or not you can have a current gift for gift tax purposes of a nonvested option.

I should also mention, by the way, that we're dealing with nonqualified stock options. Qualified or incentive stock options, by their own terms, are nontransferable and, therefore, this never comes up with them. But for nonqualified stock options you can allow this transfer, and some employers do and some executives have taken advantage of it. However, employers still like to have vesting usually on stock options, so while you get the option today, you have to complete some additional period of service before you can exercise it.

The IRS ruled in 98–21 (and this was in response to a host of questions that have been addressed to the service, both formally through ruling requests and informally over the past 12–18 months), they held that to the extent the option is not currently vested it is not property, and if it is not property you cannot have a current gift. If you can't have a current gift, you can't use the current value of that option at the point of the purported transfer to determine how valuable it is for purposes of the gift tax. If it vests in a year, or in two years, or in five years, you would have a completed gift at that point and you could still shift to the next generation any subsequent appreciation. However, that doesn't work nearly as well because, between the date of transfer and the date of vesting, there may be a significant

change in the stock price and that will still have been left on the gift tax ledger of the transferring executive.

Although the service has been criticized for this and some of the reasoning is shaky, I don't think they're going to change. They gave this a lot of thought. They were aware that a lot of people were waiting for this ruling. It means either executives are simply not going to have the full value of that transfer or they're going to press employers to give them immediate vesting. There's nothing illegal about immediate vesting, although it does sometimes call corporate policy into question and may give a lot of compensation committees a lot of headaches.

There was a companion Revenue Procedure, 98–34 that was issued at the same time and gave a safe harbor as to how to value these transferrable stock options. Don't forget, at the point a stock option is transferred, all it is, in effect, is a right to exercise. It may be a right to exercise at a price that is no different from the market value. Nonetheless, an option inherently has value. Usually, the Black-Scholes Model is used to value such options or some variation on that. They kind of approved that in the revenue procedure, but with several restrictions. For one thing, it has to be a publicly traded stock. They do not recognize any discounts from that value and, therefore, while it's nice as a safe harbor, many people who are continuing to use transferrable stock options are not using Revenue Procedure 98–34.

Of the last two notices to address, the first is Notice 98–29. This was an interesting one. It is related to, but not the same as the notices and changes to 411(d)(4) regulations that we alluded to previously. It may have been triggered by what is a continuing series of 411(d)(6) problems for the service, not restricted to 401(a)(9), although a lot of them do relate to 401(a)(9). The service noted that perhaps they ought to have broader relief in the regulations for the elimination of certain types of optional forms of benefit. Therefore, they indicated specific things they had in mind, asked for comments on that, and asked for comments from anybody on what might be appropriate situations to allow plans to eliminate optional forms of benefit.

First, the IRS indicated that they are not currently addressing defined-benefit plans, although they felt that if anyone had comments they would listen to them. They're only addressing defined-contribution plans as being appropriate. They indicated that they are considering allowing plans to eliminate certain types of optional forms of benefit as long as, in all cases, there's still a lump sum form and that there's at least one extended payment form. They also indicated that they may be considering allowing plans to eliminate forms of benefits where the plan can show very low usage over time or that it only affects a very low percentage of participants (for

example, where you have a plan that only allows certain forms to be available to subgroups).

They also indicated that in connection with mergers and acquisitions, people may want to transfer their benefit from one plan to another. Although there is an existing rule under the regulation allowing such transfers—and if you follow the requirements of the regulation, the transferee plan does not have to replicate all of the optional forms of benefit from the transferral plan—they noted that has some limited application, because it assumes in all cases that the benefit was distributable from the transferring plan. That is not always the case at the time of the merger and acquisition and they are, therefore, seeking to broaden the regulation.

The IRS notes in each case that what they're seeking is to try and make it, in effect, to allow plans to clean out old, unused, or unnecessary optional forms of benefit, and seeking to do so under 411(d) in a blanket manner. They emphasize that this does not apply to any retirement-type subsidy or early retirement forms of benefits and only to optional forms of distribution. Comments are solicited by August 31, 1998, so you don't have to run out and do it before you get back to your office.

Finally are the notices in Revenue Ruling 98–30. This is a very nice revenue ruling that was published very recently. It allows for a 401(k) plan to have a negative form of election. The plan in question provided that for new participants, they would be enrolled in a 401(k) plan with a deemed 3% contribution rate unless they elected not to make pretax contributions or elected to alter it from the 3%. If you did nothing you would simply be put into the plan at 3% and that amount would be withheld from your salary on a pretax basis. Again, the plan in question was very liberal about how frequently you could change your election, including this deemed election and, as described in the revenue ruling, it gave full information and notice to the participant. Any plan wanting to take advantage of this, and I'm sure there will be many because, in effect, it allows you to use inertia on your side to the extent that a certain number of people simply don't respond, it is better to have a formula that puts them into the plan rather than assume that they're not in the plan.

Let's move out to the cases, but I am not going to touch on all the cases. We'll start with the Supreme Court. One thing about the Supreme Court is it is right or wrong; they're right unless Congress gets involved, which is sometimes the case. The first case I want to address is *Bay Area Laundry and Dry Cleaning Pension Trust Fund vs. Ferbar Corporation of California*. The case involved the statute of limitations from the Multiemployer Pension Plan Amendment Act (MEPPAA) withdrawal liability claim. The issue is as follows. If you have a withdrawal from a multiemployer plan, the plan has, in effect, a vague period of time in which it gives you notice of

withdrawal. The statute simply says, "As soon as practicable," whatever that means. It's an issue I happen to be litigating at the moment, so I won't comment on it any further. Once that notice is given, the notice then, in effect, proposes an installment payout of the purported withdrawal liability. Under MEPPAA, the employer's supposed to pay even if he wants to arbitrate or litigate the issue of his liability or the amount of the liability. He has to start paying in accordance with the proposed installment schedule.

The issue for the Supreme Court was whether or not the six-year statute of limitations on MEPPAA claims begin at the withdrawal from the plan or at the date of the first installment payment. A further question was whether or not the six-year statute of limitations, if it starts only with the installment, applies to the entire amount as of the first day of the installment payment or whether each installment is a separate payment with its own six-year statute of limitations. That may sound silly, but it's critical in this case because the plan filed suit more than six years after the first scheduled installment payment, but less than six years before all the other installment payments.

The Supreme Court, resolving a conflict from the circuit court, held that the six-year statute of limitations begins with the date of the installment payments and, as long as the plan does not accelerate those installment payments, each installment payment has its own six-year statute of limitations. In this case, although the plan was precluded from asserting rights to its first installment payment, it could do so with regard to the balance of the installment payments even though this was eight or ten years after the withdrawal.

The Second Supreme Court decision here is *Oubre vs. Entergy Operations, Inc.* It's an Age Discrimination in Employment Act (ADEA) of 1967 claim. In effect, the employer simply did not give the necessary type of information, which is required for an ADEA waiver. It gave a defective waiver. Also, it made payment to the employee at the time in consideration for the waiver. The employee kept the consideration, and then sued under ADEA on the basis that it was not an effective or valid waiver, as it clearly wasn't. There was no dispute about that. The employer argued that by continuing to hold the payment, the employee had ratified the waiver whether or not it was defective. Even if the ratification was only conditional, the employee should not be allowed to bring the ADEA suit without tendering back the money in advance of the suit.

The majority of the Supreme Court held for the employee. It held that the 1990 ADEA amendments were quite clear and that Congress' intent was that if you want a waiver, you have to go through all of the specifics of the ADEA statute and regulations. It held open whether or not the employer has a right of restitution of settling

up from a monetary standpoint with regard to the amount of the payment, which was retained by the employee. There was not an unanimous court and the dissent is interesting, but it's a dissent.

The third Supreme Court Case is Geissal vs. Moore Medical Corporation, a COBRA issue. On Geissal vs. Moore Medical, on the COBRA issue was a unanimous Supreme Court decision. There were very bad facts. I hope I'm not offending anyone out there who may be connected to Moore Medical. I don't know what they do in the medical field, but they had an employee who was suffering from cancer and they fired the employee. The implication was that they knew he was suffering from cancer and, in fact, he died from the cancer during dependency of the case. I mention that only because I don't doubt that may have colored the way the court viewed things. However, the ultimate question was very simply a case of whether or not you read the statute literally.

Under COBRA, coverage ceases on the date a qualified beneficiary first becomes covered under any other group health plan, after the date of election. Geissal, the employee, was terminated. He was given notice that he had COBRA rights, he exercised those COBRA rights, and actually began paying and receiving COBRA coverage about six months before it was cut off. However, Geissal was also a beneficiary on his wife's health plan with her employer, TWA, and had been before he was ever terminated.

The employer argued that because he had other coverage, in effect, that the courts ought to treat it as cutting off his COBRA rights the moment he was terminated. Geissal said, "Hey, the statute said the date on which the qualified beneficiary first becomes, after the date of election, covered under any other group health plan. I was covered before, therefore, my coverage can't be an event that cuts off my COBRA eligibility."

The Supreme Court agreed with Geissal. They agreed that's the way the statute reads. They saw no reason to overturn the literal reading. The employer pointed out that would be the case if he first became covered after termination and before the election, which would be an absurd result. The Supreme Court agreed with their reading. It did not think that was an absurd result, and we now know what the answer is. This decision resolved a conflict among cases in the circuit courts, which had come out differently than this case.

Let me start at a different end before I describe our next case. Suppose I told you that there's a case of termination but an employer never declared a plan terminated or the PBGC never took action. Perhaps a plan terminates simply because coverage is limited to people who are already there as of a certain date and all new employ-

ees get different coverage. Suppose I told you that there's a case that suggests that if you amend the plan to add a new type of benefit, but the plan is a single trust, single-plan document, with a different benefit structure, that may, in effect, create two plans for ERISA purposes and, by implication, terminate the first plan.

Suppose I said a case suggests that, notwithstanding what the Supreme Court said in a case two years ago, the employer, in amending or adding this benefit to a contributory plan—and the key is that the plan was contributory may have been acting in a fiduciary capacity because it was dissipating the value of benefits for employees who had contributed to the plan. What if I told you that there's a case that suggests that, in a contributory plan, employees may have a right to more than merely their vested benefit; they become co-settlers of the plan and have a right over and above the amount of their contributions, plus interest.

I would be describing *Jacobson vs. Hughes Aircraft*. This is a case from January 1997. The reason we are alluding to it is because the Supreme Court will be hearing it sometime in the next year. There was a contributory plan where the employer and employees contributed over the years. It was overfunded by an estimated $1 billion at the time that, first, the employer provided for an early retirement window and then the employer added a noncontributory benefit structure. But all new employees in the noncontributory benefit structure were added at a lower benefit level and gave old employees, who had been contributing, the choice to remain in the first structure or to switch over to the new structure, thereby, having a lower future benefit, but not having to continue to make contributions.

The Supreme Court case is based on two critical factors. First, the court viewed the contributory feature as having, in effect, made the plan a bargain between both the employees and the employer. Second, by adding this second structure there had been a termination of the first plan. This is a question of fact, not merely a question of law, or at best a question of mixed fact and law. The court majority in this case in the Ninth Circuit reached the conclusion that it would not support a motion by the employer to dismiss.

The current case has some horrific implications, both as to when there is and isn't a termination, who has rights to overfunding, when is an employer acting in a fiduciary capacity simply by amending a plan, which is something we thought we'd seen settled most recently by those two Supreme Court cases two years ago. One would hope that the case will get fixed along way, probably at the Supreme Court level, but you don't know.

It is the type of case in which an attorney would hesitate to ever tell any plaintiffs that you have no hope or any defendant that you have no exposure. In fairness to

the majority, one could say that, and they emphasis this over and over again. The court did not holding for the employees against Hughes Aircraft. By the way, the employees were seeking, in effect, to force a constructive termination and, thereby, get their share of their overfunding, because it was a contributory plan.

In fairness, the majority keeps saying over and over again, they are simply not dismissing the complaint at this time. However, I think that's a cop-out. I think the complaint should have been dismissed. I think that dissent in this case is so well reasoned that there's no excuse for the majority that would have misunderstood all of the ERISA implications.

One interesting aside is that during the course of discussion of this case, the dissenters noted that the plan was contributory and the fact that it was overfunded at any point in time short of termination was irrelevant. It noted that the existence of a surplus in a pension fund is nothing more than an actuarial artifact. Now, I don't know what an actuarial artifact is, but perhaps the Supreme Court will address that.