Top-Heavy Rules and Regulations
by James A. Gobes

The panelists for this session were Ira Cohen, director of the Internal Revenue Service (IRS) Employee Plans Technical Actuarial Division, and Gregory Renz, attorney with the firm of Foley and Lardner in Milwaukee, Wisconsin.

Cohen described the IRS concerns that led to the creation of the top-heavy provision of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA): discrimination against “rank and file” employees, pressure on Social Security as a result of integrated plans, benefit losses due to lack of vesting, and the lack of parity between HR-10 and corporate plans. He also made note of the top-heavy modifications made by the Deficit Reduction Act of 1984 (DEFRA), specifically the special rules for 401(k) plans, the salary limitation on officers included as key employees, and the rule for terminated plans.

Renz then reviewed the changes between the proposed and final regulations. The final regulations affirm the applicability to 403(a) plans and to simplified employee pension plans (SEPs), and explain the treatment of multiple employer plans and the benefits includible from such plans. The regulations clarify the five year look-back rules and the rules for required or permissive aggregations, define terminated plans and frozen plans and the required handling of such plans, and clarify the value of death benefits in split-funded plans and the application of the 1.0 rule for combined plans. The term “employee” has been substituted for “plan participant,” although only (non-key) plan participants (or employees who are not plan participants solely because their salary is less than a stated minimum or they fail to make mandatory contributions) must receive minimum benefits or contributions. Renz expressed concern about the difficulty of determining top-heavy status any time officer responsibility could affect the calculation, particularly in acquisition or merger situations.

(continued on page 10)
From Les Shapiro’s Desk

Referrals

Many readers of this column are aware of the nature of my participation at the annual Enrolled Actuaries Meetings: I normally provide a description of the manner in which discipline cases are processed in my office and then discuss cases that are or have been under review. (The cases are sanitized and abridged for presentation purposes.)

The success of the session is directly related to participation by those in attendance. It is always of interest to me what areas generate the most comment, concern, and dialogue. At the 1985 Enrolled Actuaries Meeting, we barely had time to begin a discussion of cases because of the dialogue that ensued during that part of my presentation. The issue of most concern was that of referrals of matters to my office by enrolled actuaries.

It is my understanding from the community of enrolled actuaries that in takeover situations, an enrolled actuary often encounters work of the previous enrolled actuary that reflects poor judgement, professional irresponsibility and, in some instances, failure to understand and apply relevant actuarial principles. I stressed at the session that in those situations, the takeover actuary should refer matters to my office for review and evaluation under the Joint Board regulations. Unprofessional work, particularly that which affects the soundness of the funding of pension plans, not only is contrary to the public interest, but reflects adversely on the profession. Referrals therefore should be made to my office in order that we are able to take whatever action is warranted to prevent the enrolled actuary concerned from continuing to discharge his or her duties in an unacceptable fashion. I believe it is the professional duty of an actuary to make such referrals.

I recognize that “whistle blowing” is something none of us wishes to do. However, my office cannot know of situations raising questions of professional misconduct in many instances without such referrals, and unprofessional or incompetent work certainly should not be condoned by the profession itself. Therefore, I encourage enrolled actuaries to resolve any area of doubt in favor of making a referral. In this connection, I consider addressing improprieties in the discharge of actuarial services under ERISA to be a shared responsibility. Receipt of a referral will be acknowledged and pursued. If a question of impropriety is raised and a disciplinary action is deemed necessary, we will act accordingly. To the extent we are able, the privacy of the referring actuary will be safeguarded.

If you have concerns you wish to discuss in considering a referral, please do not hesitate to contact me. It will be treated in a confidential manner.

Les Shapiro is executive director of the Joint Board for the Enrollment of Actuaries.

VEBAs

(continued from page 1)

populations are projected to climb so high as to make one question whether or not existing plans could survive the future under pay-as-you-go.

In the past, most plan sponsors have been unaware of the significance of postretirement benefits and have promised these coverages in either negotiations or in program expansions. Due to the lack of financial details, these decisions could rarely be considered “informed.” However, the move is on to learn more and manage better.

One of the most discussed topics about these benefits has been the level of guarantee made to retirees, and that interest has grown due to recent court cases like Bethlehem Steel and White Farm. Until now, for most non-pension retiree coverages, employer obligations were felt to be less certain than for pensions.

While the types of promises for benefits vary, de facto vesting for current retirees appears to be the trend. The Bethlehem Steel case was decided in favor of current retirees; the decision hinged upon whether employer communications uniformly reserved the right to alter benefits for existing retirees. The White Farm case went further, effectively allowing vested status to retirees through a federal common law interpretation. Appeals notwithstanding, viewpoints such as these edge us closer to accounting, and even funding, changes for postretirement benefits.

Today employers are much more interested in learning the estimated values of postretirement benefits. The types of information that employers have found most helpful are listed below, with some examples of the projection results for several large plan sponsors:
• Present values of expected future benefits (twenty to 150 times current pay-as-you-go costs);
• Expected future cash flows (over the next fifteen years, three to fifteen times current costs);
• Potential accrual/funding levels under different actuarial cost methods (three to five times current costs); and
• Sensitivity tests on certain assumptions over reasonable ranges of values.

A significant force in the growing awareness for employers has been the accounting profession’s study of the treatment of postretirement welfare benefits on financial statements. The publication in recent years of FASB’s Discussion Memoranda and Preliminary Views (which were substantially devoted to pensions) is part of a FASB project of ten years’ duration. The overall changes in accounting requirements contemplated are substantial, and for many employers, could materially affect reported operating results and shareholders’ equity.

FASB’s statement last fall on footnote disclosure of basic plan data is an interim step on their part. Major considerations such as the measurement, recognition, and display of postretirement costs will be resolved at a deliberate pace because of the likely magnitude of, and lack of knowledge about, the related costs.

A research project studying measurement and recognition methods was undertaken by FASB around the first of the year, with an exposure draft anticipated in 1985 and a final statement expected in the first half of 1986.

Postretirement valuations depend upon many assumptions, several of which are similar to those used in defined benefit pension valuations. Beyond the obvious similarities to a pension valuation, however, several unique health/welfare-type assumptions must be handled. These include:

• Establishing claim costs by plan, coverage, and age;
• Estimating future inflation, utilization, cost-shifting and Medicare effects; and
• Assessing the effects of dependent coverage.

Projection results are particularly sensitive to these variables. This fact makes experience with group coverages especially important for the actuary.

Voluntary Employee Beneficiary Associations (VEBAs)

VEBAs, often used synonymously with 501(c)(9) trusts, are used heavily but are

Attendees of the second general session, “Dialogue With the IRS,” listen to Ira Cohen and Kenneth Yednock of the IRS and consulting actuaries Irwin I. Kent and Mary S. Riebold. The background, intent, and impact of recent IRS regulations were discussed in an open dialogue between the panelists.

Thomas G. Nelson is a consulting actuary with Milliman & Robertson, Inc.
Consulting Considerations in Acquisitions and Divestitures

Harvey Kesselman

The first part of the session was a general consideration of items that should be reviewed by an actuarial consultant at the time of acquisition. I emphasized that it is important that the consultant get as much advance information as possible.

The collection of all the necessary documents, summary plan descriptions, and negotiation contracts is a major task in itself. One of the first considerations is whether or not the current costs for employee benefits are sufficient. It was mentioned that the current costs affect the cash flow of the new company purchased, and will affect the expense of the company. Special consideration should be given to improvements that have not been accounted for in either the cost or the expense. Such improvements could be in labor agreements, announced increases, or a large growth of employment not yet taken into account.

Consideration should be given to how the plans of the acquired company will be operating. Examples of various techniques were given. One important point was that the sales agreement stipulate that no changes be made after a given date.

The importance of the sales agreement itself was discussed. Points were raised stating that the sales agreement should contain rules as to who will be responsible for the administration of the ongoing benefits, who will be responsible for non-actives, and who will be responsible for liabilities arising from plant shutdowns.

The liabilities for all postretirement health and life benefits were also discussed. Recent court cases have made it the responsibility of the company to continue postretirement benefits that had been promised to employees.

Other items mentioned that should be covered are actuarial assumptions of the plan, funding standard account credits, and expenses shown on annual statements versus actual cash contributions.

The seller has to be especially careful of what liabilities he intends to maintain and what liabilities will be passed on to the buyer. If a plan termination is possible in the near future, some liabilities could revert back to the seller, especially in the case of multiemployer plans.

Also discussed was the use of asset reversion as a financial tool. Many individuals commented on their experiences.

I then presented a sample set of facts concerning a sale of a company, and asked for comments on arguments that could be used by either the seller or buyer to justify their positions in the amounts of pension assets to be transferred. There were many opinions advanced on the subject. Some attendees felt that the amount of money involved in negotiating the pension plan issue normally is not significant in the overall purchase price. However, I said that since the purchase price may already have been set, any additional amount of money to be transferred affects the bottom line directly and has various tax implications. I also commented that for a relatively short time spent in negotiations, the dollars could be quite significant.

Harvey Kesselman is vice president and actuary with Miller Mason & Dickenson, Inc.

1985 Enrolled Actuaries Meeting
Transcripts and Cassettes

Written transcripts of the lecture, advanced lecture, and seminar sessions are being prepared in a bound volume and will be available in June at no charge to registered attendees of the meeting. They will also be available to those who did not attend the meeting for $25 per copy.

This year, cassette tapes of each session are available for $8 each (some sessions not available). Cassettes can be ordered directly from Eastern Audio.

Order forms for both transcripts and cassettes are enclosed with this issue.
Actuarial Testimony

by Harry M. Leister, Jr.

There was a lively discussion at this session of the actuary's role as an expert witness. The discussion related to the involvement of actuaries in marital dissolutions and the role of the actuary in personal injury cases.

With respect to marital dissolutions, the actuary's role is primarily related to valuing pensions, knowing the law, and educating lawyers about present values. Some actuaries use the Pension Benefit Guaranty Corporation (PBGC) annuity rates while others use a different approach.

The value of the pension may be different now that REA is in effect. REA says that the plan sponsors can be forced to pay benefits to the non-employed spouse, at a different time and in a different form. The value of such payments is to be determined by the plan's actuarial bases. The actuary must use 5% interest if the plan does not specify an interest basis. If agreement is hard to obtain, courts may resort to qualified domestic relations orders.

With respect to personal injury cases, the discussion first centered on the matter of preparing an accurate, concise, and preliminary report. Some consideration was given to providing alternative figures, especially in disability cases and death cases involving young people. Employee benefits were considered, including the possibility of valuing each one separately or of valuing them in total, based upon the information available.

There was considerable discussion concerning courtroom behavior, including dress (conservative, not flashy), demeanor (relaxed, avoiding excessive egotism or modesty), and temperament (even-tempered, not antagonistic or hostile). Above all, be truthful. A lack of knowledge in a particular area should be admitted and bluffing should be avoided.

Harry M. Leister is a consulting actuary with Conrad M. Siegel, Inc.

The Political and Legislative Process

by Richard G. Schreitmueller

The Enrolled Actuaries Meeting began with a panel discussion, moderated by Michael J. Mahoney of Milliman and Robertson, giving some of the best advice we have heard about how Washington works.

First, Dallas Salisbury, president of Employee Benefit Research Institute, analyzed the viewpoint of members of Congress each time they consider new pension legislation and how the actions of pension plan designers can make a difference. Then, Phyllis Borzi of the House Education and Labor Committee staff explained what the textbooks don't tell us about how laws are enacted.

Legislative Strategy

Dallas Salisbury traced the growth of government support for employee benefit plans. Up to 1982, there was fairly steady growth, both in direct outlays from government programs and in so-called "tax expenditures" resulting from favorable tax treatment. Such use of tax dollars makes sense when the programs protect against the risk of lost income, and when they increase productivity and free employees from concerns about financial security.

Since 1982, Congress and the employer benefits community have been on a collision course. Legislators have been searching everywhere for ways to reduce the budget deficit, meaning the excess of government spending over taxes. Meanwhile, practitioners have begun promoting some employee benefit plans based more on tax shelter than on protection from financial risks.

Salisbury said he believes that Congress now has two main concerns about employee benefits: annual direct cost of $313 billion in government outlays for employee benefits, and indirect costs of $123 billion in revenue losses due to favorable tax treatment, according to Treasury estimates. Most of the direct outlays are for entitlement programs that are politically sensitive, such as Social Security. But the other $123 billion would go a long way toward paying for the deficit, currently estimated at about $180 billion.

Salisbury challenged those concerned with the future of employee benefits to educate the public on the virtues of these programs, to get their priorities straight, and to decide which are the essential core benefits and which benefits can most easily be given up.

Salisbury said the way employee benefit plans are designed makes a difference, because design influences the way people think about them and the way Congress acts toward them. Washington pays attention to horror stories— anecdotes about doctors in California with their VEBAs and zero-based retirement accounts (ZEBRAS) or fat-cat corporations profiting from asset reversions and dumping their losses on PBGC. Pension plans are not viewed favorably by legislators when they stray far from being social contracts that assure financial security to employees.

One attitude to guard against is that the pension industry could do anything that might provide retirement income, if only there was a national retirement income policy. Rather, Congress expects all pension plans to meet a very basic objective: "There is only one definition of retirement income in the eyes of Congress: a check in the mail each month, guaranteed for life, supplementing Social Security," said Salisbury, in agreement. Congress would much rather have the private sector pay benefits instead of the government, but could change its opinion if private plans do not do the job. Thus, Salisbury believes that when workers are allowed to take lump-sum distributions, for example, there is a risk that retirement income will be lost and that the case for favorable tax treatment of pension plans will be weakened.

Salisbury said that Representative Pickle (D-TX), who plays an important part in tax legislation, tends to favor employee benefits that supplement Social Security and Medicare. The opposite side of the coin is that he views unfavorably any benefit programs that undermine them or erode the FICA tax base.

Salisbury believes Congress has little reason to favor flexible spending accounts; they generally don't protect against basic risks. Likewise, Congress may favor flexible compensation plans that allocate employee benefit costs more efficiently for two-worker families, but not plans that are mere tax shelters. Salisbury pointed to some other arrangements that seem to fall short of protecting against basic risks, such as group legal coverage and employer educational assistance, both of which cover tiny fractions of the working population. Also, he said Section 401(k) plans may go too far in permitting benefit payouts before retirement, through loan provisions, hardship withdrawals, lump sums, and rollovers. The danger is that Congress may... (continued overleaf)

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look elsewhere and go after essentials such as the Section 415 limits if such benefit practices are defended rigidly.

These problems and attitudes will be with us for decades to come, said Salisbury. The budget deficit will continue to exert pressure on tax policy, especially as the aged consume a growing share of government resources. Fundamental tax reform seems years away, thus intensifying the pressure to close loopholes soon and broaden the tax base. Salisbury calls for a return to basics, asking the private sector to take a leadership role in shaping the coming tax legislation.

Legislative Tactics

"The one thing that has struck me is the need for people in the private sector to understand the process." With these words, Phyllis Borzi set out to explain the legislative process, based on her personal experience over the past six years on Capitol Hill.

Borzi explained that the "normal" process allows any legislator to introduce a bill on any subject. During each two-year session of Congress, about 20,000 bills are introduced, but only a few hundred laws are enacted. Each stage of the legislative process is a major hurdle that a bill must surmount. At any stage a bill can be killed in several ways: by formal vote, by inaction, or by amending it completely, among others. The survival rates are higher if the bill is introduced by someone on the committee ultimately considering the bill. Before a private pension bill becomes law, four committees usually will be involved, two in the House (Ways and Means, Education and Labor) and two in the Senate (Finance, Labor and Human Resources), usually with the committee referring the bill to its subcommittee that handles pension matters.

If a bill is going anywhere, there will normally be hearings on it. Then comes a markup session at the subcommittee level, voting, referral to the full committee for another markup session, voting again, and a floor vote by the full House or Senate. If the bill is to become law, this whole process is repeated in the other house. After a bill is passed by both houses of Congress, a conference committee will be appointed to resolve any differences, after which it can be passed by both houses and sent to the President for his signature.

We need to flesh-out some of the above terms:

(1) A markup session allows for a broad range of changes, from the most trivial to amendments that are virtually complete substitutes. Bipartisan substitutes are not uncommon.

(2) When a bill emerges from the full committee, usually there will be a report explaining the bill's provisions. At this point the private sector often first becomes aware of the bill.

(3) The term "conference committee" can be misleading; sometimes there is little deliberation or give and take, because differences have been settled before the Conference committee meets. As a general rule a conference committee will resolve each provision by deciding on a version that falls somewhere between the two differing versions. (There are exceptions: in theory a bill that goes beyond the scope of the conference can be challenged, but under House rules the principals can waive any challenges in advance.) In a complex tax bill, a conference committee can look at many possible permutations as the two houses try to reach agreement. The role of committee staff is important at this stage.

Borzi said that everything she explained to this point is the "normal" mode of operation, as taught in high school civics texts—a fairly orderly process. In the employee benefits field, more often than not in recent years a different process is used in which provisions that were never introduced find their way into mark up sessions and reported bills. Examples are the VEBAs, in DEFRA and the top-heavy provisions in TEFRA. Thus it is difficult to track legislation on benefits issues when new provisions get inserted at the last minute. One must stay alert.

Because benefits bills may involve just the tax code, they sometimes are handled by just the tax committees without the labor committees. When this happens, the legislation may be influenced mainly by tax considerations and not by benefits considerations, said Borzi.

She then listed various pension areas for possible legislation by her committee, including among the hottest subjects PBGC premiums for single-employer plans, asset reversions at plan termination, and the "VIP" equity issues of vesting, integration, and portability.

In follow-up remarks, both speakers reinforced and confirmed each other's main points, and both said that overzealous advocates get tuned-out and become non-players. Both agreed that the best possible time to get involved is early, when the staff is still thinking about the issues. Ideally, this involvement will be ongoing, not crisis-oriented, and will consist of showing the staff how to accomplish its objectives. Sometimes this is not possible, but one should still work to get the best possible version of a bill, even if one intends to oppose it actively, which is better than regarding the bill as unthinkable, running the risk that it will pass.

Richard G. Schreitmuller, an actuary at the Social Security Administration, is currently on loan to the Senate Committee on Governmental Affairs.
Arkady Shevchenko spoke to enrolled actuaries on the eve of the release of his book, *Breaking with Moscow* (Knopf and Co.). Shevchenko, one of the wealthiest men in Russia, was the highest-ranking Soviet official to defect to the West.

Shevchenko briefly described the Soviet pension system: "For all [Russian] citizens, there is a minimum and maximum pension, depending on how many years one works. The minimum pension might buy one chicken a month. Top-level people get more, but still, even at the top, pensions will not be extremely high. When Khrushchev retired, his pension was only four times more than the maximum for ordinary people. That is why nobody wants to retire in the Soviet Union." When asked if there were actuaries in Russia, Shevchenko said there were, but not in the sense Americans knew them. "Insurance is at a very primitive stage, and only in the last two decades has Russia even begun to think about that. There is a little life and fire insurance."

Recognizing that American and Soviet ideologies are strongly opposed, Shevchenko said both sides must be willing to overlook differences in the interests of maintaining peace. "Both countries possess enormous might, and I think both realize these two nations can either save humanity or destroy it."
Dialogue with the IRS

by Daniel M. Arnold

As in previous years, two representatives of the IRS, Ira Cohen, director of Employee Plans Technical and Actuarial Services, and Kenneth Yednock, chief of the Projects Division, discussed the current status of regulations with two consulting actuaries, Irwin L. Kent of Actuarial Services, Inc. and Mary S. Riebold of Mercer/Meidinger, Inc. The questions posed by the consulting actuaries ranged over a variety of topics.

Timing of Amendments to Comply with TEFRA, DEFRA and REA

TEFRA is effective for plan years starting after December 31, 1983. The effective dates for DEFRA and the Retirement Equity Act (REA) are generally one year later. For plan and fiscal years on a calendar year basis, TEFRA amendments (which may comply with the regulations under Section 401(b)) have to be filed by September 15, 1985, the tax extension deadline. DEFRA and REA amendments, which cannot use the Section 401(b) regulations, have to be filed by the end of the plan year; for example, by December 31, 1985 for a calendar plan year. For plans where tax and plan year differ, the TEFRA amendments have to be filed by the earlier of the end of the plan year commencing after December 31, 1983 or the end of the tax year (plus extensions) commencing after the beginning of the plan year in which TEFRA changes have to be made. If the amendment is filed within the following year, the plan still complies provided a submission is made for a determination letter no later than the end of the second plan year. In general, filing dates have been set so that all three law changes can be incorporated in one plan amendment. However, plans that terminated in 1984 will still have to be amended for TEFRA.

Retirement Equity Act

1. Changing the minimum age for participation from twenty-five to twenty-one does not constitute a change in funding method.
2. For participants who terminate from a defined contribution plan, vested benefits do not have to be kept in a separate account for the full five years. However, a method of repayment (for example, from forfeitures) has to be found in case the employee returns within the five years.
3. A spouse can waive the right to a pre-retirement survivor annuity.

Changes in Benefit Program

I pointed out that before altering a benefit program, a plan actuary may wish to recommend several studies, or activities such as spendable income analysis, peer group comparisons, establishing benefit philosophies, and conducting employee attitude surveys, among other things.

Reducing Current Pension Expense

by Larry Lang

Pension plan sponsors often focus on the task of reducing current pension expense where feasible. In fact, this pattern of comprehensive benefit cost containment is characteristic of the 1980s, contrasting with benefit expansion of prior years. Pressures such as economic downturn, price competition, new ownership objectives, the need to optimize the benefit security ratio, consideration of supplemental programs, and the decoupling of expense from funding have increased the interest in this area.

This session focused on three basic strategies for reduction in pension expense: changes in benefit programs, discussed by myself; changes in funding, covered by Jeffrey Groves of Tillinghast Nelson and Warren; and changes in expense policy, related by Harvey Epstein of the Wyatt Company. Acknowledging a basic distinction between techniques that merely alter the incidence of expense versus those that affect the overall level of expense, these three strategies were examined.

Changes In Funding

Groves discussed the second strategy of focusing on the investment side of the equation, relative to changes in funding.
Launching a barrage of one-liners which took a humorous swipe at just about everyone, Dr. Paul S. Nadler, a professor of finance at Rutgers University and author on banking, delivered one of the luncheon addresses. Walter Mondale, he said, "got so few votes, you don't count them, you name them." And of the President, "The country wouldn't be in this shape if Ronald Reagan were alive." He summed up American foreign affairs as "international chutzpah.

Noting health care cost control efforts, Nadler recalled the doctor who told his patient, "If you can't afford to take care of it, I'll wash up the X-rays."

Describing how students' attitudes have changed over the years, Nadler said he used to tell his students who he was and they'd say, "prove it." Now they ask if it's going to be on the test. The universities themselves have changed too: "Today they put 90% of the students in the top 10% of the class."
TOP-HEAVY RULES
(continued from page 1)

In response to questions from Renz, Cohen confirmed that includible benefits under a multiemployer plan relate to benefits accrued during the pertinent period, and that the aggregation tests cover each of the current plus the four preceding years. The IRS does not expect to further clarify the definition of an officer, or the consequences of a retroactive top-heavy determination. Because of the closeness of the proposed and final regulations, the IRS does not expect to extend the TEFRA amendment deadline. Cohen also responded to questions concerning the applicability of salary limitations and minimum benefits in years after being top-heavy (they apply only during top-heavy years), and to questions about determination dates (must be defined, not selected annually based on the best result), and minimum benefits, which must be paid to non-key employees, employed as of the end of the year.

James A. Gobesis is a consulting actuary with Milliman & Robertson, Inc.

DIALOGUE
(continued from page 8)

Top-Heavy Plans
1. Under the final regulations, the minimum contribution under Section 416 of the code can be made to a top-heavy profit sharing plan, even if there are no profits.
2. Minimum vesting requirements apply to all plan benefits, not just the minimum benefits required by Section 416.
3. Under defined benefit plans, actuarial assumptions for top-heavy tests must be stated in the plan, but can differ from those used for benefit purposes.
4. For employees who do not want to participate under a contributory defined benefit, the minimum 2% accrual is required.
5. For top-heavy Section 401(k) plans, it may be necessary—even if this is totally a salary reduction plan—for the employer to pay 3% for non-key employees if their salary reduction is less.

Accrued Benefits
Under a Social Security offset plan, plan benefits can decrease due to an increase in the Social Security benefit. This is permissible, and the plan will continue to satisfy the nonforfeitability requirements of Section 411, since the total benefit to the employee will not decrease. However, under an excess plan with a floating covered compensation base, there is no direct relation between the increase in covered compensation and the benefit amount; these plans may have actual reductions in total benefits, and a forfeiture exists.

Many other items were discussed, including:
- Definition of earned income for those self-employed. Actual income before deduction of the pension contribution is used for determining the contribution, but net income is used for Section 415 limits.
- 401(k) plans, which are profit sharing plans. All contributions are made by the employer.
- Partial terminations. If more than 20% of a plan's participants leave the plan, partial termination may result.
- Termination filing. Form 5500 must be filed until all assets are distributed, but Schedule B only has to be submitted for the year of termination.
- Comparability. An annual check is needed, and there is a $200,000 cap on earnings.
- Universal life insurance. There is a 25% limit on the total premium, not just the insurance portion.
- Insurance prototype plans. There is no reliance for plans issued after March 19, 1984.

Daniel M. Arnold is vice president with Hooker & Holcombe, Inc.

REDUCING PENSION EXPENSE
(continued from page 8)

Funding changes aim to accomplish either an increase in the actuarial value of current assets or an increase in the investment return to current assets. Possible techniques to achieve the former include, for example, (1) the immediate realization of market gains by setting the actuarial value of assets to market value, and (2) purchasing annuities for the current block of retireds or vested terminations, paying less in assets than is released in liabilities.

Current popular techniques to increase investment return involve the use of dedicated bond portfolios. The higher return of this lower risk investment may be coupled with higher risk and return in the remaining part of the portfolio, allowing an increase in the actuarial investment return assumption. To the extent that the current asset allocation is already optimal, reducing current expense will increase future expense. Since level-dollar amortization amounts, however, tend to tilt the expense curve downward, the end result may be more level percent-of-pay expense.

Changes in Expense Policy
Epstein's first topic of discussion was changing assumptions. New assumptions must be reasonable in the aggregate, possibly pass an IRS audit, and perhaps satisfy the company's auditors. A select and ultimate interest assumption may be used. Recognition of actual salary history for those near retirement may lower costs in

Enrolled actuaries enjoy lunch, conversation, and presentations by guest speakers in the Sheraton Washington Ballroom.
Actuarial Assumptions  
by Lawrence N. Margel

Under the IRC, the IRS is charged with the responsibility of seeing that actuarial assumptions used to develop defined benefit plan costs are reasonable. This session was devoted to discussion of the actuarial guidelines handbook and worksheets prepared by the actuarial branch of the IRS for use by its field agents in their audit of pension plans.

James E. Holland, Jr. of the projects branch of the Employee Plans Technical and Actuarial Division of the IRS reviewed the worksheets to be used by the field and gave some background as to the thinking that went into the development of the worksheets. The general intent is to evaluate actuarial assumptions for reasonableness by looking at the level of gains and losses produced over a three to five year period preceding the year under examination. If combined investment and liability net gains and losses over this period lie outside an established range, this is taken as an indication that the assumptions may not be reasonable.

In making this test, non-recurring gains and losses are excluded from the calculations. It was brought out in discussion that the most difficult part of applying the principles behind the worksheet was to ascertain just which gains and losses are non-recurring. Sometimes this will be clear, such as a gain from an insurance dividend due to an adjustment in a reserve basis or a loss on the sale of a large block of zero coupon bonds. In most cases, however, what is non-recurring will not be so clear.

Asset gains are factored into the worksheet by first determining what excess earnings rate the non-recurring investment gains represent. This gain or loss percentage is then added to the liability gain or loss percentage determined by dividing the liability gains or losses by the year-end actuarial accrued liability. This total is then further increased or decreased by an adjustment for deferred gains and losses. These items are gains or losses that reflect retirement age assumptions or annuity purchase rates that the IRS deems unreasonable. Because there may not be any exposure to these retirement assumptions in the current or immediately preceding years, no gains or losses may have resulted. Nevertheless, an adjustment is made to the worksheets for these items, because the IRS believes that unreasonable assumptions for these items produce current costs that do not reflect the use of reasonable actuarial assumptions. A purchase rate outside of a 10% corridor around one based on 5% interest is deemed unreasonable and results in an adjustment for a deferred gain or loss item.

If the total of asset, liability, and deferred gain and loss percentage items lies outside a range represented by 4% of the actuarial accrued liability, the assumptions are considered unreasonable. In that event, actuarial costs developed for minimum funding and maximum tax deductible purposes will have to be adjusted and these contribution limits recalculated.

Arthur Anderson presented the results of statistical calculations he had made to see how often plans would show experience that fell outside of the acceptable 4% range. On the asset side, he created a model under which the assumed rate of return was equal to the Standard and Poor's (S & P) 500 average over a period of years. He then let the actual earnings rate in each year reflect the actual S&P 500 experience rate. In 71% of the cases, the five-year analysis (continued on page 12)
ACTUARIAL ASSUMPTIONS
(continued from page 11)

made on the IRS worksheets would show that the assumptions were unreasonable, notwithstanding the fact that the assumed rate of return was selected with the advantage of hindsight and was equal to the actual rate experienced over the period.

Similar techniques applied to the liability side showed that small cases would invariably produce experience results that would fall outside the 4% acceptable corridor, while very large cases would almost never have experience outside the limits.

I, the moderator of the panel, noted that adjusting assumptions in the current year to reflect prior year's worksheet results produces an anomalous situation. If prior year's gains are to be offset, as would be necessary to bring the five-year average results back within the corridor, the new assumptions must be designed to produce losses. This is in conflict with the Schedule B certification requirement to use "best estimate assumptions." I also pointed out that the law requires the use of reasonable assumptions; it does not require the use of assumptions that reflect unreasonable results. The latter will be the case if assumptions are selected to produce gain and loss experience that will fall within the IRS established 4% corridor.

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The Enrolled Actuaries Meeting featured again this year special exhibits for pension actuaries. Eighteen companies displayed a sophisticated array of computer software systems for just about everything the enrolled actuary encounters, including programs for 401(k) plans, defined benefits and defined contributions, profit sharing, plan valuations, actuarial assumptions, and plan administration, among many others. At the session "Computers in an Actuarial Environment," speaker Kurt H. Fichthorn said that computers will not replace enrolled actuaries; rather, enrolled actuaries who use computer will replace those who don't, and that the personal computer will soon perform the majority of tasks now handled on large main frame computers.

Following is a list of the companies in the exhibition:

Actuarial Computer Technology, Inc.
Benefit Insights
Capital Holding Corporation
Corbel and Company
Datair/FCCC, Inc.
Dolphin Data Systems
EBG and Associates, Inc.
Electronic Legal Publishers
Financial Data Planning Corporation
INTAC Actuarial Services
James J. Bagshaw and Company
Lynneval Systems
PENTABS
SBC Systems Company, Inc.
Spencer Organization, Inc.
Systems Strategy, Inc.
The New York GIC Exchange
Trans Texas Holdings Corporation