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A discussion of current developments in integration of private pension plans with U.S. Social Security benefits.

MR. RAYMOND E. PINCZKOWSKI, JR.: Integration of private pension plans with U.S. Social Security is an area where the government appears to be using a double standard. Federal Civil Service employees have imposed standards on the private sector to which they themselves are not subject, and are now attempting to tighten these standards even further.

In this session we will assume that all of you are familiar with the current integration rules. We will begin with a description of the Carter Administration's proposal for changes in the current integration rules. We will then explore the reasons for the proposal, and the reaction of the pension industry to it so far.

It is significant that the proposal is not coming from the IRS, it is not coming from the Department of Labor, it is not coming from the Pension Benefit Guaranty Corporation, or from any other agency of the U.S. government. Rather than a mere regulation, this proposal is offered by the Carter Administration as a new law, a law which would supersede all existing tax laws, Revenue Rulings (such as Revenue Ruling 71-446), and regulations. It is part of the Administration's broad tax reform package for 1979, having been deleted from the 1978 package.

The integration proposal is significant in two areas. First, it is a step beyond the "parity" issue (that is, the issue of providing for equal benefits above and below the taxable wage base). In effect, it is an attempt to broaden the coverage of private pension plans by prohibiting "pure" excess-only benefit plans. Second, it appears to be an attempt to increase benefits, since it would require a plan providing a benefit of "x" above the taxable wage base also provide a benefit of "y" below the taxable wage base.

MS. DIANNE BENNETT: First of all, I would like to make it clear exactly whom I represent here. I was in the Office of Tax Legislative Counsel, and I worked with Dan Halperin, who was then Tax Legislative Counsel, and is now Deputy Assistant Secretary of the Treasury for Tax Policy, and with Tom McSweeny on developing the Administration's proposal in this area. However, at this time I am back in private practice, so I clearly do not represent the Treasury Department. On the other hand, I do not represent the law firm, because the firm obviously would not take a position on this type of issue. What I would like to do is to try to recall, from my days in the Treasury Department, the considerations which led to the proposal, and to bring you up to date on the current status of that proposal. Despite the fact that I do not represent the Treasury Department at this time, my information should be fairly current, since I have been gone from the Department for less than sixty days.

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As some of you know, the Administration proposed the changes in the integration rules in the major tax reform proposal which it introduced at the end of January of this year. I think that the best description and analysis of the proposal are contained in the so-called "Green Book", which is a detailed description of the President's proposal. Another document describing the proposal is the House Bill which the Administration had introduced. It contains the statutory language interpreting the program. This was HR 12078, introduced a couple of months after the detailed description was published. In the drafting of that bill, some matters arose which we had not considered earlier, so there are some differences between the bill and the original proposal. A third relevant document is the so-called "spring letter", written by Dan Halperin in the late spring. The letter, containing some suggested modifications of the proposal, was sent to members of the pension community who had expressed an interest in the integration proposal. I believe the letter was published in the BNA Pension Reporter. A fourth source which is useful in understanding the Administration's proposal is the total testimony of the Administration in the employee benefit area. Dan Halperin, in particular, has testified before numerous committees in the past six or eight months on the matter of employee benefits. He has given testimony on integration and on other topics (such as IRAs). Underlying all of this testimony is a common principle which I will discuss later.

Today I would like to describe the background, the assumptions, and the details of the Administration's proposal. Historically, the principle of integration goes back to the Revenue Act of 1942. This legislation was motivated by the concern of Congress about tax benefits flowing disproportionately to higher income individuals, or individuals who controlled corporations. I believe that the integration pattern embodied in that legislation was patterned after that of an AT&T plan which was then outstanding. Since that time, integration has become widespread. A 1974 study showed that approximately 60% of plans were integrated, covering about 25-30% of employees covered under plans. Integration is rare in union plans, highest in small (fewer than 26 employees) plans (64% of these were integrated according to the 1974 study), and lower in large plans (29%). Furthermore, the extent of integration in the small plans is greater than in large plans. The 1974 study showed that approximately one-quarter of the small plans were fully integrated whereas only 10% of the larger plans were.

The current rules, most of which are contained in Revenue Ruling 71-446, are based on the 37.5% integration percentage for excess-only defined benefit plans. The determination of this number required several steps. The first step was to determine the relationship between the primary insurance amount (PIA) and average monthly earnings (AME). Both the PIA and the AME which were used in this calculation were arrived at by taking the average of their values in 1971 and their projected values in 2015. The "replacement rate" is the ratio of these two averages, which is 43%. The next step was to determine the relationship of total Social Security benefits, including ancillary benefits such as disability and survivors' benefits, to the PIA; it was determined that total Social Security benefits were 162% of PIA. The third step was to acknowledge that the employer and the employee each contribute 50% of the cost of total Social Security benefits. The product (.43 x 1.62 x .50) is close to the statutory value of 37.5%, upon which all of the other current integration standards are based.

The 1977 Social Security amendments are also important to the current status of integration regulations. One of the effects of those amendments is the

stabilization of the replacement rate, which raises questions about the appropriateness of the 37.5% integration percentage, since the latter was based upon a varying replacement rate. Second, the amendments introduce the concept of average indexed monthly earnings, which cannot simply be used instead of average monthly earnings. A change to using the indexed number would also have an effect on the calculation of the integration percentage. Third, the wage base is increasing very rapidly (from $17,700 this year to $29,700 in 1981). Furthermore, it is estimated that the 1981 wage base will cover all the wages of 94% of the workers in the United States. This could also affect the appropriateness of the current integration regulations. Finally, we should consider the effects of possible changes in the funding of Social Security, which are under discussion in the Congress. For example, there has been discussion in Congress of funding survivors' benefits or disability benefits through general revenues. Such an arrangement would invalidate the assumption that the employer and the employee each provide 50% of total Social Security benefits, which would in turn bring the appropriateness of the current regulations into question.

Why did the Administration include integration in its program? I believe that the Carter Administration first observed that integration was left open under ERISA. Those of you who were involved in pension work in 1974 may recall that it took an extraordinary concurrent resolution to remove a freeze on the Social Security taxable wage base from ERISA, and that Congress insisted that a study of integration be conducted. The fact that that study has not yet been conducted, combined with the effects of the pending Social Security amendments that I have just described, led the Carter Administration to the conclusion that this area required explicit attention. Second, President Carter directed his Administration to re-evaluate all tax expenditures. In carrying out this directive, the Treasury Department came to the conclusion that the current integration regulations were not fulfilling appropriate goals. Specifically, it was the feeling at the Office of Tax Policy that encouraging people to save for retirement, per se, was not a sufficient goal, because such a policy would likely be effective only among those who would save anyway. This principle is discussed more fully in Mr. Halperin's testimony on IRAs.

With all of this as background, the Office of Tax Policy began to look at the principles of integration. I believe that we would all be in agreement on most of these. The first of these principles is that the ultimate goal is for retired persons to be able to maintain the same standard of living after retirement that they had immediately prior to retirement. I believe that the Administration would acknowledge that it is not necessary for retirement income to exceed 100% of pre-retirement income; however, given current levels of inflation, perhaps this statement is true only for an appropriately indexed retirement benefit. In fact, it appears that, assuming indexing, fewer dollars are required after retirement than before, since certain work-related expenses, such as Social Security taxes, do not continue after retirement. Also, since the funding of pension benefits in effect reduces current pay, there really is no reason for overfunding for retirement. I would point out that those who have been most vociferous about the lack of a 100% "cap" in the Administration's program have not criticized the 1.4 rule in Section 415, but that is a side issue.

The second principle upon which I think we can agree is that Social Security is not sufficient to meet the goals. Therefore, the Office of Tax Policy concluded (and I am sure you would agree) that it is reasonable to consider

Social Security in developing a private pension system. The principle that follows is that some integration is reasonable.

Finally, I think we can agree that the current system is extraordinarily complex, and that any simplification would be beneficial.

On the other hand, there are certain areas in which the Office of Tax Policy and many spokespersons for the private pension community have disagreed. Two of the questions on which there is disagreement are: "What is the current system accomplishing?" and "Where should the first tax dollars go?" Considering the scheduled increases in the taxable wage base, the Office of Tax Policy is asking whether it makes sense for excess plans to be permitted to exclude 94% of the workforce by 1981, and whether it is reasonable for higher-paid employees to achieve the same replacement rate as lower-paid employees before any of the private pension monies have gone to the lower-paid employees. The Carter Administration concluded that such a practice was not to be encouraged by tax policy.

Given these assumptions, what approach did the Administration take? The first approach which we considered was the concept of a minimum benefit. This approach is the one which we pursued the furthest. The concept that a plan should be allowed to integrate only after it provides an adequate retirement benefit has been endorsed by several members of your organization. It was also suggested by Mr. Halperin several years ago, and was mentioned in the spring letter as an alternative for the pension community to consider. I have seen proposals for the minimum benefit varying from 70% to 100% of final pay; that is, once a plan provides a normal retirement benefit of 70-100% of final pay, then it may integrate. Corresponding service requirements of from 25 to 35 years have been mentioned. The reasons for the eventual rejection of this proposal by the Administration were its complexity and the burden which is would impose upon small plans. As I recall, the Office of Tax Policy fought hard to retain the minimum benefit concept, but it simply became too complicated to pursue. For example, I recall a discussion of a requirement that profit-sharing plans provide for contributions at the rate of 10% on earnings below the Social Security taxable wage base before integration would be permitted, and we couldn't imagine that small plans would tolerate that kind of change. Nevertheless, the minimum benefit concept is implicit in the Administration's proposal.

Let me turn now to the details of the proposal. Basically, it is a 2.0-to-1 (or "x% minus x%" for offset plans) proposal. (It used to be 1.8-to-1, but I think the Administration has given up on that.) What this means is that a defined contribution or step-rate plan could provide contributions of x% up to the integration level, and 2x% above that level. For example, under the current taxable wage base of $17,700, a defined contribution plan providing contributions of 5% of salary below $17,700 could provide for contributions of 10% of salary above $17,700. Examples of arrangements which are allowed under current regulations, but would be prohibited under the proposal, are defined contribution plans providing for no contributions below the taxable wage base and 7% of salary above the taxable wage base, or 2% below and 9% above. On the other hand, a plan having contribution rates of 10% below the taxable wage base and 20% above the wage base would be allowed under the proposal, but prohibited under current regulations. The underlying principle is that the goal of the plan should be to provide adequate retirement benefits, and that integration is appropriate only after that goal is achieved. For step-rate plans, the same two-to-one relationship would apply. For example,

benefit rates of 30% of salary below covered compensation and 60% of salary in excess of covered compensation would be permitted. Prohibited would be the old combinations of 0% below covered compensation and 37% above, or 12.5% below covered compensation and 50% above. Permitted would be 40% below covered compensation and 80% above, which is prohibited under current regulations.

Some changes were made in the proposal for step-rate plans in the drafting of the final bill. (These changes were also mentioned in the spring letter.) Basically, the bill permits a higher integration level and a lower ratio. The ratio is determined by comparing the primary insurance amount to the integration level. The ratio which applies to a given plan is the lesser of 2.0 to 1 and the ratio of the integration level to PIA. Since the ratio of covered compensation to PIA is always less than 2.0, the 2.0-to-1 rule can be applied if the integration level is covered compensation. On the other hand, if a plan uses average indexed earnings as of 1982 as the integration level, then the ratio would be limited to 1.8 to 1, and for a career average plan with the taxable wage base as the integration level in 1980, the ratio would be limited to 1.34 to 1.

For offset plans, the proposal is based upon a different model, namely the "x% minus x%" model. For example, if a plan provides for a gross benefit of x percent of final average pay, then it can provide for an offset of x percent of the Social Security amount. For example, "50% minus 50%" would be allowed. The combination "50% minus 83-1/3%", which is allowed under current law, would be prohibited. On the other hand, a "90% minus 90%" combination would be allowed, whereas it is prohibited under current law.

The Administration's proposal also provided transitional rules, which are best described in the bill. Basically, the new rules would apply only to benefits accrued after the effective date, or the plan could use a formula which stated that the employee's accrued benefit would be the greater of (1) the accrued benefit under the new rules, or (2) the accrued benefit under the plan as it was in effect immediately before the effective date, as if the person separated on that date. This latter arrangement provides a little more flexibility.

Of greater interest are the transitional rules which were suggested in the spring letter. The first of these dealt with the step-rate defined contribution or defined benefit plan and it suggested that plans which currently have a 2.2-to-1 ratio would be allowed an extra five years before changing. The second suggestion applied to offset plans, and suggested allowing an additional five years for plans whose current formulas are within ten percent of those of the proposal. For example, a "45% minus 50%" plan would be given an additional five years to comply with the new law. The third transitional rule applied to discretionary profit plans. It stated that plans which satisfy the 2.2-to-1 relationship, even though the plan does not contain that formula explicitly, may have an extra five years to comply. Similarly, plans with very low integration levels would be allowed an extra five years, provided that they satisfy the transitional standards.

Next, I would like to discuss briefly the results of some studies of the potential effect of the proposal on existing plans. The first of these is a study conducted by A.S. Hansen, Inc. They represent very few defined contribution plans, so they studied only defined benefit plans, and I believe that they represent mainly medium and large plans. The study involved 1,200

plans covering 1.2 million active participants. Of the plans studied, two-thirds were integrated. They determined that only one-quarter of their step-rate plans would not meet the 2.0 test, and that only one-fifth of the offset plans would require more than a nominal adjustment to meet the "x% minus x%" test. National Associates also conducted a survey. They represent smaller plans, and they looked at 555 of their plans. Of those plans, 46% were not integrated, and would therefore not be affected by the proposal. Thirty-seven percent of the plans failed the 1.8 test or the offset test. I do not know if they looked at the 2.0 rule or not. Seventy-eight percent of the integrated offset plans failed, and 54% of the integrated defined contribution plans failed; however, the study said nothing about the 2.0 test or about satisfying the transitional rules. Furthermore, the study did not aggregate multiple plans of a single employer, which the Administration's proposal would clearly permit. Also, a St. Louis practitioner studied 150 plans which he had in his office. In his study, he did allow for aggregation. He found that only 22 of the employers had integrated plans and that 14 of these employers had two plans each. Only five of the employers would have had to adjust their plans. He asked those employers if they would be willing to make the adjustments, and they said that they would.

Let me turn now to two other arguments which have been brought up in opposition to the Administration's proposal. One is that the proposal hurts the middle-income person. First of all, the current definition of "middle-income person" is one who earns from $20,000 to $50,000 per year, which I think is fallacious in light of the fact that the average worker earns about $14,000 per year. This consideration aside, does the Administration's proposal hurt the person in the $20,000 to $50,000 income range? In 1981, a person earning $29,700 could be "integrated out" of a pension plan under current rules. Under a 7% excess-only profit-sharing plan, a person earning $40,000 would be entitled to a $700 contribution, whereas a person earning $100,000 would be entitled to a contribution of almost $5,000. It is therefore difficult to argue that a middle-income person in such a plan would be hurt by the Administration's proposal.

The second argument, which Ray mentioned in his introduction, is that the Civil Service System is not included in the Administration's proposal. First, I believe that the Civil Service System <u>does</u> fit in with the proposal in that it incorporates the minimum benefit concept; that is, it provides 76% of final average pay after 30 years of service. Furthermore, it takes into consideration only earnings up to approximately $50,000. I doubt that a private employer would want that sort of system, where the employer had to provide 76% of final average pay, excluding considered compensation of over $50,000. Finally, the percentage of persons making that high a salary in the Civil Service ranks is very small. I think that the proper comparison is to nonintegrated plans of employers who have Social Security.

I spoke briefly at the beginning of my presentation of how the replacement rate required in order to maintain one's standard of living after retirement probably declines as annual income increases. In a manuscript for a new book, Dan McGill maintains that an employee earning $7,500 per year needs 75% of final average pay to maintain his standard of living after retirement, but an employee earning $40,000 per year needs 58% of final average pay. This type of pattern is reflected in the Administration's proposal.

Let me summarize briefly what the principles are. It seems to me that the central questions are: "Where do the first tax dollars go?" and "What kinds

of plans are being encouraged?" The Office of Tax Policy believes that tax money should not be used to support plans whose goal is simply to provide supplemental income to more highly-paid individuals. The Office believes that it should encourage people to do something they would not otherwise do; namely, to encourage those who would not otherwise save for retirement to do so, or to make it possible for them to receive retirement benefits. It is this type of program that the Administration believes can fend off those who think that perhaps Social Security should take over entirely. It is this type of program that the Administration thinks would keep the private system healthy.

MR. PINCZKOWSKI: Perhaps I look at Social Security integration too simplistically, but it appears to me that one solution would be to lower the Social Security taxable wage base. If the Treasury Department sees the problem as that of using tax dollars to subsidize only those individuals earning salaries in excess of the taxable wage base, then lowering the base and reducing Social Security would presumably solve the problem. Of course, I do not expect this solution to be pursued.

With regard to Dianne's comments on the Civil Service retirement system, I would like to point out that my experience with benefit projections in the private sector has been that even fully integrated plans produce replacement ratios which decrease with increasing compensation. That is, the ratio of the private sector pension benefit plus Social Security's PIA benefit to the employee's final average salary is a decreasing function of that salary. This is in marked contrast to the level 76% provided under Civil Service. Furthermore, this situation shows that even the current regulations do not really allow for what might (simplistically, perhaps) be understood as "full integration", namely, x% of final pay minus 100% of the primary Social Security benefit. The proposal would restrict the private sector even further.

MR. MICHAEL J. MAHONEY: Dianne has given us some very good background information on the reasoning process behind the government's recent proposals.

At the risk of being redundant, I would like to briefly go through the proposals again, pointing out some areas of concern.

In January of this year, the Carter Administration submitted proposed changes in the current integration regulations which were applicable to benefits accruing after the proposed effective date of December 31, 1979. This represented the first attempt to set specific integration rules through legislation. Up to now, such details have been left to the IRS.

Essentially, the proposed rules would have the following effects.

Excess Plans (both defined contribution and defined benefit). These plans would not be viewed as discriminatory as long as the plan-provided benefit above the integration level did not exceed 1.8 times the plan-provided benefit below such level. The maximum permissible integration level would be the Social Security Taxable Wage Base.

Barring any inconsistency, no adjustments in basic benefits would be required for ancillary benefits, different annuity forms, early retirement, or employee contributions. For example, if benefits above and below the integration level had a ratio of 1.8 to 1, and corresponding employee contributions had a ratio at least as great, then no adjustment to benefits would be required. If the

ratio of employee contributions were less than 1.8 to 1, then benefits would have to be adjusted accordingly. It is interesting to note, however, that the proposed rules made no provision for a credit if the ratio of employee contributions exceeded 1.8 to 1.

Offset Plans (defined benefit). These plans would not be viewed as discriminatory as long as the percentage offset of Social Security benefits did not exceed the percentage used to determine the gross plan benefit.

For example, a plan providing 50% of final pay less 50% of PIA would meet the new rules. If the offset were 60%, then it would not.

As with excess plans, no adjustments were required for ancillary benefits, different annuity forms, and early retirement. However, an adjustment would be required for contributory plans. The maximum allowable offset percentage would be based on the employer-provided benefit (i.e., gross plan benefit less portion provided through employee contribution). This adjustment would put "plan integration" on an individual basis and definitely complicate plan administration.

Employers with more than one plan could elect to meet the requirements separately for each plan or for all plans combined.

The Administration said that a change was necessary because (a) it viewed integrated plans as a tax subsidy, (b) some integrated plans were not providing any benefits to lower-paid employees, and (c) the existing regulations were too complicated.

Some objections to the proposals raised by industry and knowledgeable experts were:

1. It was too soon after the upheaval of ERISA to make major plan changes.

2. There were several studies of existing integration requirements already under way or about to start, and it would be more appropriate to wait for the results and recommendations of those studies.

3. The proposed requirements would necessitate plan changes, resulting in additional costs. These would be on top of those emanating from the recent changes in Social Security benefits and wage bases.

4. Without regulations, it is hard to evaluate the supposed "simplicity" of the new rules. This is especially true with respect to contributory offset plans.

5. If the problem is really one of "zero benefits", then a minimum benefit should be required, rather than a change in the integration rules.

Of course, the presentations before the Ways and Means Committee included some who praised the Administration as well as some who thought the proposals didn't go far enough.

HR 12078. In April, Congressman Ullman introduced HR 12078 at the request of the Administration. Included in the bill were revised integration proposals.

Excess Plans. For defined contribution plans, there was no change in the 1.8 integration ratio or in the Taxable Wage Base as the maximum integration level.

For defined benefit plans, there were some significant changes. First, there was no limitation on the integration level--it could be any amount. Second, the integration ratio in a particular year was defined as "the lesser of 1.8 or the ratio of the integration level for such year over the difference between the integration level for such year and the maximum primary insurance amount for such year."

This ratio was arrived at by assuming that the integration level would be the Taxable Wage Base and that the maximum primary insurance amount was equal to 45% of the Taxable Wage Base. Obviously, there are several who would question this approach for arriving at the permissible ratio.

To give you some idea of how the integration ratio would work, let's look at some examples. For a plan which wanted to integrate on covered compensation, the alternative ratio would be about 3.8 to 1, assuming covered compensation of $8,400 and a maximum PIA of $6,200. However, HR 12078 would not permit an integration ratio in excess of 1.8.

If a plan wished to integrate on the Taxable Wage Base, the alternative ratio (in the foreseeable future) would be between 1.3 and 1.4. In this instance, HR 12078 would require that this be the integration ratio since it would be less than 1.8.

Offset Plans. There were no changes with respect to the benefit/offset percentages or to the adjustment for employee contributions. However, final average compensation is defined as the "employee's annual compensation averaged over a period not to exceed five consecutive years." For those plans with benefits based on a ten-year average, adjustments will have to be made.

If the proposed rules are adopted, then those final pay-offset plans, which provide for a percentage of final pay for each year of service less a flat percentage (regardless of service) of PIA, will have to be amended--as it will be almost impossible to demonstrate that they meet the rules in all instances.

Finally, the bill will have to be more specific as to the determination of projected PIA. Under present rules, this can be determined assuming projection of level earnings or of zero earnings. The latter approach will result in an excessive reduction where the offset is a percentage for each year of service.

In May Mr. Halperin, Tax Legislative Counsel for the Treasury Department, sent a letter to those who testified before the Ways and Means Committee on the Administration's integration proposals. The letter requested comments on various alternatives to the original proposal.

In essence it recommended the integration ratio outlined in HR 12078, proposed some transition rules of up to five years, and suggested a minimum benefit. In my opinion the minimum benefit is not a viable alternative. Because of the existence of a minimum and maximum, it would be very difficult to have a step-rate plan that was not in effect an offset plan.

Admittedly, the current integration rules are complex and in need of change. Also, there has been some abuse of the existing regulations. But there are many who will question the elimination of excess benefit plans per se and the elimination of the early retirement adjustment.

MR. PINCZKOWSKI: Before calling for questions from the floor, I would like to take advantage of my position as Moderator to ask Dianne two questions. In a discussion session on this topic at a recent meeting of another professional organization, the speaker who was describing the Administration's proposal said that, for defined contribution plans, the 2.0 rule would be subject to the limitations of Revenue Ruling 71-446. For example, a profit-sharing plan providing for contributions in a "10%-20%" pattern would not be allowed (despite satisfaction of the 2.0 rule), because the difference between the two rates is greater than 7%. You said the opposite today. Which is correct?

MS. BENNETT: It is my understanding that the 2.0 rule would be the only one applicable in the case that you describe.

MR. PINCZKOWSKI: Thank you. My second question has to do with the application of the minimum benefit concept as described in the "spring letter." Does it mean that once the plan provides a minimum aggregate benefit (including PIA) of 70% of final pay, that it may then integrate? Or does it mean that a "70% minus 100%" offset plan would be allowed?

MS. BENNETT: Neither, it means only that a plan can apply the "x% minus x%" rule only if it satisfies the minimum benefit standard. In your example, the appropriate formula would be "70% minus 70%."

MR. DAVIS H. ROENISCH: One of the things which was mentioned in the release was that the employer could take credit for other plans along with his integrated plans. Has there been any detailed description of this? Could you tell me, for example, what weights would be given to a discretionary, across-the-board profit-sharing plan with contributions varying from 0% to 15% over a period of years?

MS BENNETT: That is a good question. The details, as I recall, were never spelled out. Perhaps this is an example of Mike's point that we cannot assess the "simplicity" of the proposal until we see the regulations.

MR. DONALD J. SEGAL: I have two questions about the effect of employee contributions under the Administration's proposal. First, I believe that the original proposal required employee contributions under defined benefit plans to be applied in the same ratio as the benefit accrual rates for the two segments of compensation. This is an adjustment in the opposite direction from Revenue Ruling 71-446. What is the current status of this part of the proposal? Second, what adjustments for employee contributions would be allowed for offset plans?

MS. BENNETT: As far as I know, the proposal still contains the 2-to-1 rule for employee contributions to defined benefit or step-rate plans.

MR. MAHONEY: Your question about the offset adjustment is one that I myself asked in Washington. The response was that the employee contributions would have to be reflected by a reduction of some sort in the offset percentage. For example, a "50% minus 50%" offset plan with employee contributions of 10%

might have to become a "50% minus 40%" plan. It was observed that rather than simplifying the situation, this might make qualification more complicated.

This raises another point. Under current regulations, the integration tests can be applied to an entire plan at once. Under the Administration's proposal, a plan involving final pay and employee contributions would have to qualify almost on an individual basis, rather than on a total plan basis.

Ed Boynton and I raised the question of the offset adjustment in a brief meeting with a few members of the Joint Committee on Taxation for the House and Senate, and they had no answer at that time.

MR. ERIC P. LOFGREN (Comments supplied to Recorder after the Meeting): The survey conducted by A.S. Hansen indicated that 71% of defined benefit plans using a step rate or pure excess benefit formula would integrate under the proposed rules when using the 2.0 ratio test. This survey only included 42 such plans with 25 lives or less. These small plans would fare much worse under the 2.0 ratio test than is indicated by the Hansen survey.

The Task Force on Tax and IRS Procedures of the ACLI Pension Committee also conducted a survey. They drew a sample from over 10,000 defined benefit pension plans integrated by either pure excess or step rate benefit formulas and which covered fewer than 25 participants. This sample was drawn from the case files of 9 large insurance companies. The results were that only 23% of these plans would satisfy the proposed 2.0 ratio test.

The Treasury's integration proposal would prove to be quite costly to these small plans. If this proposal was implemented, many small employers that "weathered" ERISA would conclude that funding a qualified pension plan just is not worth the effort. Substantial numbers of plan terminations would be likely.