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DESIGN OF INTEGRATED RETIREMENT PLANS

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1. Anticipating Washington
2. How can plans be designed to accommodate any changes?
3. How can consultants advise clients in a period of uncertainty?
4. Is the use of offset tables desirable and permissible?
5. New developments (if any)

MR. ROBERT L. BARNES: As you may know, the subjects for these meetings are selected well in advance of the meetings. The material distributed by the Society for this session indicates that the principles of Social Security integration will change or may already have changed. The principles have not changed and there are no signs of changes forthcoming in the immediate future. So there is no new Revenue Ruling or legislative proposal we can sink our teeth into. The last major change was in 1971 — Revenue Ruling 71-446. Over the last 12 years, private plans have survived ERISA, FASB, ERTA, TEFRA, EEOC, ADEA, major declines in the stock market, record interest rates and double-digit inflation. Integration of private plans may have been the calm within the storm.

That is not to say that proposals have not been made. Just last year some proposals, if passed, could have had far-reaching consequences for integrated plans. Although not a problem for most large pension plans, the top-heavy rules of TEFRA will cause problems for smaller plans. Just the fact that Social Security integration rules have not changed may mean we are due for a major change. That is covered in our first topic — Anticipating Washington: What Is Coming Next?

"How can plans be designed to accommodate any changes?" is the next subject. The answer is obvious. If you want to avoid having to change your plan every time a new ruling on integration appears, have a non-integrated plan.

The next aspect is very practical — "How can consultants advise clients in a period of uncertainty?" "Never in writing" would be my inclination. I hope our panelists have some better ideas.

I have long been a proponent of offset as opposed to step-rate plans. My clients all objected to the problems in determining the amount of the Social Security offset and I provided them with some simple tables that could be used in lieu of contacting the Social Security Administration (SSA) for pay records, waiting for the first Social Security check, etc. As Social Security became more complex, the tables became more complex and larger, but the principles were the same. The tables typically assume that an individual has been covered by Social Security throughout his working career and that his

earnings have increased at the same rate as the national averages. Now there are rumors that we may not be able to use those tables.

In the last year or so there have been a number of changes where integrated plans are involved.

Our format today will be for each panelist to offer his comments, questions from the audience and the comments from the audience.

MR. JOHN P. FIXMER: Integrated retirement plans coordinate plan benefits with benefits payable from the Social Security System (SSS). The combination of the primary Social Security benefit and the integrated private plan benefit provide similar benefits expressed as a percentage of pay for highly paid and low paid employees. If this is to be accomplished, plan design must anticipate future developments in Social Security benefits. The basic set of rules for coordinating plan benefits with Social Security was published in Revenue Ruling 71-446 which implements Section 1.401-3(e) of the Income Tax Regulations, as amended by T.D. 7134. This Revenue Ruling allowed a defined benefit private pension plan with a normal retirement age of 65 and actuarially reduced benefits under age 65 and no other benefits except for vesting with the following alternative benefits: (1) 37-1/2% of pay in excess of average covered compensation (adjusted if the retiree has less than 15 years of service); (2) a fixed percentage of pay less 83-1/3% of Social Security.

The Ruling also provides for defined contribution benefit plans with contributions of 7% of pay in excess of the year's wage base.

The philosophy behind the Revenue Ruling was to determine the value of benefits provided by Social Security and to assign half the value to employer contributions and half to employee contributions. Employers could take credit for benefits provided by their own contributions. The value of all OASDI benefits was deemed to be 162% of the primary insurance amount (PIA), and the employer share of these benefits therefore was 81% of primary Social Security. Anticipation of future benefit improvements allowed the IRS to justify an offset of 83-1/3% of primary Social Security. Similar reasoning was used to justify integration limits for excess benefit and defined contribution plans (DCP's). The rules were incredibly complex however. After increasing the integration level to reflect the various spouse's and disability benefits in the OASDI program, the IRS felt obligated to decrease the allowable integration if similar benefits were included in the pension plan.

Certain inequities already exist between integration rules of excess plans and offset plans and these included some of the following: (1) Excess plans do allow credit for employee contributions. There is no such credit for an offset plan. (2) Integration levels have to be adjusted if pay is averaged over a 3 or 4 year period in an excess plan, but does not have to be adjusted in an offset plan. (3) Excess plans require consecutive years of service and pay. There apparently is no such requirement for offset plans.

Furthermore, Revenue Ruling 71-446 has not been amended to reflect changes in the SSS, with the result that both excess pension plans and DCP's have been inhibited from making appropriate plan changes. There had been sweeping changes to the SSS. The first occurred in 1972 and the benefits which formerly were increased on a time-to-time basis, were automatically increased starting

in 1974. The increase in 1974 was overridden with legislation and the automatic increases started actually in 1975. Each June the benefit formula for actives and benefits for retirees is increased to reflect cost-of-living (COL) increases. Each January covered wages for actives are increased to reflect national wage increases. The automatic increases were designed to keep the System working properly if prices increased at roughly 45% of the rate at which wages increased. That happened to be true for the period from 1950 to 1970. What happened then, from 1971 to 1977, is wages actually increased slightly less than the COL. The SSS then began to provide larger and larger benefits as these two increases were companioned. By 1975 pay replacement was about 40% for the average new retiree and was predicted to exceed 50% of wages for an average age retiree by 1981. Clearly, without change, the SSS would have had benefits far exceeding income.

In 1977 the System was totally revamped. The new System provided for indexing the covered wages for the year when employees attained age 62 and then adjusted the COL increases from 62 to retirement. Covered wages were increased substantially over previous levels with 2 results: (1) covered wages now exceeded wages for most workers. Most workers had most of their benefits, as most of their wages, covered by Social Security. (2) Integration plans were tied to covered compensation which was not indexed to a year near retirement but Social Security integration recognized that, while Social Security benefits were based on covered compensation which was indexed to a year near retirement.

For a covered employee who is age 65 in 1983, 24 years are counted to determine average indexed covered wages. Some covered wages are indexed by as much as 300%. The average indexed covered wage is currently about 140% if you take all the indexed wages and compare them to unindexed wages. They are about 140% of average covered wages without indexing and if you get 6% pay increases over the next 35 years, eventually the average covered index will be about 187% of indexed/unindexed wages. Excess plans are allowed an offset of 37-1/2% of average covered wages which in 1983 equals $4,460 (i.e., 37-1/2% of $11,892, which is the average covered wages this year). That is significantly less than the current primary Social Security benefit which is a little over $8,500. So there are a lot of Social Security benefits which are not being recognized or are not allowed to be recognized in the current rules for offset plans.

By 1977 the formula used to determine primary Social Security had become incredibly complex with 10 layers of covered compensation, each associated with a replacement ratio. Each year the replacement ratio for each layer was increased by the COL and a new layer was added to cover wages. With pay going up as fast as COL, Social Security benefits increased too fast. The thing that happened though with the 1977 changes was that it perpetuated the old formula without change for anybody born before 1917. If you had somebody born before 1917 in, say, 1960 who retires at 65 in 1981, he receives all those overindexed benefits. Now we are getting pretty much into retirement under the new formula and the old formula hardly makes any difference anymore.

But it perpetuated the system that was a little too much for about 3 or 4 years. Clearly participants who were born from 1914 to 1916 who worked to age 65 received benefits that were relatively greater than either the generation

which preceded them or the generation which followed them. Obviously, they should have frozen the formula immediately. Offset plans adjusted for these increases; excess plans did not.

In the 1977 Social Security changes, the formula was simplified so that now Social Security replaced 90% of the first $2,160 of average indexed annual wages; 32% of averaged indexed annual earnings between $2,160 and $13,020; and 15% of any indexed earnings in excess of $13,020. Each one of these items is indexed each year.

A person who retires in 1983 at age 65, who had always received maximum covered wages, receives a benefit of about 24% of the current wage base of $35,700.

If the covered wage base was kept level at $35,700, eventually Social Security would replace about 29% of the wage base. Even if covered wages continued to increase, the System was indexed so that pay recplacement still would approach the 29%. At that point, a logical set of integration rules could be formulated for an excess plan. This logical set of rules probably should be different for wages up to the second bend point and wages in excess of the second bend point. Pay is replaced between those first 2 bend points at a rate of 41.6% for a retiree with average covered indexed wages equal to the second bend point (17% of his wages replaced at a 90% rate and the rest at 32%). For simplicity, this could be rounded to 40%, which is 2-2/3 times the rate of 15% applicable to covered wages in excess of the second bend point. Applying the rate of 40% to wages up to the second bend point would produce a reasonable credit for primary Social Security for an employee with average indexed wages equal to the second bend point. It would ignore Social Security benefits equal to 50% of covered wages for an employee with average indexed wages equal to the first bend point. Most of these people probably will only get about 40% pay replacement because of the changes that are in Social Security anyway and we are getting to that now. Rules for defined benefit excess plans and DCP's could be derived from these relationships.

On April 20, 1983, the President signed into law yet another revision of the SSS, caused this time by a decrease in contributions due to a weak economy and to increased benefits due to the ever-increasing number of retirees.

Increasing pay replacement ratios is not the problem this time. As a matter of fact, the new law makes only a modest change in the benefit formula, decreasing pay replacement from 90% of indexed wages up to the first bend point to as low as 40% of wages up to the first bend point, applicable to participants with less than 30 years in the SSS. The formula is modified to 80% of wages up to the first bend point for a retiree with 29 years under the System, decreasing to 30% for a retiree with 25 years or less. The intention is to cut back so-called windfall benefits for people who have been under the System for a period of time and is going to be phased-in from 1986 to 1990.

More importantly, the new law changes the definition of normal retirement age from age 65 to 67. The change is phased-in beginning with workers who attain age 62 in the year 2000 and is fully effective for those workers who attain age 62 in 2022. But there is another implication tied into this. If you are talking about age 62 retirement, it begins to effect you in the year 2000. With people who retire at age 65, the effect is 3 years later, or the year 2003. If you allow retirement at age 55, some people will be affected as

early as 7 years before the year 2000, or 1993, and that is not long from now. We are going to have to contend with that problem a little faster than you might have guessed at first.

Retirement is still permitted at age 62 but now benefits are adjusted by 6-2/3% per year for the first 3 years before normal retirement age, plus 5% per year for additional years. By the time the full increased retirement age is reached, the reduction is 30% instead of 20%. Employers will have to decide whether private plans should be modified because certain provisions in ERISA affect the normal retirement age and put limits on the normal retirement age.

The 1983 law will also delay COL increases from June, 1983 to December, 1983. Further increases will be recognized annually in December, thereafter delayed 6 months from the previous law. Moreover, because benefits are indexed for COL during the calendar year in which the employee attains age 62, employees retiring in the last 6 months, from July through December (some retire at 62 or later), they will receive smaller initial benefits than under the prior law. Offset plans which used to adjust benefits twice a year, will almost certainly adjust only once, and in January.

Social Security COL increases are now limited to no more than increases in national wages in years in which the Social Security fund is diminished, and is low in relation to benefits being paid. If the new law had been in effect in 1980 and 1981, COL increases in both years would have been substantially reduced.

Both in 1977 and 1983, Social Security multiple changes accelerated tax rates. The 1983 changes also considerably increased taxes for the self-employed. While there is a tax credit, net taxes are still considerably increased over previous taxes, from 9.3% to 14%. Even though we get a 9.27% tax credit, we still have to put out the money before we get it back.

The new law, furthermore, subjects compensation deferred under §401(k) to Social Security taxes. Logically, compensation deferred under these 401(k) plans should now be includable in a qualified pension plan.

These increased taxes probably imply several changes in plan design: (1) FICA taxes cease at retirement. The portion of income which goes to pay these taxes now is larger and will not have to be replaced after retirement. FICA taxes are not a significant portion of compensation for the majority of the workforce. (2) A combination of higher taxes and reallocation of taxes between OASDI and HI affect Social Security integration limits for DCP's because TEFRA changed these allowable integration levels for DCP's in 1983 from 7% of pay in excess of the wage base, to the OASDI tax rate applied to that year. The new law changes that rate in 1984, 1988 and 1989.

For the first time, some Social Security benefits will become taxable when received. At most, 1/2 of the Social Security benefits will be taxable. This would not occur unless the retiree's adjusted gross income, plus tax-free interest, plus 1/2 of the Social Security benefit, exceeds certain base amount. For single taxpayers, that base amount is $25,000. For a married couple, filing jointly, it is $32,000. Married couples filing separately get no credit whatsoever and are immediately taxed after a Social Security benefit is received. Taxation

of Social Security is phased-in as the amount of taxable Social Security rises over these base amounts, but no more than 1/2 of Social Security becomes taxable for a couple or a single person.

Past analysis of the tax system suggested that a combination of private plan benefits and primary Social Security, equaling 80% of pre-retirement income would maintain full spendable income at retirement. After retirement, FICA taxes are eliminated and federal income taxes are substantially reduced. Since the time of that last analysis, however, a substantial change has been made to tax rates, particularly for highly compensated employees. On the other hand, up to 1/2 of Social Security is now taxed for middle income and highly compensated employees. This was an attempt, based on some fairly broad assumptions, to predict the amount of tax paid by a married couple, with both working.

In that last 12 years, benefits under the SSS have been significantly expanded and then significantly cut back. Employers can choose from a variety of defined benefit plans (DBP's) and DCP's with varying adjustments to changes in the SSS. One choice is to design the plan so that the benefit provided by the plan is entirely in addition to the Social Security benefit and is not affected in any way by the Social Security benefit. These plans would include a non-integrated pension plan and a non-integrated DCP.

Another choice is to design the plan so that it adjusts moderately to Social Security. That could essentially be done through an excess DBP or a combination plan which had both an integrated and non-integrated formula, with a practial result of the integrated formula only applying to the higher paid people, which is perhaps less than 20% of the workforce. An integrated deferred contribution plan which would define contributions up to the wage base and over the wage base, or some amount thereunder could also be used.

A final choice is to adopt a DBP with benefits which are affected significantly and immediately by changes in the SSS. These plans include both a conventional offset plan and the so-called 100% offset plan. The 100% offset plan is designed initially so it reproduces benefits under a conventionally designed offset plan. For instance, the plan benefit plus the primary Social Security benefit for an employee with 30 years of service could be 90% of pay for an employee with a 5-year average annual compensation of $9,000; 76% of pay at $18,000; 64% of pay at $36,000; and 55% of pay at $120,000, with suitable graduation in between.

Full benefits are provided for employees with 30 years of service. The plan benefit is proportionately reduced for employees with less than 30 years of service. The 100% offset plan seems to make significant commitment to provide increased company benefits if Social Security benefits are diminished, and if there is no inflation, this is certainly true. On the other hand, if inflation persists, employees will tend to adjust to smaller pay replacements as the employees' pay replacement is covered by smaller percentages in that 100% offset plan table. In other words, if you have inflation that causes an $18,000 a year employee now to be paid $24,000, you reduce the amount provided in between the primary Social Security and the plan benefit from 76% to 70%. Maybe that is enough to keep the private plan about where it was anyway. If there is no inflation though, it is pretty clear you have to make up more of that 76% with the private plan.

DCP's have predictable cost but produce benefits which cannot be adjusted rapidly if conditions change. 25 to 30 years are required before the plan adapts for a full career employee. There have been 2 major changes to the SSS in just the last 12 years. Furthermore, we can foresee certain additional changes to the System in the next several years. There will probably be changes in the economy and in federal tax rates.

We will predict some of the following: (1) There will be additional taxation of Social Security benefits after retirement. This will occur even if there are no changes because the $25,000 and $32,000 base amounts are not indexed and they will not go up. (2) There probably will be a change in federal and state tax rates, and this time around we can expect there will be some shift in taxation from low pay taxpayers to high pay taxpayers. (3) Increases in the COL probably will continue at a low level for about a year and then there will be an increase. Increases in COL will be variable and will be influenced greatly by government policy. (4) Funding problems will continue under the SSS. There will probably be earlier recognition of delayed normal retirement age and possibly a further increase in the normal retirement age, even beyond age 67. (5) There will certainly be a shift to DCP's from DBP's in the next 5 to 10 years. But there may be a shift back to DBP's some time thereafter, as employers become disenchanted with the ability of DCP's to change with conditions.

So that private plans can adjust to changing conditions, we should urge the adoption of new regulations for integrating retirement plans with Social Security. The criteria for these regulations are basically that they should be simple, or at least a little more simple than they are right now, but they should not be so simple that they do not recognize the difference between the vast difference in pay replacement up to the second bend point and beyond the bend point. That recognition should extend to the DCP's, as well as DBP's. I find no logic whatsoever saying that the only amount which you can contribute or integrate is a certain percent in excess of the wage base. There has to be some allocation of contributions between pay up to the second point and the wage base. Thank you.

MR. BARNES: Thank you Mr. Fixmer.

MR. RUSSELL MILLMAN: Is a 100% offset plan a non-integrated plan?

MR. FIXMER: No, it is an integrated plan. It would be the combination of the pension benefit and the Social Security benefit equal to, say, 76% of pay, so that if Social Security provided the 35% of pay, it would say that the private plan would provide 40% for a career employee.

MR. MILLMAN: How would you integrate?

MR. FIXMER: Well, put the table back up there a minute. I performed the integration test about 5 or 6 times and it never turned out exactly the same way any one time, but I seem to have satisfied the people that it does integrate.

MR. MILLMAN: I guess my question would be, if you integrate at 33-1/3%, then how do you integrate at 100%?

MR. FIXMER: The thing that causes it to integrate even when you are taking off 100% of Social Security, is that the percent replaced is not a fixed percent

minus 100%. It is 90% minus 100% of Social Security for the plan benefit for somebody earning $90,000; and at $120,000, it is 55% of pay minus 100%. You just work it out so it produces the more conventionally integrated plan. But the plan will get worse as time goes on, and you have to re-integrate it every 3 or 4 years.

MR. BARNES: Why don't we save the rest of the questions until we are done with our formal presentation. Our next panelist is Ms. Patricia J. Conger.

MS. PATRICIA J. CONGER: My comments are a little more generalized and less specific.

The traditional approach to the subject of integration has been from a "benefits cost" standpoint. The discrimination standard that has historically formed the basis for integration rules has followed this approach. Under 71-446, the average value of all Social Security benefits that might be payable to beneficiaries or dependents upon retirement, death or disability, is calculated as a percentage of the PIA, and that total value is deemed to be provided equally by employers and employees. Employers are allowed to take credit for their half.

There is another aspect of integration that should be considered. That is the need to coordinate the flow of income before and after retirement so that an individual can make a smooth financial transition into a retired life. We are all familiar with various versions of spendable income analyses which are used in the design of retirement income programs. They are usually based on a definition of required spendable income as equal to after-tax compensation immediately prior to retirement, sometimes including adjustments for other items that no longer apply, or change significantly, such as personal savings or employment-related expenses. The post-retirement spendable income needs are then adjusted for post-retirement income taxes and decreased by Social Security benefits, and possibly by presumed income from personal savings, to arrive at the income required from the private retirement plan. This analysis is approaching the integration of private plan benefits and Social Security benefits from a "benefits provided" viewpoint rather than a benefits cost viewpoint. It is this type of integration that we normally consider when consulting with clients about overall retirement income policies. We then try to fulfill the policy we come up with as closely as possible within the limitations imposed by the benefits cost approach of current integration rules.

It would seem logical that a rational social policy with respect to retirement income should concern itself primarily with a smooth financial transition, and certainly should not create a situation where retirement causes a substantial increase in an individual's standard of living. Therefore, this should be the moving force behind the integration rules governing plan qualification, rather than the historically dominant issue of discrimination.

The benefits provided approach was recently examined in a paper by 12 coauthors. It was recognized at this morning's meeting and is due to be published in the next volume of Transactions. The paper began in February 1979 as a research project of the Society's Committee on Pensions. Due to recognition by the Committee of the diversity of opinion that exists on the various social and political issues involved, it is being published as the work of several individuals, rather than as a work of the Committee.

I would like to take a few moments to highlight some of the findings of that paper. The approach taken was to adopt a single premise as to the purpose

of integration and follow it through to a set of conclusions. The premise was that integration rules should be structured so as to support an overall retirement income policy of replacement of spendable income. One of the most important conclusions of this benefits provided type of approach to intergration was that each type of benefit payable under the plan should be separately integrated, i.e., the retirement, disability, death benefits, with respect to the Social Security benefits which may be payable in those situations. It is logical that benefits should not be adjusted due to the fact that a disability benefit might have been paid had the individual become disabled.

Having made that point, the paper concentrates on the provision of retirement income. Recognizing that they were seeking a broad, general solution to the problem of integration, the authors felt that the universally applicable adjustments of changes in federal income and Social Security taxes before and after retirement were the only appropriate adjustments to be made in attempting to equate pre- and post-retirement spendable income. Based upon this assumption, the paper demonstrates that a formula of 80% of final earnings minus 100% of Social Security, produces a fairly close match between pre- and post-retirement spendable income at almost all compensation levels. Recognizing that not all employees desire to replace 100% of spendable income, 2 partial replacement alternatives are explored. The first is based upon the concept of replacing a level percentage, but less than 100%, of spendable income at all levels. It provides for lower gross benefits and maintains the allowed 100% offset. This, of course, could produce minimal or no benefits at lower income levels. That is often viewed as an undesirable result. The second alternative is designed to produce a level percentage of the assumed ultimate desired private plan benefit, i.e., the 80%-100% gross benefit at all levels. This maintains the 80%-100% relationship between the gross benefit and the offset. This also has an undesirable effect in that if you are trying to target, say, replacement of 75% of spendable income for middle and higher compensation levels, you end up exceeding that target at the lower levels. These kinds of problems have always been present when dealing with the retirement income issue. The important point of the paper with respect to offset plans is the utilization of a 100% offset, with a gross benefit of 80% or less. This may be contrasted with the 1978 integration proposals which allowed 100% offsets only in situations where the gross benefit provided 100% of final earnings.

Recognizing that plan designs other than direct offset plans provide for less than perfect reflection of Social Security benefit levels, the paper explores approximate solutions for other types of plan formulas. Noting that under the 1977 Social Security amendments, the ratio of maximum Social Security benefits to maximum average indexed monthly earnings (AIME) is currently approximately 45% and will decrease to an ultimate level of about 35%; the paper suggests that excess and step-rate plans be integrated at a level equal to maximum AIME, as opposed to covered compensation, with an allowable excess percentage of 35% to 40%. That is quite close to 37-1/2%, but the level is where the difference comes in. Using the 40% rate, which is an average of the current and ultimate rates, it is noted that a step-rate formula of 40% of total final earnings, plus 40% of earnings in excess of maximum AIME, would closely achieve the objective of replacement of 100% spendable income.

Since many employees spend less than a full career with one employer, the paper also explores some practical solutions to the problem of allocating Social Security benefits between employers under both offset and step-rate plans. I will not get into the details. In addition, employee contributions and

early retirement provisions are examined and found to have a minimal impact upon the suggested rules.

Finally, possible integration rules under career-pay and DCP's are developed using the approach that the excess percentages, if applied to earnings below the integration level over an employee's career, should accumulate to an amount which approximately reproduces the Social Security benefits payable at 65. Using assumed real wage growth of 2% and real investment return of 3%, it is demonstrated that excess percentages of 1.4% for career-pay plans and 9.9% for DCP's can be supported based on the integration level equal to maximum AIME for an individual turning age 65 during the year in question. It should be noted that these developments were based upon the assumption of a non-inflationary environment. Under the defined contribution formula, the effects of inflation on salary and investment return were found to be basically offsetting. These automatic compensating factors are not present under career-pay plans. It is felt that rather than increasing the allowable excess percentage, which is the result of inflationary assumptions, any erosions would best be handled through periodic updating, and the 1.4% non-inflationary excess percentage should be used.

The recent changes relating to taxation of Social Security benefits and extension of the normal retirement age will probably require a few modifications of the paper's conclusions, but it still seems that a policy aimed at the social goal of a smooth financial transition into retirement would call for some changes in current integration rules. Where does that leave us in terms of anticipating Washington? This paper did find its way to Washington and was apparently well received by various committees and legislators studying retirement income issues. Certain findings in the paper were, in fact, included in the Ehrelenborn Bill HR-4330 and its counterpart in the Senate, which were introduced during 1981, but died in committee. There is some indication that Ehrelenborn may again try to introduce legislation, including integration provisions, but when and to what extent is unclear.

The primary problem when it comes to anticipating Washington on this issue is the conflict between a replacement income retirement policy and the social policy embodied in the progressive income tax system. It might be possible to convince legislators of the appropriateness of the theory behind a benefits provided approach to integration. The strength of the argument tends to wane in the face of statistics relating to the associated tax benefits, particularly when combined with pressures for budgetary constraint.

The conflict between these 2 policy viewpoints was illustrated by the events leading to those integration changes which were included in TEFRA. HR-6410, as introduced by Representative Rangle, contained much more extensive changes to integration rules than those which were ultimately enacted in TEFRA, including a fairly complicated set of rules relating to DBP's. Under the proposed revisions, plans would be required to keep track of accumulated OASDI contributions, credit them with interest to retirement and convert the resulting balances to an allowable offsetting benefit. These proposals were, in effect, approaching integration from an even narrower benefits cost viewpoint than do the current rules. The primary impetus of Mr. Rangle's course of reform apparently was his perception that current integration requirements were allowing for excessive integration, as evidenced by reports that only a modest slice of the tax-supported pension pie was benefiting rank-and-file employees.

One of the results of the hearings held prior to TEFRA was that Mr. Rangle and many other legislators who were disturbed by the current situation, received an education in the basic principles underlying integration with Social Security. However, their acceptance of the theory was somewhat reluctant and was not complete enough to prevent the narrowed benefits cost viewpoint from being adopted as the integration standard for DCP's. Mr. Rangle's proposed revisions to DBP integration rules were not adopted. This perhaps was more due to the fact that they would have required major revisions in almost all such plans, and to a feeling that such major changes should not be made prior to the passage of legislation relating to Social Security, than to an acceptance of the appropriateness of the existing rules.

Congress did, of course, indirectly change the integration rules for DBP's through the top-heavy rules requiring minimum non-integrated benefits for certain plans. In effect, the message seemed to be that integration may be okay in theory, but if it leads to this arbitrarily determined point where less than 40% of those tax-supported benefits are payable to rank-and-file employees, it is not okay any more. So now you have the situation where two employers, one large and one small, could have the same carefully thought out retirement income policies, and because of the size of the group covered, one has to spend more money to provide benefits in excess of the objective to lower income employees and divert resources to termination benefits due to faster vesting requirements. It is an illogical result. It is because the rules came about as a result of tax policy, rather than due to any kind of retirement income policy. If minimum benefits and fast vesting schedules are desirable, as indeed was suggested by the 1981 recommendations to the President's Commission on Pension Policy, then they should be applied across-the-board, without regard to the size of the plan sponsor or the portion of benefits going to employees.

It is the lack of any national policy that makes it so difficult to anticipate Washington with respect to integration. You might think that with the increase in the normal retirement age under Social Security that the requirements of 71-446 would be reviewed, but that does not necessarily have to be the case. I thought the same thing about the 1977 Amendments, which really had a much more extensive impact on the basic structure of Social Security. A clarification here and there, such as the age 65 PIA's for those born after 1937, should be the reduced early retirement benefit when you are dealing with integration, and we can go merrily on with 71-446 as the standard.

So with no overall national policy to aid in anticipating Washington, how do you design a plan to accommodate future legislative changes? The answer is that you do not, not directly anyway. Instead, you listen to your clients, help them to define their retirement income objectives, and work with them to design a program which most closely fits those objectives, given their cost considerations and the current regulatory environment. Hopefully, future legislative changes will be based upon rational retirement income objectives, and will not require drastic changes in the programs so designed. I admit this may not be the case, but if not, you have to adjust to the changes as they occur. You certainly would not want to design a plan which departed from the desired objective merely to anticipate changes which might never take place. This is not to say, however, that you should not take perceived trends into account when setting the objectives.

One of the most important such trends is the diffusion of the idea of a typical retirement age. We just spent some time reviewing the concept of integration

as centered around an assumed normal retirement age of 65, then noted that the standards may or may not be changed due to the increase in the normal retirement age under Social Security. But regardless of what happens to integration rules, the fact is that with respect to plan design, the definition of a normal retirement age is becoming more and more subjective. What we previously saw as a trend toward earlier retirement, is now being countered by ADEA and Social Security. We could end up with a situation where actual retirements are fairly uniformly spread over a 20 year range from the mid-50's to mid-70's. This could make it more difficult to support a plan design specifically targeted to provide a certain percentage of replacement income at the single age of 65.

What I am saying is that maybe we should be encouraging our clients to review their basic policy with respect to the delivery of retirement benefits. Since the retirement age trends and questions as to the long-term health of Social Security make it increasingly difficult to approach design from a finely-tuned income needs viewpoint, employers might wish to shift their emphasis back to cost-control. DBP's with non-integrated or indirectly integrated formulas, and greater emphasis on DCP's are options which can be, and are being, seriously considered.

Having mentioned the subject of finely-tuned benefits, I would like to make a somewhat abrupt transition here to the topic of offset tables. The program presents the question: "Is the use of offset tables desirable and permissible?" The answer to the desirable part is a qualified "yes". Although one of the main purposes of the use of offset formulas is the ability to directly reflect the level of actual Social Security benefits, arguments can be made supporting the use of tables reflecting benefits based on an average employee at each income level. It might be said that the employer desires to treat similarly compensated employees on an equal basis, and that substantial differences in total retirement income due to many years of non-covered earnings under Social Security is the fault of a coverage gap under the SSS. Another point is that no distinction is made under step-rate plans between employees with many years of coverage under Social Security and those without. You could probably achieve the same results with a step-rate formula as you get with an offset plan using offset tables.

Finally, it should be noted that a requirement that actual earnings be obtained, could create a huge burden on the SSA. I worked with one large client using actual earnings for offset calculations which had a keypunch card agreement with Social Security in order to obtain the required information. The system was supposed to result in 3 week turnaround, but delays of up to 6 months were not uncommon. They are now looking into a computer tape request system, which they could obtain up to 4,000 histories at a time. This, again, is supposed to involve fast turnaround, but you never know. And what about the small employer where volume does not warrant these types of special agreements?

All in all, there may be good reasons for an employer to use estimation techniques in determining plan offsets. So what about the issue of their use being permissible? Here the answer might be "no". I understand that the IRS is letting it be known that it feels employees should be given the option of obtaining actual earnings histories and having their benefits recalculated. If this position becomes formalized, sponsors will be forced to either switch totally to the use of actual earnings, or amend their plans to non-offset formulas, because the prospect of counseling employees as to the option raises questions

concerning the employer's responsibility to provide personalized information to the participants.

With respect to new developments, the only one I can think of, and it takes a while to realize it is a new development, is that the provision in the Social Security bill subjecting 401(k) deferrals to FICA taxes has eliminated one problem with respect to integration. The potential problem had previously arisen if you were defining plan compenstion under an integrated plan as including deferrals under salary reduction arrangements. If, for example, you were dealing with an excess or step-rate plan with lower or no benefits on compensation below the Social Security wage base, you would be creating a discriminatory situation with respect to the 401(k) deferrals unless you provided for the increased benefit percentage to apply to such earnings. This resulted in some plans being drafted in just that manner producing some pretty clumsy plan design, and, particularly in the case of excess plans, increased administrative burdens. The problem has been eliminated.

MR. BARNES: I suppose that somehow paying more taxes is good news, but then I guess the design of integrated plans is good news. Our final panelist is Mr. Craig A. Olney.

MR. CRAIG A. OLNEY: There was a statement some time ago that the feeling of ecstasy was being shot at and missed. Revenue Ruling 71-446 has been shot at for about 10 years but it is still working and it still seems to be with us.

To go through the questions that were posed to this panel, designing retirement plans to coordinate with Social Security -- as you have heard the other panelists say, "do it".

The tabular approach to calculate the Social Security benefits -- its use is almost a necessity. We have found that very few people out there can actually calculate those Social Security benefits, even given the actual wages or the wage history.

New developments -- as far as pension plans and Social Security are concerned, we are getting them almost daily. However, Revenue Ruling 71-446 has been out for 10 years and it has not changed yet.

Anticipating Washington -- I do not suggest it. You cannot anticipate Washington. They will change as soon as you try.

Designing a retirement plan, we get together with the sponsor and, before we talk about anything else, we simply sit down and say "what is your objective for designing this retirement plan? What are you trying to do?" Some sponsors have said "capital accumulations" and we then talk about 401(k) and profit sharing plans. From an actuarial recurring service point-of-view, we hope that they say retirement income. Once they decide on the retirement income we have to decide what kind of benefit to provide. If we are looking at a shop plan, it is rather easy. You take a look at all the places where the employees can receive their retirement income and you then design a plan that provides a level dollar amount times years of service.

If you are talking about a corporate plan, then, to quote the Wizard of Oz, you have a horse of a different color. You have employees earning $10,000 per year and employees earning $100,000 per month. You are trying to design

one benefit formula that would provide a realistic pension for both these employees. This leads us into the retirement income replacement theory. Looking at that $10,000 employee, the tax impact of the Social Security taxes at 5%-6%, is heavy, the food bill is heavy compared to the entire income and the disposable income is slight. After retirement, these employees need almost full replacement of their pre-retirement income. Middle-income employees have a little bit of disposable income and need plans that provide total income a little less than the income before retirement. High-income employees, the fellow who is making the decision to set up the retirement plan, have a lot more disposable income and much more room to maneuver and more plans. We then decide what the total income objectives are. Maybe 80% of pre-retirement pay lower income, recognizing there are some tax savings after retirement to maybe 50% of pre-retirement pay for a high-paid employee. I would just like to set up a plan like that. 80% for low, 50% for high. Very non-discriminatory.

However, Social Security provides a part of the income after retirement. We have a study where Social Security provided an employee earning $6,000 per year income equal to about 70% of pre-retirement pay. This comes pretty close to that 80% that we were talking about. For the middle-income employee, Social Security provides about 27% of pre-retirement pay. For the high-income employee, Social Security provides about 9% of pre-retirement pay. Of course, that 9% drops as income increases.

So what now? We integrate our pension plan with Social Security. We have heard that perfect integration would be 80% of pay less 100% of Social Security. Mr. Fixmer came up with one system where you can have that 100% integration. However, most of the plans I work with use a standard integration formula: x% of pay times service, minus y% of Social Security.

Low paid employees get very little out of this private pension system as they receive most of their income from Social Security. In a 50-less-50 pension plan, a low-income employee, at about $12,000 to $15,000 (some say $15,000 is low), receives a total retirement income of 73%, which would incorporate $200 per month from the pension plan and about $500-$600 from Social Security. Our middle-income employee receives 52%, with a $600 per month from the private pension plan. Our high-income employee would receive 43%, with $2,500 per month coming from the private pension plan. As you can imagine, most corporate plans are integrated, and of these plans, most are integrated on the offset basis.

A disadvantage to the offset method is calculating the benefit. When the Social Security Act of 1977 first came out, I gave a seminar to an audience about twice this size. I was standing up there with overheads, telling the audience how to calculate Social Security benefits. After about 1/2 hour, their eyes glazed over. After about an hour, they fell asleep. After about 1-1/2 hours, they walked out. It is hard to calculate that Social Security benefit. I am a mathematician and I am supposed to know how to do things like that, and I used to be able to. Now, I just give it to the computer.

The alternative is something called the tabular approach. At Hansen we produce a matrix table twice a year. It has salary ranges across the top and years of birth going down the side. In the matrix is the Social Security benefit. When somebody comes up for a benefit, we use this table to look up their plan Social Security. With the changes in the Social Security law, you

have to be careful that too much weight is not given to earlier. With a client of mine in the hospital business, the national average wage did not recognize that younger employees seem to receive higher wage increases than older employees. This has nothing to do with their age, but rather the promotion and the training that goes on. So to produce our table we use 10 or 15 employees from the plan to get a wage history and then use that wage history to calculate the benefit in our Social Security table.

Automatic adjustment is one of the advantages to the offset plan. It automatically adjusted for the 1972 law and it automatically adjusted for the 1977 law, and we found that it automatically adjusted for the 1982-1983 law. As Mr. Fixmer mentioned, somebody born in 1938 and later, now has a different expected benefit at age 65 than before. To calculate a deferred vested benefit, for somebody born in, say 1940, the PIA is calculated as the expected benefit to be received at age 65. With the new law, what he is going to receive at 65 is not the full PIA, because he cannot receive that until he is 66 or 67, depending on his year of birth. The Social Security benefit at age 65 is an early retirement benefit, reduced by a reduction factor.

How do we calculate a deferred vested benefit? Do we calculate the expected earnings up to 65 and then use the full PIA at 65 for the benefit? Do we predict earnings up to, say, 67 and then use the benefit at 67 for the offset? At Hansen, after having had a week to think about it, we are using a conservative approach and using the benefit at age 65, reduced by the reduction factors. As a result, for anyone born in 1938 and later, we are using a smaller offset in May than we were using in March.

We had to look at the impact of this decision on both benefits and valuations. For example, looking at an employee who is age 25 on 1/1/83, the expected retirement age under Social Security is 67. Under the plan the normal retirement age mandated by ERISA is age 65. The impact on his benefit, if he is earning $15,000, is that his plan benefit would be 7% higher on a projected basis. If he is earning $20,000, about 6% higher; $30,000, about 3-1/2% higher; at $50,000 and above, the offset is not that important. Now this is a benefit which is highly leveraged. Remember, I was talking about that $200 benefit, even though Social Security might be much larger than that.

Somebody who is now 40, born in 1943 has an expected Social Security retirement age of 66. If he is now earning $15,000, the benefit paid out of the plan would be about 5% higher. If he is earning $30,000, it would be about 3% higher; and if he is earning $50,000, once again, about 2% higher.

We then did a valuation on a case that we happened to have in-house. We used something called average assumptions: 7% interest, a 6% salary scale, 5% wage base escalation, 3-1/2% COL and CPI. The group that we happened to pick had an average age of 37.4, credited service of 7.4 years, and an average salary of $20,000. If this plan did not have any assets, the change in the law would cause an annual cost increase (under the entry-age cost basis, with a 30-year amortization of the past service) of only about 1%. Under a well-funded plan (the past service completely funded), the cost increase would be 3%. Since we think we can use the Social Security laws in effect 1/1/83 for calendar year plans, we do have a year to think about the impact of this change.

In 1974 ERISA came out and was effective in 1976 for most plans. It had a definite impact on the retirement age, the benefits, etc. Nothing happened to our integration rules.

In 1977 there was a major change in the Social Security law and a major change in the wage bases. Once again, nothing happened to 71-446.

In 1978, President Carter came forth with a proposal requiring that benefits from pension plans in an offset plan (x% of pay minus y% of Social Security) x must equal or exceed y. That proposal did not go very far.

In 1981 came the same proposals, and they were still aimed at the benefits.

In 1981, Ehrlenborn put forth a proposed law. Once again, it did not go anywhere, but once again, it looked at the benefits.

At this point, if we are anticipating Washington, we would say they would aim at the benefits. They would maybe go along with Carter, a 50-less-50 with some minimum benefit for the lower paid employees.

In 1982, they do a U-turn. Mr. Rangle introduces with his bill aimed at tax integration, not benefits. The proposed defined benefit rules under the Rangle Bill were that you would accumulate the employer-paid Social Security taxes to age 65, convert them to a benefit and use that as an offset to the plan benefit. It was related to the taxes, the money going in, and not the benefits being provided. What happens under this approach is that you do not recognize the income distribution that takes place in Social Security, e.g., lower paid employees receive more Social Security benefits for their taxes than the higher paid employees do. For the super-high paid individual, this approach would work out okay because the taxes would form a little portion of his final average pay. For the low-paid employee this approach works out to his advantage as he receives both the Social Security subsidized benefit and the pension benefit. Once again, it is the middle-income employee that gets hurt.

Fortunately, there were several arguments against this approach. It did not recognize the income redistribution of Social Security. It was complicated. It was costly. It was hard to understand, and it did not pass. I hope the reason that it did not pass was not because of the complication of it; I hope it was because of the different tack it was taking on integration. It was integrating on a cost basis rather than on a benefit basis.

What will Washington do? I do not know. What do I want? I want some direction as to retirement age. ERISA limits me to age 65, 71-446 apparently limits me to age 65 and Social Security was age 67. I would like some coordination.

As for changes in integration, 71-446 has been working pretty well. I am not too sure I would want any changes, except possibly to make the step-rate excess plans a viable alternative once again.

MR. BARNES: My fellow panelists here have indicated that they do not want to anticipate Washington. Well, I think it is fun, and I think I will try.

There have been a number of proposals to change integration, but there does seems to be some thought being given to an overall consistent policy.

The President's Commission supported integration. Quoting the Commission: (1) A mechanism to coordinate Social Security and employee pensions is an essential part of retirement income policy...needed to ensure the equitable, adequate and efficient delivery of retirement benefits. (2) Integration rules may discourage fulfillment of retirement income goals, particularly for low wage earners. (3) Complexity of rules makes them difficult for both employees and employers to understand.

To what extent will Congress and the IRS reflect the conclusions of the Commission in regulating integration? No one knows, but surely the Commission will not be ignored entirely.

If Washington is concerned about the apparent inequities in private plans where a supposed tax subsidy provides for high pensions, they can directly limit the maximum benefits under qualified plans, which was done in 1974 and 1982. Similarly, if there are concerns about vesting employees in high turnover industries, Washington can change the vesting rules. The integration regulations are not a necessary vehicle to accomplish those goals.

There have been studies demonstrating that the degree of integration permitted may be too low in certain instances. Perhaps these studies will influence future regulations.

The financing problems with Social Security have been drawn to the attention of Congress. Reliance on private plans is likely to continue to be a necessary part of any national retirement goals and discouragement of private plans by Washington seems unlikely.

One way we can anticipate Washington is to consider statements of our legislators. For example, Senator Dole stated that the "goal of tax incentives" is to help assure an "adequate retirement income for as many people as possible" and that an "additional goal is to finance productive investments". Senator Dole asked the Congressional Budget Office certain questions, including the following: (1) Who benefits from current tax incentives?...by income level. (2) What is the relationship of retirement tax incentives to the SSS? (3) Whether restricting the incentives for company-based plans to encourage broader availability of retirement income for lower paid workers can be accomplished without jeopardizing the establishment of plans.

The responses of the CBO may influence the future of private plans, including integration. One can guess at the CBO answers and what action Senator Dole will take. Attempting to do that, I would guess that there would be some pressure to reduce the degree of integration, but not substantial.

Some of the points raised by the CBO in a statement: "Public Policy Toward Private Pensions" and alternative policy directions will also give us some idea. (1) Greater reliance on IRA's and Keoghs. (2) Regulate pensions more extensively. (3) Expand Social Security and curtail support for pensions and IRA's. (4) Lower maximum contributions.

Some of those policy directions, if valid, could lead to lower integration levels. Other possibilities and points raised by the CBO in the same statement could

be encouraging: (1) Greater regulation of private plans may have a low pay-off. (The number of plans will decrease if compliance costs are increased.) (2) Social Security is a cumbersome and expensive way to provide benefits as high as are now provided by the combined system.

I believe that integration will be with us for the long-range foreseeable future, perhaps with some U-turns, and that the extent of integration permissible will be at least as great as at present, perhaps more so. I believe that any major changes will include steps towards simplification of Revenue Ruling 71-446.

In connection with the Social Security changes, the benefits of terminating employees may be affected now, so we do not have 20 years to wait.

If anyone has any questions of any of the points raised by the panelists. Who would like to take questions first?

MR. MILLMAN: When you made that study of the cost of reflecting the new Social Security, would you use a 15-year amortization?

MR. OLNEY: Yes. We have had several discussions with the IRS concerning the amortization period for changes in the Social Security law. Not COLA changes, but actual amendments to the Social Security law. They came down pretty hard and fast — 15 years.

MR. MILLMAN: I think that is kind of low. Isn't that a risk?

MR. OLNEY: Yes.

MR. BARNES: One point on the cost of the change. The cost may be a valid number, but if paying Social Security at age 67 affects the average retirement age, maybe that cost is not realistic. Do you concur?

MR. OLNEY: Correct. We presumed retirement at age 65.

MR. PETER CAMPBELL: One of the speakers this morning said that assuming distinction in the law would almost allow people to continue to use the calculations at 65 without reduction for early retirement if the document reads something about PIA instead of Social Security benefits. Do most people here agree with that?

MR. FIXMER: As I said, we are taking a conservative approach right now because we really are not sure what is going on. Reading 71-446, it says the benefit paid at age 65, it does not say the PIA. The plan, if it says the PIA, I am not sure.

MS. CONGER: Well, if you are not fully integrated, you do not have to worry about what 71-446 says necessarily. You might be able to use the higher benefit.

MR. OLNEY: If you do have some room with the integration of the plan you can. Unfortunately, many of my plans have retirement supplements, disability benefits, survivor's benefits, etc. I am fully integrated.

MR. BARNES: I think a key point is what the plans themselves say. Whether Social Security benefit is payable at 65 or PIA. It is a good subject for a workshop.

MR. DAVE LIPKIN: Just a very minor clarification. You felt that Hansen thinks that 1/1/83 valuations should be determined on the old Social Security law. Does that apply to the rest of the 1983 valuations?

MR. OLNEY: I was talking about the calendar year valuations that we are doing. I am extremely concerned about my fiscal year plans commencing May 1st. Fortunately I do not have any of them. In fact, none of them starting May 1st.

MR. LIPKIN: So you do not have any guides on that we could use.

MR. OLNEY: No. We have had only a week to think about it.

MR. BARNES: One further point on the change in the Social Security law. This does have an immediate impact on terminated vested employees who are leaving now. Maybe we cannot wait for 20 years to decide what to do.

MR. OLNEY: As I mentioned, a lot of our clients are using the tabular approach and we have a letter going out to these clients telling them how to adjust it. We are, once again, taking a conservative approach, giving them too much benefit rather than too little benefit. There is an adjustment applying to early retirement reduction for those people born in 1938 and later to the PIA shown in the table.

TABLE 1

Determining Primary Social Security Benefits

	For Employee Retiring at Age 65 in 1983		For Employee Retiring at Age 65 in 2018**	
	Average Indexed Wage	Replacement (Percent of $35,700)	Average Indexed Wage	Replacement (Percent of $35,700)
To First Bend Point	$ 0-$ 2,328	122.9%*	$ 0-$ 3,048	90.0%
To Second Bend Point	$ 2,328-$14,052	43.7%*	$ 3,048-$18,336	32.0%
Thereafter	$14,052-$16,644	20.5%*	$18,336-$35,700	15.0%
	$16,644-$35,700	0.0%		
All Wages	$ 0-$35,700	23.8%	$ 0-$35,700	28.7%

*Includes adjustments for three cost-of-living increases, compounding to 36.5%.

**Assumes no further indexing beyond indexing recognized in 1983(indexed to 1981)