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# PENSION PLAN DESIGN FOR SMALL ORGANIZATIONS

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- o Maximum contribution and benefit limitations
- o Coping with top-heavy rules
- o Comparability under Revenue Ruling 81-202
- o Design techniques to maximize tax deferrals

MR. PHILIP S. HILL: No one can be efficient in small plan design without an understanding of the actuarial mechanisms and dynamics of these plans. On the other hand, any actuary who wants to be proficient in the small plan field must be aware of the legal ramifications and the underlying risks when dealing with tax qualified plans. The Internal Revenue Code (IRC) is understandably critical in the design of these plans. I want to cover basically three areas:

1. Parity is the elimination of the distinction between corporate and Keogh Plans as required by TEFRA. TEFRA, enacted in 1982, had effective dates for the elimination of these distinctions beginning in 1984. This is important for small organizations because many of them are in unincorporated form or have elected Subchapter S status if they are incorporated. Traditionally, the rules of self-employed individuals had applied to Subchapter S corporations.

2. Comparability is important for small organizations because the owners of the business have different economic interests as compared to the rank and file employees in large corporations. Owners are primarily interested in the tax shelter aspects of pension plans and the ability to accumulate wealth through qualified plans.

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3. Top-heavy rules apply to a plan or group of plans in which more than 60 percent of the benefits, the present value of accrued benefits, or account balances are allocable to the so-called key employee groups. That is important for small organizations. If we've done our work properly, we'll probably wind up in a top-heavy situation.

Parity and comparability are opportunities and top-heaviness is something we have to grapple with in our plan design.

## PARITY PROVISIONS

### Eligibility

We're now free to select from a number of eligibility provisions including the three year waiting period rule or the one year and age twenty-one rule. Prior to parity, we included the more than 10 percent owners as owner-employees. We had to cover all employees who had at least three years of service. Now we can design plans which could exclude a particular employee or a group of employees so long as we satisfy the general nondiscrimination or 70-80 percent test under IRC 410.

### Trusteeship

Prior to parity, we had to have an institutional trustee, either a bank or insurance company, if we had a more than 10 percent owner in the plan. Now we're free to have the self-employed individual or the owner of the business act as trustee of his own plan.

A legal doctrine called the Doctrine of Merger applies to trusts. That state law doctrine may apply if the trustee is also the sole beneficiary of the trust. If we have one trustee and one beneficiary to the trust, there may be a merger of the interest, and therefore the trust would not be recognized under state law. The IRS, in a 1976 news release, indicated that this would not disqualify the plan.

The Doctrine of Merger may be an issue for creditor's rights or in certain matrimonial actions where the plantiff may try to pierce the trust by claiming there is no trust recognized under state law. The new REACT provisions require, in the case of a married participant, preretirement death benefits for the spouse and may preclude the application of the Doctrine Merger. This is something that you may want to raise with your client's legal counsel.

### Vesting

Prior to parity, we had to have 100 percent vesting for anyone who was a plan participant. If there is an owner-employee in the plan and the plan is top-heavy, we're limited to either three-year cliff or 2-20 percent vesting.

It seems that the old self-employed rule which said that you could not allocate forfeitures to a self-employed individual no longer applies. I've reached this conclusion by reading the Regulation under Section 401 which contained that rule. The rationale for the rule was that it was imposed in light of the 15 percent - 15,000 dollar limitation. I think we're just required to comply with the general 415 rules, and we ought to be able to allow for forfeitures to self-employed individuals. If you want to test whether that is the case, I would simply flag that in the determination letter process since it is a plan qualification letter requirement. The IRS ought to address it in the application for determination. I believe you'd get a favorable determination letter.

Miscellaneous Parity Provisions

Defined contribution limits and defined benefit plan limits are the same whether you're self-employed or a corporate employee. We're now free to integrate on the same basis as for corporate employee plans. With regard to death benefits, the IRC 101(b) income tax exemption now applies for the first five thousand dollars of death benefits for a qualified plan payable to the beneficiary of a self-employed individual.

There is quasiparity in the distribution rules. There is no parity on the lump-sum distribution rules. That is, an individual receiving distribution before age fifty-nine and a half would not qualify for lump-sum distribution treatment on account of separation from service which is still not recognized for self-employed individuals. However, it ought to qualify for rollover treatment. The DEFRA rules amended the rollover provisions of the Code to allow for partial distributions even though partial distributions do not qualify for lump-sum distribution treatment. (A partial distribution which qualifies for rollover treatment must be a distribution of at least 50 percent of the account.) The intent was that this change should apply to self-employed individuals, even though the Code is not clear when read literally.

There is parity in that a penalty excise tax for distributions before age fifty-nine and a half is not imposed. Pre-TEFRA, if you were an owner-employee and you received a distribution before age fifty-nine and a half, there was an absolute penalty through a 10 percent excise tax.

Post-parity, there is an excise tax, but it's only for 5 percent owners whether or not they are self-employed or corporate employees. If you are more than a 5 percent owner as defined in IRC Section 416, and you receive a distribution before age fifty-nine, there is a 10 percent additional income tax. One important aspect of this rule is that there is a way to avoid the 10 percent tax by rolling the distribution into an IRA. Remember the 10 percent tax is additional income tax. There has to be income tax owed on the amount distributed and then a 10 percent tax is tacked on top of that. But a rollover to an IRA ought to circumvent the tax.

Another important aspect of the rule is that it only applies to accumulations before 1984. By referring to the 5 percent owner definition in IRC Section 416 which includes the top-heavy provisions, Congress intended that this rule only apply to account balances attributable to contributions made before 1984. This is not clear from the code, but is made specifically clear through something called the Blue Book.

The official name of the Blue Book is the General Explanation for DEFRA prepared by the Joint Committee on Taxation. This is a very important document prepared by the draftsmen of the statute. The Joint Committee is not a committee under the House or the Senate, but it's a committee of nonpartisan technicians. They actually do the drafting of the law. The Blue Book was issued after the law was enacted. It is the technical draftsman's interpretation of what they meant to say. More and more tax legislation is drafted in rush, late-night sessions and there are mistakes or ambiguities in the law that aren't discovered until later. The Blue Book includes a lot of nitty-gritty technical explanation of the law, what was really intended, and if there were any mistakes made, they indicate that they will be corrected in a technical correction. Generally, about 90 percent of the errors will be corrected in the follow-through.

The Blue Book is free. You can get one copy per request from the Government Printing Office. So if you want to really be up on the law, get a copy of the Blue Book and read it carefully because it contains a lot of important information.

Earned Income

If we're dealing with a self-employed individual before TEFRA and before parity, Keogh contributions were always based on income. Now with the redefinition of earned income under IRC Section 401(c)2, we have to net out deductible contributions to the plan so we have a simultaneous equation that we have to run through. This is important for Section 415 purposes.

The percentage limit for Section 415 in a defined contribution plan is 25 percent of earnings. A self-employed individual, has to net out the amount of contribution being made. That works out to about a 20 percent limitation for Section 415 and about 20 percent of the gross earnings, which is 25 percent of the net earnings. For defined benefit plans, it's less of a problem. Under the regulations we can comply with Section 415(b) by reference to a pre-plan earnings regulation under IRC Section 415(b) which indicates that for purposes of the 100 percent of the high three-year-average compensation test, we can refer to earnings before the plan went into effect, even though if you read the Code literally, it will lead you to a contrary conclusion.

If we have a Keogh plan, we've been putting 15 percent of pay in, that is, 15 percent for self-employed individuals and 15 percent for common-law employees. Now for nondiscrimination, we've got to make an adjustment for self-employed individuals and that 15 percent of pay contribution will be calculated on a net basis. So it's an effective 13.04 percent of pay contribution when you work through the netting.

There is a special rule for 401(k) plans which is referred to in Revenue Ruling 83-89. This ruling says if we have a 401(k) plan and a defined benefit plan, to determine elective contributions, we can use gross compensation. We don't have to net out our elective contributions to test for discrimination under the defined benefit plan.

The new rules on earned income have an impact on deductibility. Fifteen percent of pay contribution becomes a 13.04 percent effective contribution for a self-employed individual. If we have a sole proprietor who is earning one hundred thousand dollars, he could get a fifteen thousand dollar deductible contribution to a profit sharing plan by putting 15 percent of pay in. After TEFRA, he's got to do the netting, and he winds up only being able to put in and deduct a contribution of 13.04 percent of pay. A way around that would be to recast the plan as a money purchase plan, and thereby get out from under the 15 percent limitation for profit sharing plans.

IRC Section 404(a)7 is the combined limitation on deductibility, where the same individual is covered by both a defined benefit and a profit sharing plan. The limitation is 25 percent of compensation. We again have to recalculate the compensation by subtracting out the deductible plan contribution. After parity, we can get some very substantial deductions through defined benefit plans. So we're going to have a higher numerator in our limitation fraction reflecting the increased deductible contribution through the defined benefit plan. That will also shrink our denominator because it is the aggregate compensation of all individuals covered by both plans. If we have an older individual in the defined benefit plan who is overlapping both plans, he will increase our numerator at the same time that he is going to depress our denominator, because we'll have to net out the deductible plan contribution.

There was a raging debate a while back about what Congress meant when it amended Section 404(a) of the Code. In that section of the Code, there was a long-standing limitation that said a self-employed individual could not deduct more than 100 percent of his earnings from self-employment. Now we have to recalculate earned income by netting out the plan contribution, and in effect we're left with a 50 percent limit. For example, if an individual is earning one hundred thousand dollars and puts in a defined benefit plan, his deduction would be limited to fifty thousand dollars because we net out the fifty thousand dollars deductible contribution. Congress indicated that was a mistake. So when they were going to correct it in DEFRA, they made the amendment to the wrong section of the Code (404(a)(8)(D) instead of 404(a)(8)(C)). The Blue Book makes it clear what they really intended to amend. The IRS came out with a news release that they'll administer the law on that basis. Therefore, they will relieve defined benefit plan sponsors from this netting solely for purposes of determining the special limitation on deductibility.

## Combined Plan Limit

Under Section 415, we hope to take advantage of both defined benefit and defined contribution plans. We've got a pair of fractions we have to calculate. On the defined contribution fraction, if we have been unfairly discriminated against in the past because of this special rule for self-employed individuals, we will find that we have a relatively low-defined contribution fraction, except in those rare instances where we've had voluntary contributions above the 6 percent threshold. That will leave additional room in a defined benefit plan to make up for lost time.

The selection of which plan is to be dominant is a topic we could debate for hours. The conventional wisdom is if you are under age forty-five, the defined contribution plan should dominate. If you are over that age, the defined benefit plan ought to dominate. There has been public discussion about a way of front-loading the defined contribution side by keeping track of your annual additions to the defined contribution plan, so when your defined contribution fraction hits .20, you put nothing more into the defined contribution plan. You continue your defined benefit plan on out so that as actuaries look on a funding basis, you can assume that you'll have a full ninety thousand dollar benefit to fund for. Because we have planned this out beforehand our defined contribution fraction will never exceed .20.

So long as we never go above .20 on the defined benefit side, we are free to front-load or make a series of thirty thousand dollar contributions to our defined contribution plan for a period of years until that fraction hits .20. We then make no further contributions to the defined contribution plan and just let the defined benefit plan run up to the ninety thousand dollar limit.

This does not force your clients to decide which plan will be dominant until the defined contribution fraction is .20. So we may have four to eight years, before we go from the restricted Keogh plan to an unrestricted parity defined benefit defined contribution mix.

If we have two plans, we have to be careful of earned income calculations. We have a double netting effect. Deductible contributions to the defined benefit plan will have to be netted out as well as deductible contributions to the defined contribution plan. We first net the defined benefit contribution, recalculate earned income and then apply that to the defined contribution plan. We make a separate calculation to determine the defined contribution plan limitation.

## Absence of Parity

There are several areas in which Congress did not give parity. One is loans for an owner-employee who has more than a 10 percent interest in either the firm capital, the capital of the business or the profits of the business, or where a Subchapter S shareholder has more than 5 percent of the stock. If such an employee borrows from the plan, it's a prohibited transaction.

Deductibility of postretirement funding is not entirely clear in the Code. The Code tells you how to calculate an overhead item if you're working with common-law employees. It's a separate allocation if you're working with a partner or with someone who was formerly a partner.

Clearly the intent must have been to allow for postretirement funding. As a tax matter there are some problems on who claims a deduction and how. The individual can't claim the deduction because he's no longer active in the business. There is a question whether or not the business can claim a deduction because he was never an employee.

Life insurance PS58 costs are just simply nondeductible. The only instance where a self-employed individual would pick up a PS58 cost is if no contribution is made to the plan, and trust earnings were applied toward the life insurance. Where there is a contribution to the plan, the PS58 cost is a nondeductible element of the contribution that flows through to the individual on his K-1 and nondeductible on the IRS Form 1040.

## Comparability

Comparability is a very important area for small plans. It allows us to recognize different employee groups and to treat the owners of the business as separate and distinct from the rank and file. If we are dealing with a professional firm, typical employee groups are the partners, the nonpartner professionals, and the nonprofessional staff.

Typically, the partners want to put away as much as they can afford and are attracted by the tax shelter aspects of the retirement savings features of these plans. Small firms generally want to provide something for the professional nonpartner group because they want to retain them. Larger firms typically view the professional nonpartner group as transient. Because we are relieved from the old rule which required us to cover everyone who'd been with the business for three years, we can design some eligibility requirements that would exclude this group if we wanted to.

With regard to the rank and file nonprofessional employee, we generally want to keep this group and provide some benefits so that they will have some retirement income security. Usually we find 401(k) plans in the mix. A 401(k) plan is attractive and allows for flexibility.

## 401(k) Plans

There have been some late changes in 401(k) plans that some of you may not be aware of. These are the changes made by DEFRA. Under the proposed regulations, we could have two types of 401(k) plans. One plan would operate under the one third/two thirds nondiscrimination rule. The other plan would qualify so long as it satisfied the general nondiscrimination rules. DEFRA makes it clear that the only way a 401(k) plan would qualify is by using the one-third/two-thirds test.

Under the old rules, we could disregard elective contributions so that the key employees had a zero contribution rate. They would just make elective contributions which were not taken into account. Many people saw an opportunity there to get around the top-heavy minimums by simply having the employee pay all 401(k) plans. Everything was made on an elective basis, and therefore, the contribution rate was zero.

DEFRA changed that rule so that now you must account for the elective contributions. So on the one hand, if we've got key employees putting any money in on an elective basis, that is going to key in to the top-heavy minimum requirement. The good news is that we can also use the employee deferrals to satisfy the 3-4 percent minimum.

The other new development under DEFRA is that 401(k) plans must be aggregated, not in the top-heavy sense, but in applying the one third/two thirds test. We have to aggregate in either one of two situations. The first is when we have a 401(k) plan that has to look to another plan to qualify for Section 410 to meet the coverage requirements. If that other plan was not a 401(k) plan, we have a problem because the rule says that the employee who is eligible to participate under the 401(k) arrangement must satisfy 401(k)(3) and must meet the requirements of Section 410(b). If we've got a 401(k) plan that we were trying to prove comparable to a defined benefit plan, a profit sharing plan, or some other non-401(k) plan, we've got a problem. That 401(k) plan will have to meet the requirements of Section 410(b) on its own or in combination with another 401(k) plan.

The second change is when we have two 401(k) plans, and an individual is in both plans. The deferral percentage test, the one third/two thirds test, for that individual will have to account for the elective contributions he makes to both plans.

Top-heavy status with respect to 401(k) plans, is a problem. In defined contribution plans with participant-directed accounts, there is more potential of becoming top-heavy. Key employees are usually the more sophisticated people who are more risk oriented. They will choose the equity investments; the rank and file will invest in passbook savings or money market funds. If there has been a big rise in the market when we test on a determination status, the advantage would be to the key employees. That could push us into top-heavy status, and we'll be stuck for the next five years. If you did not have participant-directed accounts, the ratios would remain fairly uniform.

There is an opportunity in defined benefit plans for shielding or delaying top-heavy or super top-heavy status. We can select among one of three accrual methods for a defined benefit plan under 411(b). If we have our defined benefit plans for our key employee group and some other plan (a profit sharing plan or another type of defined benefit plan) for non-key employees, and we select a 3 percent accrual method for the key employee group, we will be slowing down the present value of the accrued benefits. The present values will be relatively small. So if our primary concern is to avoid super top-heavy status selecting a 3 percent accrual method for our key employees will probably buy some time away from super top-heavy status and we can utilize two plans. We may even buy ourselves out to avoid top-heavy status for a couple of years and keep our costs down.

In the case illustrated in Table 1, a law firm didn't have any pension plans. They had three senior people that they were really interested in easing out. They wanted to open up a savings opportunity for them, so they could put some money aside and feel more comfortable about retiring. We did a 401(k) plan for everybody, but with the option that the three senior partners could each select his own individually designed defined benefit plan. We did a comparability analysis selecting a contribution rate for the rank and file which would serve several purposes.

One purpose was to achieve a deferral percentage for the lower two thirds so that we could have adequate deferrals for the upper one third as much as they wanted. We get some people in the upper one third putting away twenty-eight to thirty thousand dollars, but keeping the average deferral percentage for the upper one third below 7 percent. The average deferral percentage is what counts in the nondiscrimination test. We wrote the plan so that everyone with three years of service was eligible, but the three seniors who each had a defined benefit plan simply made no contribution to the 401(k) plan since that would have violated comparability. Because they were not actually putting money into the 401(k) plan, their deferral percentages were zero which opened up room for others in the upper one third. They got some very nice deductions because, as it turned out, the 4 percent when projected out for the rank and file produced enough comparability that, even with the relatively small benefits given their advanced ages, the seniors could sock away sixty-five to seventy thousand dollars each.

A historical Keogh balance might have been a concern. Suppose this had not been a situation where they didn't have any plans, and that there had been a Keogh plan in place. Then we might have been compelled to put a 4 percent contribution in to meet the 1.25 combined limitation. We may have wanted to expand our denominators for a combined limitation by the multiplier of 1.25. So long as we're not super top-heavy, we have to give an extra point of minimum contribution to do that.

In summary, the three things in designing the 401(k) plan that we were aware of were:

1. The deferral percentages at the bottom for the rank and file so that we could leverage sufficiently for the top.

2. Figure comparability so we can get the deductions that the older people wanted for defined benefit plans.

3. The top-heavy minimums of 3 percent or 4 percent if we want to buy into the 1.25 combined limitation. Of course if we were super top-heavy, then we're stuck at 1.0, and no matter how much we put in for the rank and file, we could not expand the fractions to 1.25.

TABLE 1

SCHEDULE OF ANNUAL CONTRIBUTIONS TO CASH OR DEFERRED ARRANGEMENT (CODA) AND DEFINED BENEFIT PLANS (DB)

| Partner | Present Age | 1984 Est. K-1 | CODA | CODA Actual Defferal % | Individual DBs |
|---|---|---|---|---|---|
| A | 69 | $142,000 | $ 0 | 0% | $ 70,000 |
| B | 65 | 142,000 | 0 | 0 | 65,000 |
| C | 64 | 177,000 | 0 | 0 | 70,000 |
| D | 47 | 205,000 | 30,000 | 15 | 0 |
| E | 47 | 191,000 | 28,650 | 15 | 0 |
| F | 41 | 184,000 | 27,600 | 15 | 0 |
| G | 40 | 142,000 | 5,680 | 4 | 0 |
| *H | 37 | 135,000 | 5,400 | 4 | 0 |
| *I | 41 | 96,000 | 3,840 | 4 | 0 |
| *J | 39 | 90,000 | 3,600 | 4 | 0 |
| | | | $104,770 | | $ 205,000 |
| *Employees (12 participants) | | | $ 15,013 | 4% | $ 0 |

| Summary: | Group | Number | Contribution |
|---|---|---|---|
| | Partners | 10 | $309,770 |
| | Employees | 12 | 15,013 |

*Denotes participation in bottom two-thirds compensation group. The deferral percentage for the group which includes 3 partners and 12 employees is 4 percent. The average for the other 7 partners is 7 percent.

MR. BRIAN J. MATTSON: The general rule under 81-202 is that several plans, considered as a unit, will satisfy the nondiscrimination rules if either benefits or contributions are not a greater percentage of compensation for the prohibited group members than they are for the rank and file. The choice of whether to test on benefits or contributions may be made by the plan sponsor independent of whether the plan being tested is a defined benefit plan or defined contribution plan. Social security benefits or contributions can be taken into account. It also allows for a reasonable grouping of participants by compensation ranges. It gives us quite a bit of flexibility in the tools that we have to design a plan.

If the testing is done on benefits, the benefits can be determined either on a flat benefit basis or on a unit benefit basis. Testing on a contribution basis for a defined contribution plan is relatively straightforward. Contributions used are simply the sum of the contributions and forfeitures allocated to participant accounts. Social security contributions are imputed at the rate of 5.7 percent of compensation up to the social security wage base. Revenue Ruling 81-202 says 7 percent, and it was revised by Revenue Ruling 83-110 to 5.7 percent.

In the case of a defined benefit plan tested on a contribution basis, the contributions to be used are the annual level dollar contributions from the date of initial participation in the plan to the latest of age sixty-five, the current age, or the plan's normal retirement age - essentially, the individual aggregate calculation from the inception of participation. Contributions must be determined using reasonable interest and mortality assumptions.

Testing on benefits is more complicated but offers more potential flexibility in plan design. The benefit to be tested is a single life annuity commencing at age sixty-five with no death benefits or other ancillary benefits. Benefits other than this are adjusted to this form before testing. The benefit to be tested is the employer provided portion of the participant's most valuable projected benefit. The benefits tested may be flat benefits or unit benefits.

If unit benefits are used, they may be obtained by taking the flat benefit and dividing by the years of service the participant would have at the age at which the flat benefit is determined. Service has to be determined on a reasonable basis.

Social security benefits may be imputed on a flat benefit basis by using 37.5 percent of the highest five-year average compensation, again up to the social security wage base. The 37.5 percent has to be reduced proportionally for less than fifteen years of service just as it has to under Revenue Ruling 71-446. Alternatively, 83.33 percent of the expected social security benefit may be used.

For a unit benefit basis, the imputed social security benefit may be divided by the participant's projected years of service. Alternatively, social security benefits may be imputed on a unit benefit basis as 1.4

percent of compensation in any year, again up to the taxable wage base for the calendar year in which the plan year ends. If a defined contribution plan is going to be tested on a benefit basis, a flat benefit is first determined as the amount that can be purchased as a life annuity at age sixty-five. Both the current account balance, in the year in which the test is made, and the projected future employer contributions are accumulated using reasonable mortality and interest assumptions.

This gives us four possibilities for developing plans for different groups of employees remaining within the bounds of nondiscrimination. We can use either defined benefit or defined contribution plans and we can test on either benefits or contributions. In addition, there are some subsets of these things; for example, testing benefits on either a flat benefit basis or unit benefit basis. Some choices also exist for the methods of imputing social security benefits. So we have a lot of flexibility under this Revenue Ruling. It was modified slightly by Revenue Ruling 83-110 in the area of defined contribution plans because of changes in the integration rules made by TEFRA and this includes target plans. The rules for target plans changed some under Revenue Ruling 83-110.

Satisfying the requirements of Revenue Ruling 81-202 does not automatically satisfy the top-heavy rules. They are two independent things. Both sets of rules must be met. However, for minimum benefits in a top-heavy situation you can show that the plans are providing benefits at least equal to the defined benefit minimum.

MR. ARTHUR H. TEPFER: There are many definitions of small plans. They usually relate to the number of participants covered or the amount of assets accumulated in the plan. A workable definition of a small plan is one where the costs from year to year are dependent upon what happens to a selected group of fewer than ten employees.

Small plans require small plan consulting on the choice of actuarial assumptions, actuarial cost methods, and benefit design. The IRS issues commentaries in the form of regulations, rulings, announcements, notices, and whatever else they decide and these must be viewed as interpretive in nature. Regulations have taken on the characteristics of the law and in most instances have the same force of law as the Code itself.

The original discussion of the accrued benefit cost method, also known as the unit credit cost method goes back to a Bureau Bulletin on Section 23(p)(1)(A) and (B) of the 1939 Internal Revenue code as issued by the Bureau of Internal Revenue on June 1, 1945. This Bulletin indicates that the unit credit method is "strictly applicable only where the benefits for each employee can be expressed as the total of a series of specific unit benefit credits for his compensation during specific periods of his service so that the costs may be allocated to specific periods of service of individual employees." A more recent interpretation of the operation of this method can be gleaned from a description contained in Rev. Proc. 81-29 Sections 4.02 and 4.03 which indicate what forms of benefit stucture lend themselves to using the accrued benefit cost method. Under this Revenue Proclamation a useful tool for plan design is available for the small plan.

A certain mindset exists that small plans must be based on pay yet for many highly compensated individuals, the plan formula generally becomes inoperable due to the limitations on annual benefits contained in Section 415. For example, a 100 percent of high three-year pay benefit payable at age fifty-five for an employee whose three-year average is two hundred thousand dollars is limited by Section 415 to seventy five thousand dollars. The formula, therefore, is inoperable; this design is commonplace in the small plan marketplace. If we consider for this employee providing an accrued benefit of seventy five hundred dollars per year for years one through ten, we now have a flat dollar plan which achieves the same result. For those of you who cannot break their mindset, we can express this as a plan which accrues a benefit of 3.75 percent of high three-year pay for the first ten years and nothing thereafter. The point is that we are keyed to the seventy-five thousand dollar pension. Once we have established the formula which fits within the parameters of Rev. Proc. 81-29, we can comfortably use the unit credit method for costing with presumably higher contribution figures than under most other methods.

As a by-product of using the unit credit method, some relief is granted in the calculation of the full funding limitation because the accrued benefit cost method directly produces an unfunded liability, and there is no need to default to the entry age normal cost method for full funding limitation calculations. With a bit of creativity in matching current assets to accrued liabilities calculated under the accrued benefit cost method, it is possible to achieve contributions in plans where the entry age normal cost for full funding limitation indicates that no contribution is available.

One must be careful to assure the minimum accrual rules are met in accordance with Section 411 and that the IRS views benefit accruals faster over a ten year period to be excessive. Personally, I am not in agreement with the IRS position concerning accelerated accruals and find that they seem to straddle both sides of the fence on this issue. In Letter Ruling 8444001 the Service required an allocation based upon an interpretation of Code Section 415 which implicitly limited the amount of accrual to a period of ten years as well and Letter Ruling 8349063 permitted a full deduction for a plan using individual aggregate over one year. I find it difficult to rationalize both positions on the basis of a choice in funding method.

Let me now address some of the rules contained in Section 415 specifically with regard to the limitations of benefits under a defined benefit plan when an existing defined contribution plan is also maintained by this same employer. This leads us to an analysis of Section 415(e) - perhaps the most complicated. The defined contribution fraction is maintained by the accountant when the corporation adopted its first profit sharing plan and a simple phone call is generally all that is needed to obtain the current value for this fraction.

The calculation of the defined benefit fraction is often neglected. Notice 83-10 indicates in question G-8 that the numerator of the fraction is computed as under prior law. Prior law means before TEFRA, DEFRA and REA. Therefore, one must consult the law and regulations under Section 415 for this determination. Reg. 1.415-7(b) describes how one calculates the defined benefit fraction.

The most crucial elements are contained in subparagraph (3) which indicate using continued service, continued compensation, and most importantly continuation of all other relevant factors used to determine benefits under the defined benefit plan. The presence or absence, as well as the benefit design of an existing defined contribution plan, is a relevant factor for the 415 calculations. As an example, an existing 10 percent money purchase plan may not be assumed to terminate to allow a larger projected annual benefit in a defined benefit plan. Conversely, a frozen or terminated defined contribution plan may not be assumed to ressurrect contributions in the calculation of the defined benefit numerator. The defined benefit fraction, like the defined contribution fraction, is a dynamic fraction which must be calculated each year to assure that the transitional rules which virtually eliminate the defined contribution fraction for super top-heavy plans beginning in 1984 will continue to permit funding of a maximum 415 annual benefit under the defined benefit plan.

We have had some success in interpreting these special transitional rules because of some good forethought in our coordination of plan language regarding restricted accruals in the defined benefit plan prior to the enactment of TEFRA. A thorough review of the plan document is mandated to see the exact operation of the 415(e) requirements as they relate to these transitional rules. Once the defined benefit fraction is established and the projected annual benefit is known, the rules regarding funding will have no effect on these calculations but must instead satisfy the requirements of Sections 412 and 404.

MR. DONALD J. SEGAL: When Mr. Mattson was talking about calculating comparability, he was talking about the modifications required by Revenue Ruling 83-110. We have to remember that not only does that seven-ninths adjustment apply to the contribution imputed on behalf of social security but also to the 37.5 percent and the 1.4 percent rules that are being used. The exception is if you are comparing the defined benefit plans only, the seven-ninths adjustment is not required.

Do you have to do comparability annually? At the Enrolled Actuaries meeting, the IRS response was no, but be prepared to show that at any time it works; meaning yes, you have to do comparability every year.

You're permitted to group. What's a reasonable grouping if you have a group of ten participants, where salaries may be clustered? Is that ten groupings or can you recognize clustering of salaries? They just don't give you any guidance on this one.

Revenue Ruling 85-15 came out earlier this year regarding incidentality of death benefits. The topic in the Revenue Ruling was the question of a retirement plan with an incidental death benefit of one hundred times the projected monthly benefit. The Retirement Equity Act (REACT) required them to add a qualified spouse's benefit, which they wanted to add to the plan on top of the one hundred times death benefit. The IRS said that the plan would fail to satisfy the incidentality rule. The two solutions they offered were to drop the one hundred times death benefit or define it as one hundred times minus the value of the required REACT death benefit. Make sure your death benefits are incidental when you're designing your plans. The IRS has said that all of the death benefits in the plan, including those required by ERISA, must be included in the overall test for incidentality.

There is always the question of how to measure the comparability of a death benefit. You may use factors in 71-446 as amended. Are there any other techniques you can use to measure the comparability for the death benefits?

The IRS audit guidelines present practical questions that we actuaries have to face in terms of the actuarial assumptions we're using for the funding. The IRS is going to be challenging our assumptions. This raises many questions, especially in the realm of what you certify to. They have certain tests that they want to perform. They're saying over five years they expect your actuarial assumptions to be reasonably close to actual experience.