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TAX REFORM ACT -- INTEGRATION AND EFFECT ON DEFINED BENEFITS

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- A discussion of the effect of the Tax Reform Act integration rules on defined benefit plans:
  - Current law versus tax reform
  - Current formulas versus possible new formulas
  - Effect on replacement ratio (from pension)
  - Effect on costs
  - Effect on plan design
  - Discrimination considerations

MR. JAMES M. JACKSON: We have no inside information on the IRS regulations. What you're going to hear are Bob's and Ira's thoughts, what they think is going to happen, and the costs of what they think the IRS will say. We're going to start with Ira who will talk about the changes in the law and what he thinks the effects of the new rules will be. Bob will follow with an analysis that he's done on the costs to various kinds of plans. When this session was first set up, it was hoped that the IRS would have released something; they haven't, so we won't be discussing detailed regulations which haven't been released.

To set the stage, I thought that a little bit of Lewis Carroll's *Alice in Wonderland* might be appropriate: Alice has met the Cheshire Cat sitting in the bough of the tree just a few yards away.

> The cat only grinned when it saw Alice. It looked good natured she thought: still it had very long claws and a great many teeth, so she felt it ought to be treated with respect.

> "Cheshire Puss" she began, rather timidly, she did not know whether it would like the name. However, it only grinned a little wider. "Would you tell me, please, which way I ought to walk from here?"
>
> "That depends a good deal on where you want to get to," said the cat.
>
> "I don't much care where," said Alice.
>
> "Then it doesn't much matter which way you walk," said the cat.
>
> "Well, so long as I get somewhere," Alice added.
>
> "You're sure to do that," said the cat, "if you only walk long enough."
>
> Alice felt that this could not be denied so she tried another question. "What sort of people live out here?"
>
> "In that direction," the cat said, waving his right paw around, "lives the Hatter. And in that direction lives a March Hare. Visit either one you like, they're both mad."
>
> "But I don't want to go among mad people," Alice remarked.
>
> "Well you can't help that," said the cat. "I'm mad, you're mad."
>
> "How do you know I'm mad?" said Alice.
>
> "You must be," said the cat, "or you wouldn't have come here."

MR. IRA I. SIEGLER: As Jim said we don't really know where we are. I'm going to tell you where we think we are. Historically, Social Security has had a formula which skews benefits heavily towards the lower paid employees. Pension plans should therefore be able to skew their own benefits towards the higher paid employees. This is permitted within limits prescribed by IRS regulations.

The last set of regulations which addresses the entire scope of Social Security integration was Revenue Ruling 71-446. As the number indicates, it was issued at the end of 1971. However, it was virtually obsolete the day it was issued because it did not anticipate the indexing of Social Security, which occurred at the beginning of 1972. Through the years it has been modified in many ways, primarily with regard to shortening the averaging period. It's been attached to other revenue rulings, most notably the comparability regulations under Revenue Ruling 81-202. Revenue Ruling 71-446 was the last law which addressed Social Security integration. Now we have a new one -- the Tax Reform Act of 1986 (TRA).

TAX REFORM ACT -- INTEGRATION AND EFFECT ON DEFINED BENEFITS

Under tax reform, integrating with Social Security has become "a limit on the difference." This was done with two objectives in mind. The first was simplification. Final average pay plans and career average pay plans are now treated similarly. There used to be a wide variation between the two. In addition, ancillary benefits are virtually ignored except with regard to early retirement subsidies. Also, there is no longer a need to calculate an actual Social Security benefit.

The second objective was supplementing benefits of lower paid employees. The government felt that Revenue Ruling 71-446 permitted too much differentiation and hurt the lower paid employees. That's what I mean by a "limit on the difference." Tax reform has eliminated all excess-only plans, whether defined contribution or defined benefit. There is a minimum benefit that must be provided for lower paid employees relative to the benefits for the higher paid people.

The overall limit on benefits which eliminates the excess-only plans is the 2:1 ratio. If you provide benefits for higher-paid employees at a certain level, you have to provide benefits for the lower-paid employees at half that level. If you provide benefits under a defined contribution plan of 2% of pay up to some integration level such as the wage base, you can't do more than 4% for your higher-paid people. The 2:1 ratio is the overriding consideration no matter what type of plan you have, no matter what type of integration you have.

In defined contribution plans prior to tax reform, there was a maximum of 5.7% difference between contributions for lower-paid and higher-paid employees, but you could have an excess-only plan. As I've stated, excess-only is gone. The 5.7% referred to under the old law is the Old Age, Survivors and Disability Insurance (OASDI) rate under the Social Security Act. The new limit is grandfathered at 5.7% and will not increase until the old age portion of the Social Security tax rate exceeds 5.7%. The old age portion of the tax is that currently less than 5%, so it will be a few years before the 5.7% differential increases. Defined contribution plans are still permitted to use the Social Security wage base or anything lower as the integration level.

With regard to defined benefit plans I'd like to first look at step-up or excess plans, which integrated at covered compensation. Covered compensation is

defined in Revenue Ruling 71-446 as the average of the maximum taxable wage bases for a certain number of years ending when the employee would have been age 65. That number for someone hitting 65 this year is 28 and will gradually increase until it reaches 35. For those of you who have seen the new law, it appears to redefine this as being a pure 35-year average. This is not so. The commentaries with the treasury indicate that the intent is to use the Revenue Ruling 71-446 definition of covered compensation. So where I use "covered compensation," I am presuming the old law and the new law to be the same.

If a plan integrated at the covered compensation level, there was a 1% differential permitted for each year of service for final average, unit benefit plans. There were decreases in the 1% level for averaging periods shorter than 5 years, for certain death benefits, disability benefits, and early commencement on a subsidized basis. There were increases permitted in the limit if the plan had integrated employee contributions. If you integrated at a level higher than covered compensation, the maximum integration level was reduced proportionately. For example, consider an integration level of Final Average Compensation (FAC), as defined in the new law (final average compensation ignoring anything in excess of the Social Security wage base in the last three years). Final average compensation this year is approximately $41,800. If the integration level is FAC, prorating the 1% down for the difference between the current covered compensation limit of $15,700 and $41,800 produces a differential of .38%. I don't know if anyone is using any integration level higher than covered compensation for final average pay plans but it could be as low as .38%.

The new law permits a .75% differential if you're integrating at covered compensation. The only ancillary benefit adjustment is for early retirement and we will get to that later. There is nothing in the law with regard to death, disability or employee contributions. If the integration level is higher than covered compensation, the Act says that the .75% is reduced in proportion to the replacement ratios under Social Security. Our rough tests indicate that for someone whose compensation at retirement is equal to final average compensation, the replacement ratio under Social Security is approximately 2/3 of what it is for an employee whose compensation is equal to covered compensation. Therefore, a plan integrating at FAC could have a .50% differential. Treasury regulations are supposed to be issued every year, indicating the bracket differentials that are

permitted if you use something in excess of covered compensation, but I've used .50%.

Also, under the new law you are limited in the number of years you can take into account when integrating. The 35-year maximum times the .75% makes a maximum integration level of 26.25%, as compared to the prior maximum of 37.5% spread over as few as 15 years.

Career average pay plans are hardest hit by the new law. Traditionally, career average pay plans have integrated at the Social Security wage base. Under the prior law you were permitted a 1.4% differential if you had a career average pay plan which integrated at any level up to the Social Security wage base; you got no extra credit for integrating at something lower than the wage base. Most plans integrated pretty close to the wage base. Again, as with final average pay plans, there were adjustments for the ancillary benefits and credits for employee contributions; those are gone now. Now, career average pay and final average pay plans are treated the same. In essence, the law contemplates a series of breakpoints under the plan for a career average plan which looks suspiciously like Table 1 in Revenue Ruling 71-446 and will theoretically change every year. If plan sponsors want to implement that, that's one thing. I'm sure that the law would allow, much as it does for final average pay plans, the use of the lowest integration level in that table as being the integration level in the plan, but that would increase the cost dramatically. The integration permitted under career average pay plans as compared to final average pay plans is approximately 1/4 to 1/3. In other words, a final average pay plan can have three to four times as much disparity between the low and high paid employees as a career average plan can have.

For offset plans the old rules permitted up to 5/6 of the primary insurance amount as an offset, with adjustments downward if you had ancillary features and upward if you had integrated employee contributions. There was no distinction as to the rate of accrual -- we've seen plans that say 1.5% of final average pay per year of service offset by 3/4 or 5/6 of Social Security, regardless of service. Obviously, under Code Section 411, the accrual of benefit rules had to take into account people leaving before normal retirement age, but the formula at normal retirement age could throw the entire offset in the first year. Under the new rules the offset is the smaller of two pieces. The first one follows the 2:1

overall rule -- you can't offset more than 50% of the gross benefit. The second one is very similar to the excess step-up approach of 3/4% per year on covered compensation with a 26.25% overall limit. For offset plans, the 3/4% is not necessarily applied to covered compensation. The law applies it to the employee's final average compensation, which is the employee's final three-year average excluding pay in excess of the wage base. To the extent that FAC exceeds the covered compensation limit for the year, the .75% is prorated in the same manner as excess plans. So rather than having the same proration for everyone terminating in the same year, you have different prorations depending upon the employee's level of compensation in the last three years. My guess is that you can't offset more than 50% of the Social Security benefit.

There are several open issues under tax reform and we were hoping, as Jim said, to have some of these open issues resolved by regulations. It hasn't occurred. They're still open -- we have no secret information. The first of the open issues is early retirement. The law calls for reduction if the plan provides unreduced integrated benefits before the Social Security normal retirement age (currently age 65 and increasing for those people born after 1937). Will it be permitted to have unintegrated plan benefits before age 62 and use the Social Security 1/15 reduction per year of service after age 62? Would it be permitted to satisfy the worst case Social Security normal retirement age and automatically qualify at ages under age 62, or will there have to be adjustments on an actuarially equivalent basis below that age? As a small side note, we find it interesting that early retirement is based on Social Security's normal retirement age, but the definition of covered compensation under the new law is age 65 regardless of when an employee is born.

A second issue under the new law is employee contributions. Although there is no specific section in the law which addresses employee contributions, plans which are contributory on an integrated basis have to address it. Will the 2:1 basis be maintained or will you be permitted to have excess-only employee contributions? It's not clear. Will there be an extra differential if integrated? We doubt it. Again there is nothing in the law to allow for it and it would be a bit of a stretch by the IRS. And if there must be some integration level, will a defined benefit plan which has employee contributions be allowed to integrate at the wage base as a defined contribution plan or will it be limited to integrating at the covered compensation limit?

The biggest open issue is the one of transition. When we get to 1989 we have to worry about freezing the 12/31/88 accrued benefit (presuming January 1 plan years). Will that benefit be frozen in dollar amount or will the plan formula and service under the plan formula for service prior to 1/1/89 be frozen and permitted to live on a dynamic basis? That's not been addressed. Will the 35-year maximum under the "3/4% for 35 years limit" be applied to all service or just the post-1988 service? These are issues which are causing us some grief and probably a reason why not a lot of clients have addressed this yet. In this transition situation we always have to worry about the anticutback issues under Code Section 411.

In a brief summary, plans that will need revision are obviously excess-only plans, because of the 2:1 rule, and any offset plan with a fast accrual of offset (defined apparently by the IRS as anything less than 35 years). Also, almost all career average pay plans will require some kind of amendment unless they're integrated to the least possible extent. Many final average pay plans will require amendment for technical reasons but our reaction is that a plan which is 50% minus 50% on a 35-year proration might not need any significant modification unless it's heavily subsidized on early retirement.

That gives you a little bit of a sense of where we think we are. We're standing around waiting for some clarification from the IRS and hoping that our clients don't beat on us before the IRS comes through.

MR. ROBERT J. BARRY: I will touch on a couple of points that I think are also very critical open issues. One is the fact that we're not sure at this point whether the statutorily required offset is going to be a required formula or is simply going to be a maximum offset. That really is not set forth in the law -- most people believe it is going to be a maximum, but we don't know that for sure. That makes a big difference in its impact on the plans that we're talking about. We're not sure how Cost of Living Adjustments (COLAS) will be treated. We presume that they will be treated as an ancillary benefit but we are not sure.

Another point I'd like to make is that the new law does impact on all integrated plans. Specifically, what I've looked at and costed out for you today are a couple of examples of some offset programs and a step-rate program. Based on

some of the calculations we've done for our clients this year, a typical program with a 50% offset is experiencing about a 7% or 8% increase in cost. Now that's a terrible generalization because the effects of the new integration rules vary significantly by age, compensation level, service level, early retirement provisions, etc. There are significant variations in the maximum offsets allowed, prospectively depending upon the demographics of the group involved.

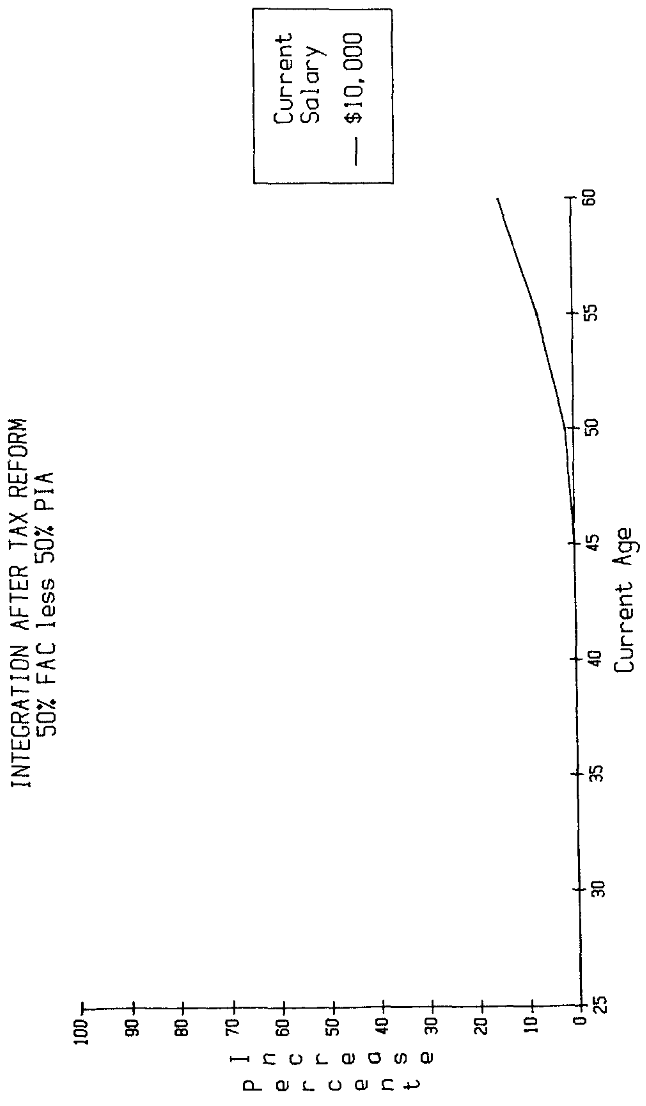
Now, with the passage of TRA 1986, for the first time we've come up with legislation or regulations that treat offsets as being related to compensation rather than to the Social Security benefit. That's a big switch and a big difference.

Let's look at offset plans first. The maximum offset under the old law is 83.33% with reductions for ancillary benefits, early retirement, etc. Under the new law, as Ira says, it is the lesser of 3/4% of final average compensation up to 35 years or 50% of the gross benefit. The new law will increase benefits for the lower paid people. More importantly, it guarantees that every participant in the plan who remains to a vested status will receive some benefit. Tax reform has clearly set forth the intent to guarantee a benefit for everyone who participates in a plan.

Let's look at offset plans under an early retirement situation. Before tax reform we had a maximum offset of 83.33% at the Social Security normal retirement age. Early retirement reduction was not required if we had benefits commencing at age 65. So therefore, the adjusted offset is at 83.33%. The maximum offset permitted at age 60 was 55.6% and at age 55, 41.7%, for an employee born before 1938. Where the Social Security normal retirement age is 67, we have an 86.67% early retirement reduction factor to apply at age 65, so we're down to 72.2%. The maximum offset at age 60 is 50% and at age 55 is 37.5%.

Now let's look at some specific examples. At a $10,000 salary level, pre-TRA benefits projected to age 65 for someone currently age 25 would be $30,174. The post-Tax Reform benefit at age 65, is the same. (See Graph 1.) At age 40, $9,000, again there is no change. At age 55 however, we see an increase of 7%. This highlights that the Tax Reform Act change has the most impact on early retirement benefits and early retirement offsets. At a $50,000 salary level we see no change at all.

GRAPH 1



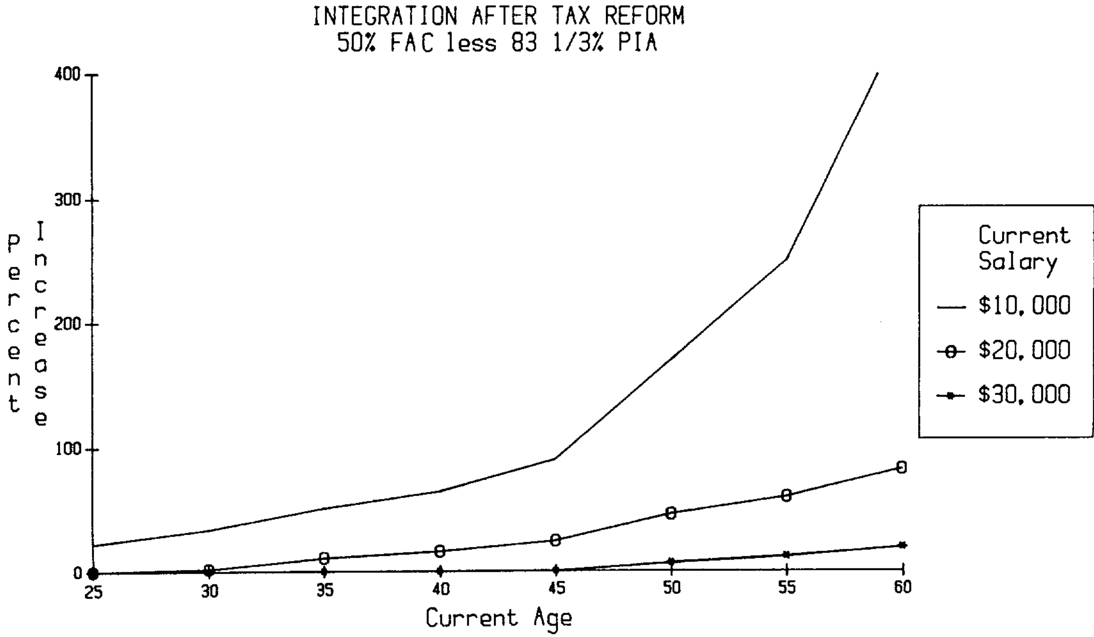
Now let's look at a 50% FAC less 83.33% primary insurance amount (PIA). (See Graph 2.) There are not too many of these around, but there are some. Graph 2 shows how Tax Reform's impact depends upon your current offset percentage. Here at age 25 we have a 22% increase, and at age 55 we have a 251% increase at the same $10,000 salary level. Between 50% and 83.33%, where a lot of plans fall, the marginal impact can be substantial. The age of a group has a significant impact on costs as well. The salary level is equally important (at a $50,000 salary there is no change). This is why I say it is very difficult to generalize about the cost effect that Tax Reform is going to have.

For early retirement in career average step-rate plans, we were allowed 1.4% maximum spread (.93% at age 60, and .70% at age 55). After Tax Reform, not only do we have a switch from 1.4% to .75% but there is a further reduction because of the change in Social Security normal retirement age. This reduces the maximum spread at age 65 from .75% down to .65%. The maximum spread at age 60 is only .45% and at age 55 only .34%. That's a big difference from what we had before -- the amount of integration that you are allowed in a step-rate plan in the case of early retirement has been virtually cut in half.

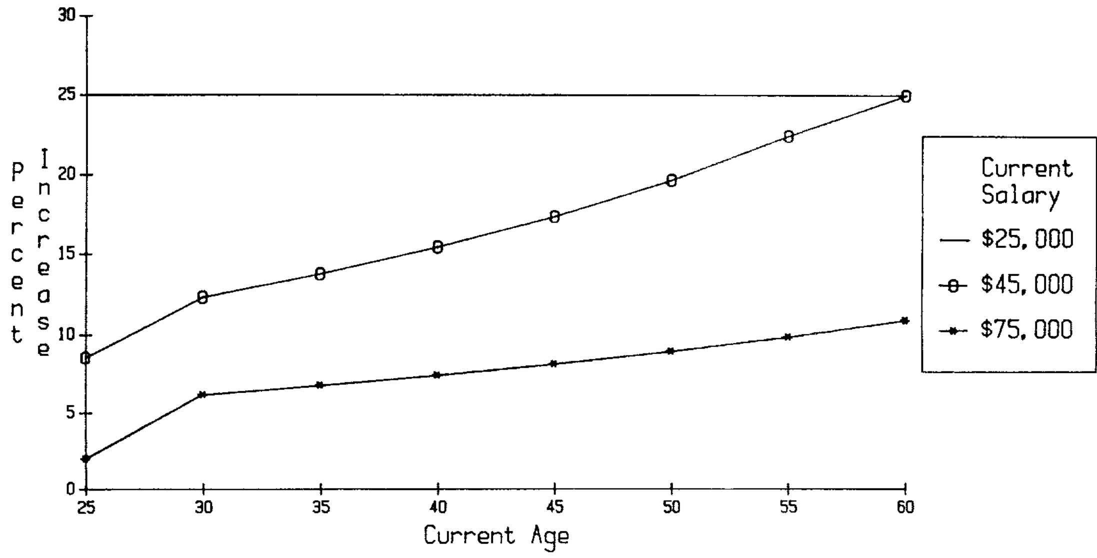
In final average excess benefit plans, pre-TRA we could have a formula of 1% of final average up to the wage base and 2% in excess of the wage base. Now under TRA, in order to meet the test, we have 1.32% up to the base and 2% in excess. (See Graph 3.) I'm presuming here that you want to leave the top 2% alone. Graph 3 shows the percentage increase in benefits and consequently, cost. At $25,000 of salary there is a level 25% increase in cost here. At $45,000 (center line) the cost increase depends heavily upon age, starting out at about 8% and growing up to 25%. Similarly, at the highest salary level you will see a cost increase, but not as severe. Graph 4 shows the cost decrease if you leave the formula alone at the bottom end and reduce the top end benefits substantially.

When we ran some of our clients through the valuation this year, we found that the effect on cost also depended heavily upon the assumptions used. In costing these new rules, I suggest that you vary both the demographic and economic assumptions because they each have such a substantial impact and are leveraged significantly. The plans that we've run have shown increases in cost from a low of 0% to a high of 300%. The 300% increase occurred in a population with a lot

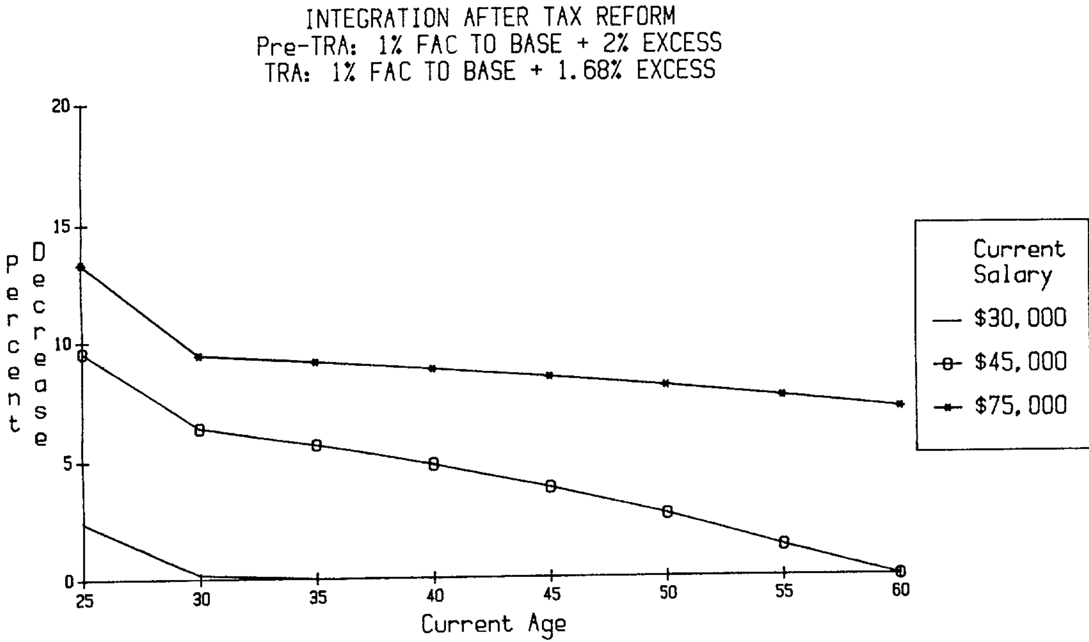
GRAPH 2



GRAPH 3



GRAPH 4



of part-time people earning less than $10,000. As I've said, it's difficult to generalize.

MR. DONALD J. SEGAL: Weeks ago, Jim Holland of the IRS indicated there was a list of 11 regulations that they had to get out by February 1, in final form, according to TRA. Integration was about #9 or #10 on that list. And they hoped to have the proposed regulation out by February 1st. So much for not having regulations today. Ira, if you were putting in a new plan today, could you draw it up using the new integration regulations?

MR. SIEGLER: Not working for the IRS, I'm not sure, but my gut reaction would be no. I don't know of any situation where they have changed the rules this dramatically, where they've allowed the new rules to be interpreted in the new plan. My guess is you probably have to design your plan to satisfy Revenue Ruling 71-446 as well as what you think the final regulations will be and submit it that way.

MR. DONALD S. GRUBBS, JR: I have a couple of items. First, on defined contribution plans, it was mentioned that you can use the higher of 5.7% or the old age portion of the Social Security tax. I looked at the Social Security reports to try to decide when we're going to cross the 5.7% and I concluded it was not during the first 75 years. Therefore, I think one might simplify the plan, if you have a defined contribution plan, just saying 5.7% and not talking about the alternative.

Second, the definition of covered compensation -- as to the confusion over that, in terms of sources of information about the law, we have several. One is the Act itself, and one is the Conference Report, which told us at the time what Congress thought it was about. Then we got the Blue Book, which the joint committee staff publishes to tell us their understanding of the law, and then we have a Technical Corrections Bill to make some changes. The confusion arose because the act itself clearly says 35 years ending at age 65. The Conference Report starts out by saying it's the same as the old law, but then goes on to say that it's 35 years ending at 65 which is clearly not the old law. The Blue Book says that both of those are wrong, that it's the 35 years ending with the Social Security normal retirement age. The Technical Corrections Act apparently

will implement that, so it looks like it will be the 35 years ending with Social Security normal retirement age.

Another item that I think might be well to point out is this early retirement reduction as it affects excess plans. It is a reduction from the Social Security normal retirement age which is, for the younger people, age 67. At age 65 for the younger people, the reduction is 13/15 of the .75%. So it's really only .65. It would seem, taking a literal reading of the law, that the reduction applies not only to the .75% factor, but also to the 2 for 1 rule or the 1/2 rule, if you want to call it that. The early reduction seems to apply to the limitation in its entirety. That means that the excess benefit for the younger people could not be equal to the base benefit percentage, but could only be 13/15 of the base benefit percentage. I've not heard anyone from the IRS address that question. This fact that we're going to have not .75% but .65% for the younger people, and, for some in between-people, .70%, poses a dilemma. Are we going to have 3 different benefit formulas for people at different ages, or are we going to go with the same benefit formula for people at all ages? I think that most employers will opt for simplicity, which means that we are really going to be limited to .65 for everyone if you want only one formula.

With offset plans, it has been pointed out that the .75% gets reduced for those individuals whose final average compensation exceeds covered compensation. A look at that question would indicate that those factors will need to vary both by age and by the level of compensation, so that the offset percentage would not be a specific number. You can't use just .75% -- it needs to be related to final average compensation, or at least the portion of it not exceeding the taxable wage base. That introduces a complexity with the factors for the maximum allowable offset. Will they vary both with age and with year of birth, and maybe change every year (as theoretically they should)? And with that complexity, I have said that I can summarize everything you need to know about offset plans in just three words: Don't have one.

MR. SIEGLER: Don, you said that if you want benefits at age 65 you would have to use a .65% instead of a .75%. You could change the formula to have benefits commence at the employee's Social Security normal retirement age and retain the .75% for everybody with no cutback in accrued rights in accordance with Section 411. Plans are going to have to be redesigned anyway. That could

be part of the redesign and the concept could tie your plan's normal retirement age to Social Security's normal retirement age.

MR. DAVID R. KASS: As mortifying as some of these further restrictions are on the ability to integrate a plan, one aspect that I think might be stressed a bit more is that the offset is .75% per year over 35 years. Most of us, I'm sure, are responsible one way or another for plans that validate full benefits over 30 years. In such a plan, the .75% obviously is automatically scaled down to 22.5% in total, before any other playing around takes place. That is an issue which should be considered in plan design. While I've heard the commentary that no adjustment need be made in the integration percentage for death benefits, etc., if the normal form of pension is other than a straight life annuity, are no adjustments necessary?

MR. BARRY: It is my understanding now (none of this is written) that any form of benefit other than life annuity is considered ancillary, including post-retirement benefits such as a 10 continuous and certain CC or joint and survivor.

MR. SIEGLER: I forget whether it's directly in the Act or in the statement of managers, but it is specifically stated that as long as the optional, or standard form of benefit applies to the lower level as well as to the upper level, it is considered ancillary. On the first comment that you made on the .75% where you have an accrual over 30 years, the .75% applies to the covered compensation limit. I understand that in an excess plan, for instance, if you were permitted .75% per year and a 26.25% maximum, and you only integrated at a .5% you could integrate on the first 52 years. Your test is done first on a year-by-year basis and you can't exceed .75% of the integration level; then it is done on an overall basis. If you satisfy both of those your formula can be .5% differential on the first 50 years, because that satisfies both the .75% and the 26.25% overall. So you're not limited necessarily, the way you explained it, because the .75% applies to covered compensation rather than the employee's Social Security benefit.

MR. KASS: Let me clarify my comment. To the extent the plan benefit formula recognizes only 30 years, then your integration, if I recall the phraseology of the statute, similarly must key on the same number of years recognition. Thus, the .75% would be limited in that instance to 30 years recognition.

MR. SIEGLER: Yes, I agree. I believe that the statute calls for years recognized under the plan.

MR. JOHN B. MCQUADE: There's a concern that I've had since looking at the new rules, and I'm not sure if I'm just trying to make life more difficult for myself or if there's really a possible concern here. What has been troubling me is the question of whether or not under the new law it is permissible to explicitly incorporate Social Security benefits into the calculation of a pension amount. Obviously, if you could do so, you would have to integrate not more than what the rules say but in doing so, you would have perhaps a different skew of benefits between lower and higher paid people. The section of the law that specifically sanctioned the use of Social Security benefits is now gone. I just wonder if anyone has thought about that and if I can stop having nightmares.

MR. SIEGLER: We kicked that around just before the session started. Jim raised the question: Can you take a 50% minus 50% plan prorated over at least 35 years and just slap the new regulations on it, and say it will be 50% minus 50% but the offset won't be more than permitted under the new law? My gut reaction is that should fly. I hope that regulations would allow something like that. In terms of presentation to employees, it might be really complex to say that you've got a 50% minus 50% and the offset won't be more than ... etc., for four more pages. But, I would think that technically it should work. You can have your plan designed the way you want it to be, a 50% minus 50% plan. As long as the offset conforms to the maximum offset permitted under the new law, technically you're not violating the law.

MR. MCQUADE: My concern is not really with the integration rules per se, but with general discrimination in favor of high- and low-paid. That is where my concern is. Maybe that's the angle you are thinking of as well. I'm worried about the general rule that you don't replace a larger percentage of pay for higher-paid than for lower-paid. Right now, it's the Sec. 401(a)(5) exception which is gone.

MR. SIEGLER: There's an overriding rule that says you can replace 100% of compensation minus the employer-provided Social Security benefit. Under tax reform it's the employer-provided Social Security benefit prorated over 35 years.

It can't recognize service with another employer for that particular offset. It's 100% of pay minus 100% of the employer-provided Social Security.

MR. MCQUADE: Right. That's a limit. That was the only place I saw the permission to use the Social Security benefit in the computation.

MR. SIEGLER: I guess the point that Bob and I both made is they're taking the Social Security benefit out of the calculation of the maximum permitted differential. My theory is that you should probably design your plans with that in there, if you think that that's a good design. As long as your maximum differential conforms in other areas, you're going to be okay. It's not specifically stated in the law.

MR. BARRY: John, just to amplify that, one of the things that I said, but didn't explain sufficiently is that we're not sure at this point if the formulas set forth in the Act are going to be mandated or be maximums. Most practitioners tend to think that they are maximums, I think, but that is still an open issue. To the extent that they are stipulated, then you wouldn't need the enabling section that you are referring to, because there would be no reference to Social Security at all. If they are not stipulated and they are maximums, then I think the technical corrections will address exactly the point you are raising.

MR. GREGG L. SKALINDER: I'd like to just respond a little to Don's comment about not having an offset plan. I would propose that if people who have offset plans were worried about complexity, they wouldn't have them in the first place. I don't think they're going to be affected at all by your comments about complexity. However, I have done some preliminary analysis of the new integration rules and, as far as I can tell, you can't do much more integration under the new rules with an offset style plan than you can with a step-rate plan.

Traditionally, as far as I can tell, most of the reason for having offset plans is having an offset unrelated to service, subject to the back loading provisions. In other words you could have a larger offset for short service people than you might otherwise have under the new rules. It also responded automatically to liberalizations in Social Security. I don't really expect a lot of those to be coming along in the foreseeable future. So it strikes me that it's particularly forceful under the new rules that there's no particular reason to have an offset

plan. There's no particular reason to deal with that kind of complexity. Obviously I'm projecting my own feeling that step-rate plans are much easier to communicate and to administer. I'd be interested if anybody else has any reactions to it.

MR. BARRY: I think that one of the intents of the Tax Reform Act was to make the maximum amount of integration the same under step-rate and offset plans. To the extent that has happened, I think one of the types of plans is going to see a demise, because the relative advantage of the offset program is gone now. Because of that, I think quite clearly you're going to see more people going to step-rate programs. It is easier to administer, understand and to explain. I think offset programs for whatever reason, Don, are going to go away.

MR. SIEGLER: If we weren't in the midst of a resurgence in inflation you might see a switch to integrated defined contribution plans with nonintegrated defined benefit plans. In a low inflation environment, you'd get the maximum integration that way.

MR. SHELDON GAMZON: This is a follow-up to Dave Kass's question about subsidized postretirement benefits such as 50% joint and survivor or 100% joint and survivor benefits. If you had a plan that initially integrated at 1%/2% at covered compensation, which was acceptable, and now you had to reduce to .75%/1.5% at covered compensation, which would presumably be acceptable, can you say that benefit is payable as a 100% joint and survivor and then offer a 25% actuarial increase to anyone who elects the life annuity to get you back up to 1%/2%. Is that my understanding? That seemingly gets around almost the entire integration problem, for married people at least.

MR. SIEGLER: For married people it appears that is correct. You can apparently apply any standard form of benefit on a postretirement basis as long as it applies to both the covered level and the excess level.

MR. GAMZON: And presumably give an actuarial increase to people who take the life annuity.

MR. BARRY: That's going a little step further. I'm not sure that that's going to be allowed. It's not mentioned anywhere. Obviously the equivalent value

would in essence get you there, but I'm not sure that they're going to allow that. In other words, if there's an optional form, I still think they are going to go with the worst case rules. If you have an optional form within the program that pays a greater amount than the case that you just mentioned, I don't think that they will allow that. At least my feeling is that they are going to go with that worst case rule if you allow that increase.

MR. SIEGLER: I disagree. And as you can tell, without the regulations it's a matter of opinion on which way they are going to go. There is something else in the law which talks about equivalence of benefits. If you have optional forms of benefits they have to be actuarially equivalent. Unless they specifically address this issue in the regulations by saying that, "No, we really didn't mean what we said, when we said you can provide any form of benefit as long as it applies to high- and low-paid the same." Unless they address that in the regulations I think that they are going to have to allow it.

MR. C. V. SCHALLER-KELLY: I wonder whether you could say a little bit more about the kind of formulas which were quite common in certain collectively bargained situations, where the maximum benefit of Social Security plus the pension plan could not be in excess of some formula such as 100% of wages or 85% of wages. It seems that the rule that you were describing earlier -- using only the employer-purchased portion of Social Security -- is going to lead to some rather strange results. The law only seems to talk about the maximum if pension plus employer-purchased Social Security adds up to 100% of earnings. What happens if the maximum is to be something other than 100% of earnings?

MR. SIEGLER: Well, since I said it, I'll comment. Those are really plan design issues. The one you raised about the maximum offset being 50% on that type of plan -- I'll just read to you from something that our legal department threw at me. According to the Act, the cap cannot exceed "the excess of the employee's final pay over the employer-derived retirement benefit created under federal law attributable to service, by the participant with the employer." It is presumed to accrue over a 35-year period and presumably the employer-provided piece is the 50%. So that's where that comes from. In terms of design issue, I've seen the types of plans you're talking about -- the steel plan which says 70% plus half a percent per year of service, I believe. It will have to have a lower limit, if we've got the plan benefit plus employer-provided piece of Social Security. The

70% would theoretically have to be reduced in order to reproduce the same benefit level.

MR. SCHALLER-KELLY: Will that be legal?

MR. SIEGLER: It will except in the case of reduction of accrued benefits. You could freeze the accrued benefits under the old law. Again, that's a transitional issue. But you could presumably freeze the accrued benefits under the old law, as long as they satisfied and go forward under the new.

MR. GRUBBS: Charles is talking about the steel industry plans primarily although they had some imitators which said your benefit plus the Social Security benefit cannot exceed 100% of pay. You've alluded to the language in Sec. 401(a)(5) which are the new cap rules specifically designed for those plans by some staffer in Washington who didn't understand those plans. As soon as I saw those new rules, my reaction was there won't be any more cap plans. Within a couple of months, we had negotiations between U.S. Steel and the United Steel Workers and indeed, they eliminated the cap provision from their plan. I expect that most others will follow suit.

MR. SEGAL: Just one more comment about that. The only angle I see that you could get approved, treating it as a cap, is it's not the formula. The formula is still basically a flat, nonintegrated formula. The cap is just the maximum that can be paid under the plan. On that basis, it may still be acceptable.