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DESIGNING AN INTEGRATED PENSION PLAN

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- A basic discussion of issues and problems under the new IRS rules effective in 1989 for pension plans integrated with Social Security.

MR. RICHARD G. SCHREITMUELLER: My presentation is going to be in three parts: first, integration and why we have it; second, the rules we have under the Tax Reform Act of 1986, which appear under Section 401(l) of the Internal Revenue Code and regulations and rules thereunder; and finally, what this means for pension plans, primarily existing plans, but perhaps there will be some new ones too.

The reason that we have Social Security integration, obviously, is that we have Social Security. And in fact, one of the things that these rules make clear is if in the rare circumstance you have an employer who is not in Social Security, which is not going to happen very often at all, that employer is not entitled to use these rules; integration is not available. That was more important before 1984 when it was easier not to be in Social Security. But there is a link between these rules and Social Security. The link is becoming less direct as time goes on.

Under the Social Security benefit formula, you know that the primary insurance amount is figured in three steps. For the first part of your pay, you're earning benefits at a 90% rate. Then you have a fairly broad band in which you're earning benefits at a 32% rate. After that you earn benefits at a 15% rate, and then finally you reach a certain level of pay, which varies each year, and if you're earning more than that you earn no benefits; it is simply disregarded under Social Security. That amount of pay in 1989 is $48,000 a year, or $4,000 a month. Someone who is earning that amount of pay under this year's formula is earning about $1,144 of monthly benefit under Social Security. Now if you take that very same formula and you convert it to a percent of pay, it decreases. It starts out as a very high percent, 90%, and it gradually goes down. For someone who is at the Social Security maximum, it's about 28% of pay and it continues to tilt down because as pay goes up the benefit is a fixed dollar amount, so the percentage keeps dwindling. Those people who are policy makers and who deal with this sort of thing refer to this phenomenon as the Social Security tilt. It is something which is built in because lower-paid people have certain basic needs and they want to have a fair amount of adequacy at the low end.

Now what happens when you try and design a pension plan to go with that? Well if you have a very simple formula, such as 1% per year of service, and a pension plan that's not integrated in any way, for an employee with 35 years of service, all you're doing is adding on 35% to what you already had. The tilt in the total benefits, pension plus Social Security, is the same as the tilt in Social Security itself. You haven't accomplished anything as far as changing the pattern of benefit delivery, and the problem with that is that if you are shooting for a replacement rate, say of around 70%, if you achieve that at the low end, you fall short at the high end. And if you achieve it at the high end, you overshoot it at the low end. So you can't come very close to 70% using that kind of a formula. On the other hand, if you integrate the pension plan formula, you reduce the tilt. You're about halfway up to a horizontal line from where you were, and that is what integration is all about. You get rid of some but not all of the tilt within the rules that are allowed by IRS.

Now to do this, you've got several sections of the Internal Revenue Code which come into play. You have a basic section called 401(a)(4), which essentially says that you are not supposed to design your pension formulas in such a way that you're discriminating in favor of Highly Compensated Employees (who and there's a long definition of who they are), but we won't go into that at this session. Then Section 401(l) of the Code says that even though you are not supposed to discriminate in favor of highly compensated employees, you can do so within certain limits because of the existence of Social Security. And finally, you have another section of the Code which serves as a stepping stone between them, and it says, in Section 401(a)(5), that it is okay if you favor the Highly Compensated Employees within the rules and limits that are set forth in Section 401(l).

When laws are being written, you have conflicting objectives. What were they trying to accomplish? First, a criticism of the old rules was that they permitted an undue amount of emphasis on highly paid employees. Horror stories were told of pure excess plans in which highly paid people got benefits, low-paid people got nothing. This was possible if the high-paid people didn't get very much. So the rules were changed so that certain minimum benefits were required and that is something we'll talk about, called the two-for-one rule. Another issue had to do with portability and backloading, and it said that under the old rules it was possible to have a good deal of disparity -- the word they're using now -- and you could pack it into as few as 15 years. That's no longer possible. Under the new rules if you want to give somebody the maximum amount of integration, you have to spread it over 35 years. A third criticism was that the old rules were considered too complex. As we all know, TRA-86 was a tax simplification law, and I think that integration certainly is within the spirit and scope of that effort. The way that this was approached was two-fold. First, the rules were forced into a very rigid pattern. Whether it seemed appropriate to that type of plan or not, the rule is to be applied. And second, a lot of new terminology was devised, which didn't necessarily mean what it appeared to mean, so you have to read the words carefully to see what they now mean.

A fourth criticism, and this was really not an overt part of the legislative history, but it certainly comes through in the result, is that the old rules were deemed to produce too much integration, and so the new rules produce less. Specifically, the old rules allowed an additional benefit for pay over and above the Social Security base of 37.5% of pay. You could have that much additional benefit under a defined benefit plan. Under the new rules the most you can have is 26.25%, so that's a substantial cut. There are a number of other rules which cut into the 26.25% very substantially, so in a rough way you could say that about half of the integration that was available under the old defined benefit rules is no longer there for one reason or another.

There's a further fix that was made in the new rules. I have a little note pad of my own here which says here's the problem and here's the solution. I couldn't find a problem for this solution, but I'll tell you what it is anyway. There's a lot of discrimination testing which is built into the new rules. I was not able to find a problem, some abuse, that was being addressed there, but the testing is there anyway and if they don't change the rules we have that solution. Maybe some day someone will think of the problem that it was addressed to.

Now the rules we are going to be talking about were proposed by the Internal Revenue Service on November 15, 1988. They basically are in three pieces. There's defined contribution (DC) defined benefit (DB) excess, and defined benefit offset. As we'll see, the defined benefit excess and offset rules are far more complicated than the DC. However, the excess and offset are not very different from one another, so that's a little help.

For defined contribution plans, all you have to know are four things. First of all, you are supposed to integrate it at the Social Security wage base. You don't have any problems or adjustments about integrating it at some higher or lower amount. You can't do it; it's not allowed. That could change, but according to those regulations, that's the way it works.

A second rule is that the basic limit on the disparity for a DC plan is 5.7% of pay. Now what does that mean? Suppose you have a plan which is essentially a 6% of pay defined contribution plan -- a money purchase plan, let's say. The employer is basically putting in 6%. He wants to do something extra for his higher paid employees. Could he put in an extra 6% over and above the Social Security wage base? The answer is no. The most he could do is 5.7%. So he would have 6% on all pay, and then an additional 5.7%, a total of 11.7% on pay above the Social Security wage base. That would be right up to the limit of what these rules allow.

There's a further rule -- the two-for-one rule -- which says that you have to have certain minimum benefits. Let's go back to my first example. Let's suppose it were a 5% of pay type of plan. Now he no longer can have 5% plus an extra 5.7% because he's limited to two-for-one; he's limited to

10% at the high end if he has only 5% at the low end. If you have no benefit at the low end, two times nothing is nothing, so that automatically gets rid of your pure excess plans.

And finally, in all of the rules and limits for all these types of plans, we're talking about employer contributions. So if you have employee contributions, you have to somehow back them out, which we'll talk about. Furthermore, under a DC plan you have forfeitures, and forfeitures are deemed to be part of this. The 5.7% and these other limits relate to employer contributions plus forfeitures. That's it, that's everything you have to know about DC. If you want to go on to DB, we can go on for quite a while.

First there are some definitions -- Social Security retirement age. There are three possible Social Security retirement ages -- 65, 66 and 67. The way I remember it is that 66 applies to the people who were born in 1938-1954 inclusive and 65 and 67 are the ones on either side of that. So people born before 1938 have a Social Security retirement age of 65, and those born after 1954 must wait until age 67. Where did those ages come from? Well the Social Security Amendments of 1983 bring the old retirement age of 65 up to 67 for people who were too young to complain at the time they were doing it. It was graded up in steps of two months, so it took a dozen steps to get from 65 to 67. But you see only three ages in these rules, with only two steps to get from 65 to 67. What happened was that the Internal Revenue Code, Section 415, put in a simplified definition rounded to integral ages. They got rid of the months, and said they would round it down. But then in a certain document called Internal Revenue Notice 87-21, they went the other way. They said they would round these ages up. And that is really what we're working from. We're working from Notice 87-21, which was issued under Code Section 415, which gives you these numbers, and as far as we can tell this is the official definition of Social Security retirement age, not the one in Section 415 of the Code, and certainly not the one in the Social Security Act. I've had many discussions with people and they all seem to believe me, so I'll stick to my story.

Now we get into covered compensation. As you can see, I'm trying to define the terms in order so that we can use them as we go along. Covered compensation always has been essentially a 35-year average of Social Security wage bases; it's a backward average for someone who is ready to retire. You look back, average the Social Security wage base over those 35 years, and that is the number called covered compensation. It is a basic integration level or bend point for your integrated defined benefit plan. But there are some more definitions to it. First of all, which 35 years are you talking about? Under the Code, the new Section 401(l), it says that the final year is the year in which the employee reaches the Social Security retirement age. But the regulation says it is the year before. So, there's a potential difficulty there as to which one you believe. One school of thought is that the Code would take precedence. The other is that the IRS does have broad authority to issue regs, this is consistent with the way it has always been done, and there are some things in the Committee Report to back it up. So there are arguments both ways. The only thing you really have to know is it's not determined, but that is definitely one of the things that has to be nailed down before it is determined.

There's a third issue -- how do you round this? Do you round it to the nearest dollar? Do you throw away the cents? The old rule was you divided it by 12, you threw away the cents, and you multiplied it by 12 so that you got a consistent number, whether you were using a monthly or an annual way of administering it. That is an open issue. The regulations do not address it.

And, finally, there are some issues about treatment of employees past Social Security retirement age, those who are currently 65 and up, which we're not going to get into right at this moment, but suffice it to say that until you define that, you have not fully defined covered comp. Let's just think of covered comp as a concept at this point. It is something that we'll be talking about and using as we go through some other rules. Later the IRS will have to specify what covered compensation is, and then we'll have firm answers to these questions about it.

Another important definition is average annual compensation. This is the individual's pay averaged over three or more consecutive years. The thing about this definition is that any integrated DB plan must base benefits on average annual comp; nothing else is allowed. Think if you will how a career average plan would fit into that, and the answer is, it doesn't. A career average plan uses year-by-year pay; you've heard about the death of career average plans or the problems of career average plans. At the moment this is the rule that we have in the regulation and on its face it does not allow career average. This is part of the simplification, by the way.

Final average and career average plans are now the same thing. Final average is merely a special case in which you average pay over a very few years.

Final average compensation is another term which isn't what we used to think was final average, but it's in the Code and it's in the Regulation. It is average pay over exactly three years -- no more and no less than three years. So it's kind of a special case of average annual comp, but in addition, it excludes pay above the Social Security wage base. That is something which is used in determining the offset under an offset plan. You do not run into this definition anyplace else except in determining the offset under an offset plan. Your basic pay definition of average annual comp is still the one that's used before you get into the offset part of the plan.

Another definition, a very important definition, is the integration level. Really it's an easy concept. I don't think anything changed much here in terms of what the regulation has got in it. For an excess plan, also known as a step rate plan, it is the line defined in the plan at which the benefit rate steps up. Anything below that line is known as the base benefit percentage. Anything above that line is known as the excess benefit percentage. It is one that's a familiar concept; it's what we always thought it was. Then we go down to an offset plan. Now the regulation really does not use this term to describe an offset plan, but it will become convenient to think of an offset plan as having an integration level, because the way the rules are put together it really does. It is the upper limit on the amount of final average compensation which you are going to count when you go through the process of computing your offset. With those definitions out of the way, let's talk about the basic limits for an excess plan.

Again, there are three basic limits to talk about just as under a DC plan. First of all there is a basic annual limit; your disparity cannot be more than three-quarters of a percent of average annual compensation. If your annual benefit rate is 1% up to the integration level, you can have another three-quarters of a percent above it; that's what that rule allows, a total of 1.75% in this example.

The second rule is that you have a cumulative limit of 26.25% of the average annual compensation. In other words, if you have a very long service employee with, say, 40 years of service, you're not allowed to have 40 times three-quarters; that would be 30%. You can't have that much. You have to cut it off at 26.25%. It's all right if you spread the thing thinner than that. If you're using only a .5% a year, you can give the 40-year employee .5% a year for 40 years because that's still only 20%; you are within the 26.25. So I think of it as a 26.25% rule, but it's often described as a 35-year rule because the way they get it is by multiplying 35 times the .75%. And when you're talking about adjustments to the .75%, that might not be a bad way to look at it.

The third rule is a two-for-one rule. Here it works pretty much the same way as under a DC plan. This rule says that your excess percentage may not exceed two times the base percentage. So, again, if you have a 1% plan up to the integration level, you can have an additional .75% above the integration level, a total of 1.75%. That, of course, is your annual rate of benefit accrual. However, under the two-for-one rule, if you have .5% up to the integration level, you cannot have an additional .75% above. You are limited to another .5%, a total of 1.0% above the integration level, because that's as far as you can go under the two-for-one. If you want to get .75% above, you are going to have .75% below for a total of 1.5. These limits are on employer-paid benefits. Some plans still do have employee mandatory contributions, and so you have to deal with the issue of how to back those out of there, which we'll get into.

Next we have a rule which was in the Code when they passed the Tax Reform Act. Not too many people paid attention to it. They are paying attention to it now. This rule is called Uniformity. It says that the difference between the excess and the base percentages must be the same for everyone. You cannot differentiate in various classes of employees or different pay levels. You are allowed to differentiate if you've got young versus old employees with different Social Security retirement ages. You can take that into account, and we'll be talking about that later. That exception is explicitly allowed in the regulation. It's silent about other exceptions.

Now why is that important? Well, one of the most popular ways of designing an integrated plan has been a plan with an offset based on some percentage of the primary insurance amount, such as 2% of pay per year of service, minus 2% of the primary insurance amount. When you talk about the primary insurance amount, as we saw earlier, you are talking about something which is not directly proportional to pay. It is more heavily weighted toward the low end of pay, and so when you subtract it out as an offset, you are differentiating in a way which violates the uniformity rule. This is the rule that is causing problems with the primary insurance amount (PIA) offset plans, and which is leading analysts to believe that the PIA offset plans appear to be dead, at least in terms of meeting the rules of Section 401(l). There's no way that I can see that a PIA offset plan can comply with this rule.

Next we have the integration level. In the old days you could have essentially any integration level you wanted. If you went below the standard level of covered comp, that was all right. It meant there was less integration and it would appear as though that would make the IRS happy rather than unhappy. If you went above the integration level, you would reduce the percentage that you were allowed and you'd make up for it that way. Under the new rules, it works quite differently. There are three ways you can do it. First, the standard way is you use covered compensation as your integration level under your plan. It's a little more rigid definition than what we are used to; it's a 35-year average and it ends at a year based on when the individual reaches the Social Security retirement age. What you've got there is a dynamic type of a table.

In other words, in the old days somebody might produce a table based on a wage base of $48,000; they would produce what you might call a 1989 covered compensation table. They would use that table and write it into their plan. They would say that was going to be the integration level forever and ever, even though next year the wage base might be $50,000. It's more trouble than it's worth; we'd just as soon stick with this table. You can't do that under these rules. You have to go at it some other way. Another way that has often been used is to take the amount of covered compensation for someone who is currently reaching age 65 and just write that into your plan. That number is approximately $16,000. We don't really know exactly what it is, but it's in that neighborhood. And you would just write that into your plan. Again, that's not explicitly permitted here either. It's very difficult to see how you can use it.

If you put covered comp into your plan as the integration level, you're talking about a moving table which must be recomputed every year. It means that around November 1st when the Social Security Administration announces what the new wage base is going to be, people run their little Lotus programs and figure out how to do covered comp. That then holds them for another year, and they crank that into their administrative procedures for your plan.

The second way you can set a plan's integration level is to have a flat percentage of covered compensation, provided that percentage is over 100%. In some specialized situations that might make sense. I don't know that it's being done very widely. I've heard of it used in a few cases. There's a penalty that you'll pay for it, as we'll see; it's not a free lunch by any means.

Finally, a flat dollar amount is useable as the plan's integration level. You can have a flat dollar amount subject to either of two rules. The first rule is that amount can be up to $10,000, no more than that, or 50% of covered compensation for an employee currently reaching the Social Security retirement age. Under any reasonable definition of covered compensation, the one that currently controls is the $10,000 rule. So it's kind of a de minimis rule. It means that all these old plans that use $7,800 don't necessarily have to change. But if you've got anything that's been updated in the last 10 or 15 years, it would have to change.

The other way you can set a plan's integration level is you can use some higher amount, above $10,000, but then you've got to pass two other nondiscrimination tests. I'm not going to get into them here, but they are known as demographic tests and the idea is that your employee group and their pay have to line up a certain way, and if they don't then you have to do something else, and you are expected to test those periodically. I believe it would be at least every year, perhaps more often that than. It's an ongoing test. And this is another distinction from the old rules. Under the old rules, you could qualify your plan on day one and put whatever demonstrations in your letter you needed to the IRS. You know this plan integrates; here are the numbers as they relate to this plan. They are within the limits of your rules. The IRS, if they understood it and agreed with it, would give you a determination letter and that was good for a long time. It was good indefinitely. Even though certain things might change, it was just not part of the process to keep testing. That's not true under these rules. So that's the way you set a plan's integration level.

Now there's another important rule which says that if the plan has got any valuable features on benefits above the integration level, it must also provide those benefits below that level. An obvious example is if you allow lump sum cashouts of benefits for your higher paid people above the integration level, you must also provide comparable benefits below that in terms of the availability of the lump sum, and in terms of the liberality of the factors that are being used. If your plan has required a determination that the individual is able to handle the money, that no longer is going to fly. A highly compensated person could demonstrate that; a lower compensated person might have a problem with that.

We've just been through the rules for your defined benefit excess plans, which is the term that they're now using. Your offset plans really do almost the same thing. And that was one of the intentions of simplification, to have the same rules apply to both kinds of plans. They pretty much achieved that. Under an offset plan there is an annual limit of .75% for your maximum disparity. You have the same cumulative limit of 26.25%, you've got the same two-for-one rule. It is administered a bit differently. It is based on dollar offsets rather than percentages of pay, and so as best I can tell, you are going to have to test that to be absolutely sure that it works. You are going to have to test it by figuring it out on the computer for each employee and subjecting it to the two-for-one test, rather than by just doing it on the back of an envelope and looking at the two percentages and saying, "well, 1.5% is not more than double .75% so it must be okay." Because of the interaction among these different pay definitions, that doesn't seem to always work under an offset plan. And finally, you're talking about employer-paid benefits, so for the first time you actually can get some credit for employee contributions under an offset plan. As we said, the same nominal limits do apply for offset and for excess plans. There are some slight differences because of these pay definitions and because the two-for-one rules operate differently.

Now what happens if your plan has a high integration level? We said that there's a price that you pay. There's a little table in the IRS proposed regulations with six steps in it. (See Table I.) It says that if your integration level is 100% of covered comp, then you get your full basic limit of .75%. If it's a little more, then you have to back the .75% down, and if you go all the way up beyond 200% of covered comp, then your .75% comes down to .42%. The reason that that is not linear is that the Social Security replacement rates don't come down in a nice smooth fashion. There are Social Security replacement rates which underlie this table, the idea being that you have about the same amount of integration at all points in terms of how much Social Security is really involved.

A second rule involves Social Security retirement ages that are above 65, and this is a very important one. It seems to affect all plans that are DB plans, because you can't just limit your plans to people who have a Social Security retirement age of 65 -- the ones who were born before 1938. Typically you are dealing with people who have all three of those Social Security retirement ages. There's a table that has 13 rows and three columns in it, and it tells you how to adjust your .75% for an individual whose benefits begin before the Social Security retirement age. In the first column, for an older employee, his Social Security retirement age is 65, so he is entitled, for his normal retirement benefit, to the full disparity of .75%. There's nothing in the Code that says you have to have early retirement benefits, but just about everybody does. From age 65 down to 60 there is the familiar 1/15th rule; so at age 60 you 10/15ths of .75%, or have .50%. So far nothing has changed. But everything else on the chart is a change, because you go down below that and the reductions are steeper than the old 1/30th rule. So if your plan was 1/15th, 1/30th, you are going to have to cut back in that area a little bit because the .32% at age 55 is a good bit less than .5 times the .75%, which is what you would have gotten under the old 1/15th, 1/30th. More important is what's going on in those other two columns, because those relate to the younger employees who were born from 1938 on. For those people, you have to reduce your .75%. If you're talking about a normal retirement age of 65, which is usually what we have, it means that your .75% is back down to .70% or .65%. So as a practical matter, your limit is really not .75% at all, it's .65%. Even for a plan that doesn't have early retirement benefits, the most you could have is .65%. Why can't you have .75%? Because the Code does not allow a normal retirement age over 65. It's just illegal to have one except in the very limited situation of someone hired at an older age. But for your typical employee who is hired at a younger age, it's not allowed. Age 65 is as high as you can go; therefore .65% is as high as you can go on your maximum disparity. So a lot of people have been spending a lot of energy the last six months or so trying to figure out how to design plans within these rules. Those are probably the most important adjustments that we will see.

Next we have rules for plans with mandatory employee contributions which give you a way of backing out the part that is attributable to the employee. Table II has six numbers in it which

TABLE I

ADJUSTMENT FOR EARLY RETIREMENT

Social Security Retirement Age 67		Social Security Retirement Age 66		Social Security Retirement Age 65	
Age at which Benefits Commence	Annual Factor in Maximum Excess Allowance and Maximum Offset Allowance	Age at which Benefits Commence	Annual Factor in Maximum Excess Allowance and Maximum Offset Allowance	Age at which Benefits Commence	Annual Factor in Maximum Excess Allowance and Maximum Offset Allowance
66	.70%	65	.70%	64	.70%
65	.65	64	.65	63	.65
64	.60	63	.60	62	.60
63	.56	62	.55	61	.55
62	.52	61	.51	60	.50
61	.48	60	.47	59	.46
60	.44	59	.43	58	.42
59	.40	58	.39	57	.38
58	.37	57	.36	56	.35
57	.34	56	.33	55	.32
56	.31	55	.30		
55	.28				

range from 20-75%, depending on the entry age and the type of pay definition that's being used. What's really happening here is that, if you can figure out where to enter the table, tell you how much you should attribute to the employees. If your entry age is a very young entry age, you attribute more. If it's a rich pay definition, say five-year average, you attribute less. If it's a less liberal pay definition, say 10-year average, your percentage goes up. So you multiply these percentages by your basic benefit percentages and this tells you how much of it is attributable to employees. The rest is attributed to the employer. And what happens in practice is that by taking out a big chunk of it and attributing it to employees, for the part that's left, you quite often have difficulty complying with the two-for-one rule. What really gets you under a contributory plan is the two-for-one rule. Furthermore, you can't just automatically use this table. You first have to pass some demographic tests.

TABLE II

Adjustment for Employee Contributions

	Factor to Multiply by Contribution Rate	
Average Age	Final average compensation benefit formula	Career average compensation benefit formula
Less than 30	.5	.75
30 to 40	.4	.6
over 40	.2	.3

Finally, transition rules are important to know as they are a very current topic. How do you deal with an existing integrated plan? Well first of all, you are supposed to freeze your accrued benefits. Let's talk in terms of a plan with a January 1 plan anniversary. You are supposed to freeze your benefits as of December 31, 1988. In other words, it's as if the individual had no further service, no further pay. It's as if he quit. And that's really what the rules say. If you were using a three-year or five-year pay definition, that's going to be strictly a backward pay definition. You cannot count any pay or service beyond December 31, 1988.

Now beyond that you have two routes you can go. The first route that you can go is you may comply with the new rules for future service only. You take your old benefits under the old rules, and forget about them; you apply your new rules to your future service only. And in that case there's a special adjustment to the cumulative limit, which as we will recall, was 26.25% based on 35 years of service. You do not get 35 new years, you get 35 total years. You first have to count the pre-1989 years, subtract them out, and take the ones that are left. You are entitled to those under the new rules. That's true whether the old plan was fully integrated, partly integrated or not integrated at all. A year is a year, and it counts on an individual-by-individual basis. A brand new employee is entitled to 35 years worth of integrated benefits under the new rules. Somebody who has already had a benefit for 35 years really is not entitled to any integration at all under the new rules. And then it will vary in between depending on how long people have been around. The other way you can do it, and this is a way that more and more people are coming around to, is to use total service and apply the new rules to both old service and new service. You're going to be using the old frozen benefit as a minimum, but you will probably find that employees get some instant upgrading, especially your lower paid employees on the date of the change; let's say on January 1, 1989, some of your people will get some instant benefits.

There are some open issues there about how you deal with frozen employee contributions. Suppose you had a plan where about 10 or 20 years ago they decided that mandatory employee contributions didn't make a whole lot of sense. They got rid of them. But they did not give them back. They're sitting there as part of the accrued benefit. If you are trying to apply the new rules to that kind of a situation, it does not work out very cleanly.

What is the impact of the new rules? First of all, there's less integration as we've discussed briefly, and there's a lot more rigidity. Neither of those comes as good news to us practitioners who like to design plans and have a little elbow room. Second, there is a theme running through these rules which in effect says that under the old rules, for any plan which didn't meet the rules at that time, you still could demonstrate that you met them in some other way, which was equivalent, and if you met them on day one that was good indefinitely. Under the new rules, if you don't meet the standard rules, you're pretty much out of luck. The regulations do say that the only path to salvation under 401(l) is to use these rules, not something else. Furthermore, with all of the testing for discrimination, many, many situations that do not seem particularly abusive are now deemed to present a substantial potential for discrimination and you are guilty until you are proved innocent by repeated testing. Offset plans no longer look very attractive. Unless the Service can come up with some newer and better rules, offset plans do not have a very bright future.

Finally, as with so many other rules from recent laws, there are a good many open issues, things that we simply don't know. For example, we don't know what covered compensation is. That doesn't seem like a particularly nasty problem, but two and a half years after enactment we do not know what covered compensation is. I've got it narrowed down to four sets of numbers, depending on how they resolve the two biggest issues. As best I can tell, based on what they said at the EA meeting in February, one of these open issues is will we average it over 35 years in all cases, or for your older people, will there be a phase-in such that for someone born in 1929 it would be 35 years, for someone born in 1928 it would be 34 years, and you'd follow the rule of the year of birth plus 6. You'd use this rule of year of birth, forgetting the 1900 part of it, plus six, with a maximum of 35. That's the way it has always been done; however, the Code says 35 with no reference to that. So there's a question of which way you would go. The other one that's open is your final year of the 35, or whatever number you're using. Is it the year when reaching the Social Security retirement age, or is it the year before? Since there are two possibilities on each of those issues, that gives me four ways of computing it. If anyone really wants to know what the numbers are, we can get into that.

A second open issue is PIA offset plans. Perhaps it's a nonissue, perhaps they truly are dead. But some people think that maybe this type of plan can be or will be revived, either under 401(l) or under Section 401(a)(4), if there is a way of testing it. Because remember, all these rules are simply a way of getting past 401(a)(4). And if you don't like these rules, if you can think of some other way to pass 401(a)(4) and you can get the Service to agree with you, you're home free. And since we don't have rules on 401(a)(4) yet, maybe there's a way of doing PIA offset plans there.

I will say the same general things about career pay. Notice I'm no longer saying career average; that seems to have been one of our problems in communicating with the government. At some point they said, "oh, you want career average. All right, we'll let you average it over whatever number of years you want." Well it turned out that's not what we tend to think of as career average. Some of us have started using the terminology career pay just so we understand that it's not career average. It is a year-by-year type of thing; something that can be administered and explained easily.

There's another open issue about frozen employee contributions. We really don't know how you can test those for pre-1989 service. Another open issue is cash balance plans; there aren't that many of them around, but there are a lot of strong believers in them. It's not very clear how they come out under these rules. And one of the big unknowns is this whole business of Section 401(a)(4) tests, the major set of which 401(l) is kind of a subset. We don't have any rules on that. We don't even know when we're likely to get some. My understanding is that it might happen this year, but that's a very rough and ready kind of understanding. I wish I knew more about it. So, with that, I will turn it over to our plan design expert, Mike Hill.

MR. MICHAEL R. HILL: Dick has gone through the rules, the nuts and bolts, and what he's asked me to do was step back and tell you how to go ahead and apply these rules. What things should we be thinking about or considering as we go through the redesign process for our clients on the various plans? I think the different things to think about will vary depending upon the plan and on the client. One of the first things you should ask yourself, maybe it sounds like a no-brainer question, is should we maintain this plan as an integrated plan before we even start deciding to just make a few modifications? Take a look at the demographics of the plan participants; it may be such that integration as we had before wasn't really getting you much. And by that I mean the benefit percentages that were being provided to the various participants did not vary a whole lot. If that's the case, you might want to go down the nonintegrated route and save all the trouble of worrying about the integration rules. For some of the plans that satisfied the old rules, when we moved to the new rules the reduction in integration or permitted disparity was such that by going forward you would have hardly any difference in benefit percentages by pay level. And if that's the case, you may also want to say, does it make sense to maintain integration?

Now you've gone through that step and said it does make sense to maintain an integrated plan, but what are some of the other parameters that need to be thought about as we go down that road? You need direction from your client. All the clients are going to want a plan that satisfies the new rules and doesn't increase benefits and doesn't increase costs. I think we all know from just looking at the rules that that's an impossibility. The client is going to have to make a decision somewhere along the way. Is it going to be a cost-neutral type of formula that we will be asked to come up with? If it's a cost-neutral type formula, there will be some losers. And by losers I mean that on a projected basis their benefit under the new formula will be less than the benefit under the old formula. And in that case what you'll probably find is that your losers will be your highly compensated individuals, but your low-paid individuals will probably still come out winners under a cost-neutral scenario.

If the client doesn't say cost-neutral, they'll probably then ask for, let's say a benefit-neutral type of formula where nobody gets hurt. Well under that scenario you can right away tell the client that that's going to cost more money to the extent you do it. Because by making benefits neutral we keep the high-paid employees whole. Well the thing to remember about the integration rules is that they have narrowed the difference in disparities regarding benefits that you can provide to the high paid as a percentage of pay relative to the low paid. So if we've narrowed the differential and we keep the high paid whole, we obviously have got to increase the lower-paid individuals. A benefit-neutral type of plan is really going to cost the client more and actually increase benefits for a group of plan participants. Also, if you go down the route of what I'll say is benefit-neutral, you need to ask yourselves what ages we are deeming to be benefit neutral. We can sit there and design a plan such that at age 65 no one gets hurt, but for people who leave prior to 65 there may be some reduction in prospective benefits. That might be one scenario. Another scenario would be to make sure there are no benefit reductions on a prospective basis for normal retirees and early retirees. And maybe a third and more costly scenario is to make sure that no one gets hurt, not deferred vested or early retirees. So you've got those three types of parameters to think about if you're going down the benefit-neutral type of approach.

That leaves us with the third approach, where a client is willing to look at reductions at the cost or reductions in benefits. And so that way you have to somehow tilt the curve so that obviously high-paid individuals will end up with reduced benefits, again going prospectively. Then you've got to consider the medium-level individuals. They may have some type of benefit reduction, but probably in this case, unless there's a dramatic reduction, you still probably have increases for lower-paid individuals. So really, what you'll find is that the lower paid individuals will end up with the same or higher benefits, and the question is, what do we do with the mid-range or highly paid individual? Sometimes under the old rules, a lot of times in designing our integrated plan, we wanted to maximize the disparity in benefits between the high paid and the low paid. And to do that we all jumped onto offset plans. Because under an offset plan based on Revenue Ruling 71-446 and everything else that came along with it, you could get the biggest differential in benefits from high-paid to low-paid using a Social Security offset plan. Now they've changed the rules so that offset and excess plans are essentially the same things. You really have no reason to pick one over the other just because you want to maximize the disparity in benefits. Basically they both get you to about the same point. So maybe another parameter to think about is communication and administration of the plan.

Going back to before, where most of the integrated plans were under the Social Security offset basis, we said that was because of the fact that offset plans got a bigger differential and there was this direct tie to Social Security benefits. And as you know, a majority of the plans cap the Social Security offset at 50%. And even though the offset was a subtractive element in the formula, it was usually communicated to the employees as saying, that the employer was paying for half and you were paying for half. Therefore the employer was going to take credit for half of it in determining your benefits. Well now with the offset plans not being able to offset Social Security, what we really have is a final average pay accrual minus a final average pay offset. Now try to think about explaining that to the employees if you had trouble explaining the Social Security offset to employees. So now, from the communication point of view, you have a reason to maybe move away from offset plans and move over to an excess-type formula; just from the communications view and also the administration of the plan.

Your concerns on administration are probably a function of the client's capabilities. If you are doing manual benefit calculations, then you probably do not want to use a covered comp table by year of birth where each person, depending on their year of birth, will have a different integration level assigned, which could obviously be quite burdensome if you are doing manual calculations. However, if you've got it computerized on some basis, then I think you can use the year-of-birth covered comp tables; you don't have to worry too much. You put your table in the system and it goes ahead and calculates the benefits for you. So another thing to think about is who is going to administer the plan, and what the capabilities are of the plan administrator in doing all this.

Also regarding communication, are you going to take advantage of the fact that you could have three formulas that vary by Social Security retirement age? The regulations say we could vary the disparity just because of that, and again the answer to whether you go that route is your answer to the communication and administration issue. Using the three formulas may get you to where you want to be regarding benefit replacement, but then when you think about having to communicate that to the employees and having someone administer it, they may say to forget about it and just focus on complying with the rules as they apply to someone with a Social Security retirement age of 67.

Once you get through all of that, there are some other features that clients decide to give or take on. One of those features is subsidized early retirement. As you know, the new rules really cut down the disparity, especially when you have subsidized early retirement. So the question to the client is, do you want to keep your subsidized early retirement benefits? If the answer is yes, then we're looking at a smaller disparity in benefits high-paid to low-paid, and we're looking at, obviously, increased benefits. The other scenario would be to say, well, they want to keep the disparity that they currently have between high-paid and low-paid, which really then means that for early retirement we are going to have to take away some of those subsidies in order to work within that framework. So again, you can't have your cake and eat it too here. You have to give up something or be willing to pay a little more in order to maintain some semblance of what you had before.

Another thing to consider is the appropriate integration level. Under the old rules we could pick any integration level. We could use pretty much any break point we wanted and not have to worry about the demographics of the group. Well now depending on the plan you're working with, demographics will have a very strong impact as to where you set that integration level, if you want to use something other than year-of-birth covered comp, or some of the very low breakpoint numbers like $10,000 or half of covered comp. If you are forced into using a break point that's $10,000 or half of covered comp for someone reaching Social Security retirement age in a year, you've got to ask yourself the question, does it even make sense to integrate the plan? If I'm using a break point of $10,000, in most cases almost all plan participants are going to have a big portion of their pay in excess of $10,000, so you're not getting much integration for doing all of that.

Also in thinking about the demographics of the group, looking at the distribution of high-paid versus low-paid, you've got the issue of how this distribution is going to work in the future. One of the open issues is that if we design the plan now, and it satisfies the demographic test, do we have to maintain that satisfaction every year? Or can we just do it once and if there is no major amendment in the interim we'll be all right? If the answer turns out that we have to satisfy that demographic test every year in order to use these certain breakpoints, then we've got to think when we're doing this initial phase that the distribution of high-paid to low-paid is such so I can use the number now, but where's it going to go in the future? Is it going to be such that two years down the road I'm going to have to modify my plan? If I do, in most cases it's probably going to be an increase in cost under those scenarios. So I think more than before when we're designing these plans we have to think about impact on benefits now and also impact on benefits out in the future. You have to look at what's going to happen to the normal retiree, the early retiree, and the deferred vested individual and see if what happens to those individuals meets the client's goals regarding all of these things.

Another issue is employee contributions. That's a big open issue. We don't have much direction on that right now, but what little direction we have is that the use of employee contributions could hurt you regarding the maximum disparity. For example, let's say we have a simple excess formula where it's 1% up to some number and 1.75% over, and let's just say that for practical purposes the reduction in that due to employee contributions that we have is .5%. So we start out with a formula that's 1% and 1.75%, which meets the disparity rules right there. But when we make the reduction of .5% to reflect that the employees are paying for it, now we're down to a formula that's .5% and 1.25%, which doesn't meet the disparity rule. So under the old rules, if you had employee contributions, you got to increase your maximum disparity. Whereas under these rules it's possible that they would make you decrease your maximum disparity. So because of that, if you have employee contributions you need to step back and ask if you really need them. Are they here for a financial purpose such that the client cannot afford the plan unless we have employee contributions? If the answer to that is yes, then you go ahead and keep them and you work your way around it. On the other hand, if the only reason you have employee contributions is to try to distinguish this plan from another plan -- let's say there is a salaried workforce, a union there are the employee contributions in the salaried plan just so it is different, and you must keep that there to maintain a difference -- well then what you want to do is take those employee contributions and reduce them to the minimal level that you can afford to have in your plan.

The transition rules should also be given some thought if you are doing something other than the all-service route. If you are going with frozen past service, consideration needs to be given to the fact that we don't know how that past service benefit can be increased in the future to reflect future inflation. If it can't be increased at all, well then you've got a piece of benefit that is going to decline dramatically as people's pay goes up in the future. That needs to be given thought if you're going the frozen past service route.

And then, I'd just like to add one other open issue. Dick mentioned quite a few other open issues that we are waiting for additional guidance on. I think another one that would be quite helpful to us would be the impact on the permitted disparity of, let's say, either ad hoc or automatic cost-of-living increases. The old rule said that if you had cost-of-living increases that didn't exceed the consumer price index (CPI), you didn't have to make any adjustments to your maximum offset or your disparity on excess plans. There are plans out there, albeit there are very few, that have these automatic features in them, and those companies really can't go forward unless they know that the rules will be maintained status quo on the cost of living, or they have to take some reduction in permitted disparity because of the fact that they have this cost-of-living feature in the plan.

MR. JOHN F. WADE: I'll discuss mostly topics that either need a little additional clarification, or where we are considering some changes or modifications to the regulations. Ordinarily when we put out a proposed reg, we receive comments from the public and we analyze those and go back and look at the reg and then at some point in time put it all together and produce a final regulation. Now there are four or five areas that we believe are sufficiently important where we are going to try to put out something much sooner than that in the form of a notice, and I'll be mentioning some of those topics. This notice is fairly far along and has gone through all the layers of review that it has to pass in order to be public, and it may be out soon, perhaps as early as next month. I'll also try to make comments about some of the open issues that both Dick and Mike brought up. Some of them can give you a pretty good idea what our thinking is, and with others all I can do is agree that it is an open issue and it will have to be resolved later.

I'd like to clarify how you handle the different percentages because you have individuals with three different Social Security retirement ages in your plan. As was pointed out, if someone has a Social Security retirement age of 67, that .75% drops down to just .65%. It's .7% for someone with a Social Security retirement age of 66. The regulations do say that if you have a difference in disparity just because of this that it's not considered a violation of the uniform disparity requirement. However, how do you go about writing your formula to accomplish this? Well the Regs give an example. That example has a formula of 1.25% of comp up to the integration level and 2% over for those with a Social Security retirement age of 65. For people with other Social Security retirement ages, the way it was handled was to increase the base percentage to achieve the proper amount of disparity. So for someone with a Social Security retirement age of 67, the base was increased to 1.35%, the excess remaining at 2%.

Now is that the only way to do it? Could you, for example, keep the base the same, let the base be 1.25% and just let the excess percentages vary? The answer to that is no you can't. I'm not sure the reg is as clear as it could be on that. But you cannot do that. And to see that, I think you have to look at what 401(l) accomplishes. As it stated in the reg and also the preamble, it's not an automatic safe harbor in showing the plan as nondiscriminatory, although generally it is enough. There are a couple of obvious exceptions. For example, you may have an early retirement benefit that applies to one group as opposed to the other. But really what 401(l) allows you to do is if you have a formula that's higher for a comp above the excess level, you can consider that plan to be providing that level of benefit on all comp. So in our example of 1.25% and 2% for discrimination purposes under 401(a)(4), you can consider that plan to be providing a benefit of 2% of pay on all compensation. Now what happens if you have this same base, a 1.25% level, but the excess varies? Well, for those with a Social Security retirement age of 65, we are looking at it because of 401(l) and its permitted disparity as a 2% of pay plan. For those with a Social Security retirement age of 66 where you kept the base at 1.25% and we lowered the excess to 1.95%, then the formula is only 1.95% of pay for those individuals. Likewise, it's 1.9% for those with a Social Security retirement age of 67. So you have percentages that are different. Even though the permitted disparity requirement is met for each individual, the plan is providing different benefits for different people, and it may be discriminatory. It most likely is. So that is not an accepted way to do it.

Another way to look at this, if you go back to the historical reasons for allowing integration, or permitted disparity now, to reflect the fact that if the plan benefits and Social Security benefits together are providing the same benefits as a percentage of pay for everyone, the plan is all right. Now if you compare in this case someone with a Social Security retirement age of 67 to someone older who is retiring at 65, the person whose Social Security retirement age is 67 is receiving a lower Social Security benefit at 65 than the other individual. If you just keep the base the same and lower the excess, you are compensating for it by also giving him a lower benefit from the plan, so it's lower from both sources, and that really does not accomplish the objective of equalizing things when you consider the two combined. The only way to do that is to increase the base percentage.

Now I'd like to jump into one of the topics that we expect to address in the notice mentioned earlier. That topic is the integration level in defined contribution plans. The regulations, as they are written, don't allow any flexibility at all; you have to use the taxable wage base. However, you do have the option of possibly under 401(a)(4) demonstrating that some other integration level would be acceptable. One problem is that those regulations aren't out yet. The other is you would have to test that basically every year and show that it works year after year. You couldn't just pick up the plan document, look at it, and say, it is fine.

What's the problem with integration levels below taxable wage base? Basically for a DC plan 401(l) defines a standard type of permitted disparity, if you want to call it that, which is determined by integrating at the taxable wage base. It does permit lower integration levels, but there is a pretty strong indication in the committee reports that that should be allowed only if it doesn't result in discrimination. And it can very easily result in discrimination. Just to take a simple example, let's say we have a plan with two participants. One is earning $20,000 and the other is earning $100,000. And let's just say the wage base is $50,000, just to have nice round numbers. Now, if you integrate at that level, going back to our idea of combining plan benefits and Social Security benefits, both employees are treated approximately the same way. Well what happens if we were to lower the integration level, let's say to $20,000? The result would be that the individual earning $100,000 would get increased benefits based on this additional excess compensation of $30,000, the difference between the wage base and $20,000. The individual earning $20,000 would receive no additional benefits whatsoever. That's just the type of situation that was viewed as a problem, and why the regs don't allow this lower wage base. However, under 401(a)(4), it is possible that the plan could justify that $20,000 wage base. I don't think it could in this case, but it could in another situation where there are other employees at a range of compensation levels going up from $20,000, where a significant number of employees who are not highly compensated are benefitting from this lower integration level.

We received a number of comments from people indicating that they feel we are really being a little too severe by not allowing these integration levels, and they have a variety of reasons. Traditionally they used the lower level. It may be quite low, it may be the $7,800 figure Dick mentioned or $10,000 or $15,000. Now if they had to jump all the way to the taxable wage base, that would be a tremendous problem for them in communicating that to their employees. Also some employers have stated that the backbone of their workforce are those making $15,000 or $20,000 on up. And these are their career employees who they would really like to reward by having this lower integration level, and they are not allowed to under the regulations. So we are considering modifying this. How would we do this? Well, first of all, if the integration level is low enough, it really shouldn't be a problem. An example is, if you integrated at, to take an extreme case, a dollar, doing that really doesn't introduce any discrimination whatsoever. Likewise if you integrate at a level just below the wage base, say one dollar less, again, that doesn't introduce any discrimination. So at the two ends of the range, some sort of integration level should be allowed without much of a problem. So we are looking first of all at some sort of de minimis integration level. That likely will be permitted under this notice. I can't give you any exact figures now. That hasn't finally been decided on, but you might draw some parallels with what's being done in the DB area. We have a de minimis level so it shouldn't differ from that by much.

Now, what about other integration levels in between the mid-range? What we hope to be able to do is allow integration levels in that range, but with a tradeoff; the tradeoff being that the 5.7% has to be lowered. That would be similar to what's done in the DB area where you can have an integration level higher than covered compensation, but the .75% is cut back according to the table as Dick showed. So that's another thing we hope to be able to do in this notice. Now, an employer would still have the option of using some other integration level without adjusting the 5.7%, if he can show that it's nondiscriminatory under 401(a)(4); 401(l) does not help you. Doing it this way would be permitted under 401(l). Therefore, it would not have to be tested each year. It does not depend on the demographic characteristics of the employees.

Another area that we're looking at is the area of integration levels for defined benefit plans. There are other integration levels permitted currently other than covered compensation. But, some of those require demographic tests. And that has its share of problems. Basically, you have to test it each year under the regulations. So, again, we're considering permitting other integration levels of uniform dollar amounts, fixed dollar amounts that would not require this demographic testing; but again with a tradeoff. And the tradeoff being some additional reduction in the .75%, or the .65%, whatever is appropriate. We hope to have it in the notice that will be coming out. I think one advantage of this is if a plan doesn't want to fool with the demographics, it is too much trouble, but they decide to go strictly with the covered comp definition, that's an amount that changes each year.

Not only does it present problems in communicating to the employees, but there's another problem under the regulations which perhaps doesn't come through very clearly. But there's some talk in the regs about Sections 411(d)(6) and 411(b)(1)(G). They both deal with reductions in accrued benefits that aren't permitted. Section 411(d)(6) deals with plan amendments. Section 411(b)(1)(G) deals with reductions due to increasing age and service. What this means is that if you are using covered comp, this amount which floats each year, as it goes up it could cause someone's accrued benefit to go down. And that would not be permitted under these two sections, so it would require that you check this each year. Going to one of these fixed dollar integration levels or something else where it doesn't automatically change would get you out of that particular problem.

I might mention that another idea we're considering for this notice is the idea of a frozen table -- you can start with a table and then freeze it. It would be frozen, however, for a period of time; a few years perhaps, four or five years, something like that, before you have to change it. You know at that time you would have to protect benefits that are accrued, but I think it would alleviate some of the administrative problems, and it's something that people have been requesting.

Let me comment briefly on the definition of covered compensation. I think Dick covered it pretty well. As he pointed out, there is some conflict between what's in the committee reports and what's in the Code. The regulations took sort of half-and-half if you want to call it that, some from one and some from the other. And most of the comments we received have been critical on that. A lot of people said we should just follow the Code itself. In general it doesn't make a whole lot of difference. There is some difference, but we are looking at that again, and we hope to have it clarified one way or the other with this notice. At that time we do plan on publishing the 1989 covered compensation table, also giving the covered comp amounts for those who have already turned 65 in the past also. That would continue to be used in the future. As Dick pointed out, there are basically four ways of doing it; with or without the phase-in he mentioned and with or without using that final year, the year they reach their Social Security retirement age. As far as the rounding that Dick mentioned, we are really planning on doing it the traditional way, which amounts to adding up all the wage bases, dividing by the 35 times 12 or the 420, and just truncating it. Then multiply it by 12 to get it back on an annual basis. We also plan to allow the table where the amounts are rounded to the nearest 600 dollars, as has been done in the past. But we hope to have that clarified one way or the other within the next month or two.

Another topic I want to mention, and it's already been discussed, is the idea of career average plans. What the regulations permit really isn't the traditional career average plan that everyone knows and loves so much. I didn't know people loved them so much until the regulations came out, but apparently they do. And also apparently a number of these are integrated plans, and we do intend for those plans to be permitted, that you can have a formula that is integrated where the benefit is based on the individual's compensation in that year. There probably will be some adjustments, however, to the .75%. That is another topic for this notice and we hope to get it cleared up there.

I'll just mention a couple of things that have been raised earlier. One is the idea of cost-of-living increases. As was pointed out, Revenue Ruling 71-446, the old bible of integration, permitted cost-of-living increases for retiree benefits without any further adjustment in the integration rules. The reg was completely silent on that, but we do expect that will continue to be permitted; that you can have the cost-of-living feature without having any adjustments. Another area people have raised questions about deals with late retirement. Just as there are reductions in the percentages permitted for early retirement, what about late retirement? Can you just take the plan's formula and actuarially increase it without violating the rules? If you do that, you are essentially increasing the excess percentage in an excess plan or the offset percentage in an offset plan. We do expect to allow an integrated plan to provide these actuarial increases and I anticipate at some point in time we will give some safe harbor practices for that. That's not part of this notice, I mentioned, but it will be done at some point in the future, either in the regs or perhaps some follow-up revenue ruling to cover all these details that are left unanswered by the regulations.

What about a plan that was contributory but is no longer? Perhaps there haven't been contributions for several years. Well, it may depend on the transition rules used. If you are using the transition rule where you are freezing the accrued benefits at the end of the 1988 year, and just adding on future accruals under the new rules, in that situation I think it's fairly clear you can ignore those past contributions. If you are using the other transition rule where you are placing the benefits for all service under the new rules, and what's accrued through the end of 1988 is a minimum, it's not as clear what the answer will be. This is one of those areas where I can just say it is an open question and we are still considering it. Hopefully we'll have it resolved at least by the time of the final regulations, but perhaps a little earlier.

One other point I want to mention is the idea of early retirement reduction factors. If you want to subsidize early retirement, the regulations seem to say you have to use exactly the same factor for compensation above and below the integration level. I think what was really intended was that for compensation below the integration level you had to use a factor at least as favorable; it could be better. But you can't use a better factor for compensation above the integration level.

MR. SCHREITMUELLER: John, you mentioned cost-of-living adjustments, that those essentially would be permitted. I assumed you were talking only about postretirement cost-of-living adjustments. You didn't mean to solve the cash balance problems.

MR. WADE: Yes, postretirement, as in 71-446 where it stated that they are due to some generally recognized cost-of-living index. I don't even want to touch cash balance plans. Quite frankly, cash balance plans are pretty far down on the list of priorities. I know to some people they are very important, but with the other things that have to be done, they are probably low on the list.

MR. HILL: John, I'd like to ask you one question that has to do with the demographic tests. It seems like the demographic tests were there to prevent abuse with what I'll call small plans, where you have just a couple of people in them. And because of trying to prevent abuse there, it seems like it made life harder for most of the larger plans. Isn't there some way to eliminate these demographic tests in larger plans, where they're very complex to do? This may be justified since picking an integration level to discriminate in a larger plan is kind of hard to do.

MR. WADE: Well we are considering something. It's not exactly on those lines, it's more in the area of extended reliance. As I mentioned, generally you'd have to meet these demographic tests each year. One option we're considering will be a topic addressed in the notice I mentioned. We're considering this extended reliance idea where, if you meet the demographic test for a year and receive a determination letter on the plan for that year, then as long as there aren't really any significant changes in your workforce, you can rely on that determination letter. In other words, you would not have to do the demographic test for a period of years, it's not going to be unlimited, but perhaps for three, or four or five years to cut down some of the administrative problems there. It's not going to be differentiated according to plan size, and I might add that in order to have this reliance, it only applies if there's not any kind of significant change in your workforce. If there is a significant change, then you'd have to go back and do your demographic test again. That sort of significant change may be more likely to happen in a small plan, so that may be the effect, but it's really not viewed as a large plan or small plan type of rule.

MR. LANE B. WEST: John, are there answers to the following questions at this time? Will the fractional accrual rule be deemed to satisfy the uniform benefit requirement? Will the 1/15th, 1/30th early retirement factors be reinstated as permitted? And then finally, in your definition of annual average compensation do you think we will be allowed something like the high five of the last ten or fifteen years as a definition?

MR. WADE: Well, those are all good questions. First of all, let me just say the fractional rule and the deemed uniformity, is really an area where additional work on the 401(a)(4) regulation has to be completed before that can be answered. The committee reports indicate that in certain circumstances at least Revenue Ruling 81-202 has to be modified. One modification is to take into account the rate of accrual. The rate of accrual does vary in a fractional rule plan. It's different for older and younger employees. And the question is, what does that mean? It can't mean that you can't have fractional rule plans. I think most of the plans are written that way. But that's just an area that will have to be looked at and I really can't give you an answer now. The 1/15, 1/30, I don't know. That's again open for discussion and consideration. We have had a number of people write in, indicating they didn't really understand why that wasn't permitted and they did point out quite correctly that the 1/15th, 1/30th factors are stated there explicitly in the committee reports. I have to say I really haven't heard any discussion on the high five of 10 but just my offhand reaction is that I don't see why it shouldn't be permitted. It's been permitted for a long time, so I don't see why it shouldn't be permitted now.

MR. MICHAEL E. CALLAHAN: On the uniformity issue, one of the things that was brought up was that the Social Security PIA offsets may no longer be allowed. Do you find that the same, John? Is that your feeling as well?

MR. WADE: Yes, I think the regulations really don't permit that under 401(l) because it does involve differing offset percentages. So I don't think 401(l) brings it in. It's just a question of, can you somehow justify it under 401(a)(4)? To justify it under 401(a)(4) you may want to do that by somehow computing Social Security. I really am discussing permitted disparity, and you would have to do that under 401(l) approaches, you know, the .75% and using the two-to-one ratio, but as far as 401(l) is concerned, I would say that it's awfully difficult to have a PIA offset.

FROM THE FLOOR: Regarding changeovers from a defined contribution plan to a defined benefit plan, or vice versa, where we have an allowance there for double integration in a sense, if we were able to have say a fully integrated defined benefit plan and then install a defined contribution plan, at that point in time do we have additional integration rules?

MR. SCHREITMUELLER: Well it sounds like we're back to the basic rules, so let me try to take that one. The rules do speak to that. There's a section in there about combined plans at the end. They define a DB fraction and a DC fraction, and it all hangs together perfectly well except it seems utterly impossible to administer. That's the impression that I came away with.

MR. DONALD J. SEGAL: Could you address the maximum permitted offset, or maximum permitted disparity, and the transition rules, if you had a plan where you were not using, let us say, the maximum integration for any individual? I know it's going to be an individual-by-individual test. Let's say you had the equivalent offset of .5% of covered comp for 20 years. Therefore you are only using 10%; could you use another 16.25%, let us say, for your future service? Or would you be limited in this particular case to just 15 years of offset in the future, because you have used 20 already.

MR. WADE: Well, the rule in the regulations really does not take into account the extent to which you were integrated in the past, and I believe that's what you are suggesting doing. To do that, perhaps in certain cases you may have a simple example where it can be done. Actually, it was considered in drafting the regulations, but it was dropped for a number of reasons. Plans' integration levels may have varied over time. An individual may have been in a DC plan at certain times and a DB plan at others. It was just decided that it got unbelievably complicated and just impossible to make it work, so that idea was dropped. And what's allowed now is you really don't look at the extent to which it was integrated. Perhaps if you could come up with a rule for us that works in all cases and is nice and simple to use, we'll be glad to read it and look at it and use it.