RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 4B

SOCIAL SECURITY INTEGRATION

Moderator: RICHARD G. SCHREITMUELLER
Panelists: DONALD S. GRUBBS, JR.
KATHRYN G. MARTICELLO
Recorder: WAYNE R. FOSTER

- o What limits on pension plan integration take effect in 1989?
- o What is the impact on final average, career average, offset and defined contribution plans?
- o What actions can plan sponsors take in response?

MR. RICHARD G. SCHREITMUELLER: This session is going to be on the subject of Social Security Integration. Also, you will get credit for this course under the new rules for continuing education of enrolled actuaries (EAs). It's considered a core subject as is any subject that deals with plan qualification.

My job will be an easy one, because I have two very distinguished people with me to really do all the work putting on the session and a third one to help immortalize it afterward. Donald Grubbs has had a long career in the world of pensions -- in consulting and insurance and in government, and currently he is in consulting with his own firm in Silver Spring, Maryland. Don, among other things is an EA. He was in at the inception of the EA Program back in 1974, and among his many talents, he's particularly good at explaining integration. I've tried it myself and it's very difficult and so I'm happy to have Don doing that part of it. After Don, we will hear from Kathy Marticello. Kathy is with the IRS and is also a member of the Society. She's also had some experience in consulting. Kathy has had some involvement in these regulations -- how much I'm not sure, perhaps we can judge better after we hear from her and try to field some of the issues. Finally, Wayne Foster, from TPF&C, has very obligingly agreed to record this session.

We had hoped to have some regulations by this time, but we don't. The law was passed approximately two years ago. The Tax Reform Act of 1986 pretty much rewrote the Internal Revenue Code as far as the ways that you are allowed to integrate pension plans with Social Security. That law said that any necessary regulations would be out by February 1988. Someone made the point that perhaps no regulations are necessary, but I think we would disagree with that, so there has been some delay. The Revenue Service is busy and these are difficult problems. So that's where we are. The compliance date for this is nominally at least January 1989. Exactly how much needs to be done by that point is open for discussion, but obviously it takes a great deal of planning. There are many alternatives available in getting a plan to square up with these new rules and a lot of things to explain to employees, so it's a subject of great interest.

MR. DONALD S. GRUBBS, JR.: I'm going to start out saying a couple of very obvious things. To put it in context, why do we integrate plans at all? For most of my clients, the reasons for integrating plans are to provide a suitable level of benefits for people at all levels of pay. If an employer has an objective to provide suitable replacement ratios, say if they feel that long-term employees ought to have 70% of pay as a pension to provide an adequate retirement income, there is no way that you can even come close to that objective if you don't integrate the plan. However, I have a client like many of you do, a small employer, who uses integration as a way not to provide benefits for low-paid employees while providing as much as possible for high-paid employees within the rules of the game. So integration has been used for both purposes.

The statute really does three things. In a nutshell, it places some limitations on the amount of permitted disparity between what the high-paid employees get and what the low-paid employees get. Second, for the first time it brings the idea of minimum benefits. In the past, we only focused on whether the program was discriminatory, whether the pension benefit plus the employer-provided portion of the Social Security benefit was in the aggregate producing more for the high-paid employees than for the low-paid employees; and, if you could show that providing no benefit under your plan for the low-paid employees plus their Social Security benefits gave them a bigger percentage of pay than what the high-paid employees were getting, that was OK. We can't do that any more because there is now a concern that at least minimal benefits be provided for everyone. And the third objective, and we may have differing views about how well it's accomplished, is the objective to simplify the requirements. There was widespread recognition in Congress, as well as by those of us in the field, that Revenue Ruling 71-446 and all of its permutations were just too much. People couldn't understand them, and they were difficult to work with. Thus, we have a legislative history saying we're trying to simplify things. I have a paper that tried to summarize the new requirements. I would warn you though, there are some things in there that will soon be obsolete when we get regulations; there are some things that are going to change in there. I'll mention some of those as we go along.

Effective dates -- this generally applies to plan years beginning in 1989. Benefits -- it applies to benefits that accrue after that point. Benefits that accrue prior to the effective date are not subject to new requirements and presumably you can keep using the rules under Revenue Ruling 71-446. On the other hand, it's my expectation that if an employer wants the same benefit for past service and future service, it will be OK if your entire benefit formula, for past and future service, complies with the new rules. I hope when Kathy's turn comes she will point out anything that I'm saying that's incorrect.

A word regarding regulations. As I looked at the statute, I found something very unusual. Usually the IRS has authority to issue regulations to carry out the provisions of the statute, and that's to be expected. Here, it says, however, that the IRS has the authority, or the Secretary of Treasury has the authority, to publish regulations to carry out the purposes of the statute. Now that's good news and bad news. The bad news, perhaps, is that where they are only issuing regulations to carry out the statute itself, courts don't hesitate to put down the regulation, to set it aside, if they go astray. We've seen a lot of examples of courts saying "No, IRS, this wasn't what the statute said." The good news part of that, however, is that we have a statute that's not well drafted, and the IRS has the opportunity to correct those things and they can take a rather free hand as it says, "Well, here is the real purpose, we can get over those glitches." One of the really bright hopes, it seems to me, is that we have a legislative history of an intent to simplify the requirements. Thus, the IRS can say, "This is the purpose, therefore we can write our regulations that may twist the details in this statute a little bit because we know it was Congress' intent to try and simplify things." That provides a very good opportunity, it seems to me, to the Service. Now these regulations, the statute said, were required to be published as final regulations before February 1, 1988. We don't have final regulations yet, we don't have proposed regulations yet, and I want to say that I am absolutely certain that it's not Kathy's fault.

The Secretary of the Treasury indeed had a difficult task when this law was passed in 1986. The burden, not of just this regulation, but an enormous number of regulations in the employee benefits field and others that were required to be published, was obviously a tough job. Now you and I also get tough jobs at times. We have clients who say, "I have a Board meeting coming up on such and such a date" and your first reaction is to say, "I don't see how we can possibly get it done," and somehow you manage to adjust your schedule to do that, and one of the reasons that I'm so confident it's not Kathy's fault is that Kathy used to work for me over at Buck and she was someone who worked as hard as anyone I've seen to meet those deadlines, and I always appreciated it, Kathy. But it would seem that the Secretary of the Treasury, recognizing this tremendous burden of regulations to get out, somehow would say, "We're going to have to beef up the number of people assigned to this task, we're going to have to hire some other people, I'm going to have to find some other way to meet this responsibility." It wasn't done. We are about to get proposed regulations, we think quite imminently, but they are just proposed regulations. The regulatory process under the Administrative Procedures Act is one where we have a system of developing proposed regulations as a basis for getting input. That input is pretty important and it may be the most important thing I have to say here -- that you have the opportunity to get in the input. Now I know that when I was in the Service, I felt that this input was extremely valuable for two reasons: one is the maze, the variety of pension plans out there is just enormous. While I have seen a lot of different kinds of pension plans in my career, I always had the feeling that I could develop a rule that seemed really very suitable and then someone was going to say, "Say have you ever seen a plan like this one over in Company A?" I look at my proposed rule in light of that and I say, "No we didn't really think through how it was going to apply in that situation." That's a valuable kind of input that can help in developing the final regulation. The other reason I was always happy to get input was that I knew that although we had some bright people in the Service, I also knew there were a lot of bright people outside and I knew that we didn't have all the bright ideas and so we welcomed, I think, ideas from elsewhere. And so we're going to get their best thinking to date on these proposed regulations. Look at them carefully, think creatively. Are there problems? Are there ways we can better achieve these Congressional purposes? Give them your ideas through comments.

Now these requirements. First a word about defined contribution plans, which are not the primary concern of actuaries. As always, we define integration level, we used to call it the break point. We have a base percentage of contributions below the break point and an excess contribution percentage above. The permitted disparity, the difference between the two, may not exceed 5.7% of pay. The statute says 5.7% or the tax for the Old Age portion of Social Security. Just ignore that, because it's never going to be above 5.7%. At least in my review of the Social Security 75-year projections, I don't think it's going above it in the next 75-years, so it's 5.7%.

The other rule was a rule of parity, which says that the disparity, the difference between these two percentages, can't be bigger than the base contribution percentage -- you can't have the ratio of the two percentages more than 2 to 1. As for the break point, the integration level for a defined contribution plans must generally be set at the Social Security taxable wage base -- $45,000 this year. A higher integration level is just not permitted. A lower one can be permitted only if it's nondiscriminatory, and perhaps Kathy will comment later on those circumstances where it might be discriminatory. My written outline discusses that in some detail as well. As for this integration, for defined contribution plans, it gets a little tricky because it also has to be tied in, if you have a top-heavy plan, with the top-heavy minimum contribution requirements. If you have a profit sharing plan, it's a little trickier yet, and in my written paper I kind of step through that.

But let's go on to defined benefit plans. Think for a moment about the compensation which is used in your defined benefit plan, regardless of whether it's an excess plan or an offset plan. If you read the statute literally, it would seem that all defined benefit plans that are integrated have to be based on three-year final average pay. That clearly was not the intent. It would seem if I read it that I just couldn't have a five-year final average pay that was integrated, or a career average pay plan that was integrated. That was not the intent and I expect that regulations would recognize that that was not the intent and you would be able to have integrated five-year final average pay and integrated career average pay plans. It's not entirely clear, but maybe Kathy will enlighten us on this later, whether in my career average plan I can integrate it on a year-by-year basis, as we've generally done in the past, or whether I'm going to have to look at average pay over the career for purposes of integration.

A word on defined benefit excess plans. Under prior law, of course, we could have pure excess plans. Nothing below the break point and some percentage above the break point, if it wasn't too much. Now we can't have a pure excess plan, we can only have what we used to call a step-rate plan. One percentage of pay below the break point and another percentage above the break point. We have a base benefit percentage and an excess benefit percentage. These terms are the new lingo that we apply. The difference between the two is called the maximum excess allowance: the difference between the percentage above and below the break point. We have three limits on what that can be. The first is a 2 to 1 rule or rule of parity that says the benefit above the break point can't be more than twice what it is below the break point. The second rule is a rule on the total benefit for all years combined that's .75% of excess compensation times years of service, but in no case more than 26.25% -- that's equivalent to 35 years at .75%. And also a third rule that relates to the individual year and says with respect to any individual year, my maximum excess allowance cannot exceed .75% of my excess pay.

Now, these years that we count, when I said how many years we can take into account, can only be years during which benefits accrue. And that doesn't mean the years upon which the benefit at age 65 is determined. For example, I might have a plan that's just going to credit all years of service for determining the benefit at retirement. But when it comes to the accrued benefit, if I use the fractional rule based on years of participation in the plan, I haven't counted those past service years, those pre-participation years, for purposes of determining the accrued benefit. Therefore I may not count those years for determining my maximum integration. In that case, think of the strategy, and this often comes up in establishing a new plan, where in the past you might have been inclined to use the fractional rule based upon years of participation, now maybe you want to use a fractional year rule based on years of service -- years of all service to date compared to projected years of service. That satisfies the vesting requirements of Section 411 and it allows you to use all of the years for purposes of integration. Not only that, that particular approach produces a larger accrued benefit and helps you avoid problems with the full funding limitation for funding purposes and so that can be desirable too.

Small employers have been reluctant to establish initial accrued benefits for past service because they have been concerned on plan discontinuance, fearing they might get stuck with that liability for Title IV purposes. Now the full funding limitation may be pushing them in the other direction. To recognize that past service for benefit accruals and integration produces even greater benefits.

Next, we talk about the break point -- What is it? Well, it generally has to be set at covered compensation as defined by the statute. It can also be at any lower level. A higher integration level may be used, but if I use a higher level of integration instead of covered compensation, I have to cut down the allowable percentage. If I use a lower integration point than my covered compensation, I don't get to increase the percentage. My allowable percentage stays the same for this lower covered compensation.

As I read the conference report, I was just delighted. I saw in there this phrase that says, "It's the same as covered compensation has always been." I was just so happy to find something that hadn't changed in this whole thing. Then I went on reading a little further and it says, "Covered compensation is the average taxable wage base for 35 years, ending with the year someone attains age 65." I said, "Wait a second, that's not the old law at all!" It actually differs from the old law in two important respects. Under the old law, covered compensation was a period of years ending the year before someone became 65. Now it's the year they reach 65. Under the old law, we took account of the fact that under Social Security, although the maximum averaging period is 35 years, for older people it's less than 35 years. The new law doesn't do that. It's 35 years for everyone. And then having seen this disparity between what the statute said and what the Conference Committee report said, when they got around to issuing the Blue Book, which is the Joint Committee's explanation of all of this, I was very anxious to see which of these two viewpoints was right. What is right according to the Blue Book, and I'm assured the regulations are going to follow the Blue Book, is the 35 years ending with the year someone would attain his/her Social Security normal retirement age.

That's age 65 for old fogies like me. But if you were born between 1938 and 1954 it's age 66, and if you were born after 1954, it's age 67. That will be the basis on which it is determined. Now, that makes the numbers come out a little different. I have a table with my outline that compares the present ones with the new ones and in a nutshell the new requirement, compared to the old covered compensation, is a little lower in the early years and a little bigger in the later years. If this were in effect in 1988, it doesn't go into effect until next year, but I figured it as though it were in effect this year -- $15,709 for the people reaching age 65 this year, gradually increasing to some $45,000, the current taxable wage base.

As under prior law, I believe we will have three choices in deciding what our break point is going to be or three approaches that we can take. The most common thing that was done in the past was to put in the plan document a single break point that applied to everyone. It was usually the number at the top of the covered compensation table. The one that was the lowest number that apparently could affect anyone, and that break point would apply to everyone. If I were doing that this year, I would say it's $15,709.

A second permitted approach is to take that table and put that in your plan document and say it depends on your year of birth what your break point is, and that would be a number, which for the old people is $15,709, gradually increasing to $45,000. On the other hand, if you could put into the plan a definition of covered compensation, as it was in the past under Revenue Ruling 71-446, or is now under the new statute, that will make it automatically move. In my paper, I put in a table showing what it would be if the taxable wage base were to increase 6% per year in the future. It shows that it starts out at the $15,709 like the other one, but for the younger present employees, I projected a number of something like $180,000 as the break point. That $180,000 really is comparable to the $15,709 this year. If your objective is to continue to have benefits that are properly correlated with Social Security and continue the replacement ratio for the people in the future that you have for people retiring today, comparable people, then you can serve that need best by putting that moving break point into your plan. Otherwise, you are unconsciously and automatically really getting a gradual year-by-year erosion of the integration, less integration and automatic benefit increases year by year.

Also, if you have clients like some of mine who say, "Tell you what I want to do, I know we have to change what we have. I currently have an offset plan and you tell me I would be better off changing to a step-rate plan or excess plan under the new law. I don't want to cut anyone's benefit, I would like to be able to assure my employees that no one's benefit is going to get cut. On the other hand, I have the objective that I don't want to increased costs. At least I would like to have the minimum possible increased costs." I think that I can demonstrate that if these truly are your real objectives, you can best accomplish those objectives by using this definition in your plan rather than either the table or the fixed number. With it you can come up with a formula that provides virtually no increase for the high-paid people and a rather modest increase for the low-paid people compared to the present typical offset plan with a 50% offset.

It seems to me, though, that in designing these plans, although I can use these 35 years ending at age 65 for the people born before 1938 and 66 for the next group and 67 for the next group, this is overly complex. I think participants in the plan are going to question that. They are going to say, "Why aren't I doing as well as those older people there?" and this will be an area of contention. It makes more sense to me to use the 35 years ending at age 65 for everyone, and in most situations that is going to be clearly nondiscriminatory. It's a little lower than the maximum break point that you could use, but it simplifies the explanation of the plan to employees. Very little change in benefits and cost.

Now, this maximum excess allowance -- I told you it was .75%, I was lying to you. It's only .75% if you were born before 1938. It has to be cut back for people who retire prior to the Social Security retirement age. It's cut back 1/15 for each of the first five years prior to the Social Security retirement age, 1/30 for each of the next five years, and an actuarial reduction thereafter. That means that for those young employees (and your plan of course cannot have a normal retirement age higher than 65 -- the statute doesn't allow us to have a normal retirement age higher than 65), the integration they can have at age 65 is .65%. It's cut back. Therefore, your formula, assuming that you don't want to have a different benefit formula for three groups of employees (and I think that if you have a formula that's .75 for one group, .65 for another, you're going to have unhappy employees), should use the .65% for everyone. It's permissible for everyone and it's the only number that you can use if you want to use the same thing for everyone. It's possible that using different ones would be discriminatory. So I could use the .65% at age 65, reduced 1/13 for each of the first three years. 1/13? I thought I was talking about 1/15 a minute ago. Well, it's 1/15 of the limit at the Social Security retirement age, and it's the 1/15 of .75, but when you've chopped it down to .65, it's only 1/13. So I could use my .65, reduced by 1/13 for each of the first three years and then reduced by 1/26 for each of the next five years, with an actuarial reduction thereafter. I'm hopeful that the Service will eventually give us some kind of safe haven on that earlier reduction. It would be nice to have something from the Service that says X% is the right number when you are back beyond the 10-year period below the Social Security retirement age.

The other limit my paper speculates about is the maximum excess allowance -- you know there are two limits on the .75% limit and then the 2 for 1 limit requiring that the maximum excess allowance cannot exceed 100% of your base benefit percentage. Does that 100% of the bases benefit percentage also get cut back for early retirement, so that my young person retiring at age 65 only can have 86.66% and not 100% of his base benefit percentage? The literal reading of the statute might lead one to that, but I think that's not apt to be. I understand that the 100% will not get cut back. Kathy indicated that she thought that was her expectation and I was a little relieved on that front.

The good news, after all those things you might consider bad news is that we have no adjustments in this maximum excess allowance for the form of annuity, for death benefits or for disability benefits.

Now we come to offset plans: fortunately, I've been able to summarize (I think some of you have heard me say it in the past) everything you need to know about offset plans in just three words -- "don't have one." The allowable integration for an offset plan is going to be approximately the same as under step-rate plan or an excess plan. There may be some circumstances in which you can get somewhat more integration in an offset plan than an excess plan. Note that in an excess plan, counting more years of service helps you. In an offset plan, counting more years of service works in the opposite direction, and you may reach a different conclusion about whether you want to use a fractional rule based upon years of participation and years of service in an offset plan.

In a nutshell, the rules for an offset plan say that the offset per year is not a function of Social Security anymore, not related to Social Security, rather it's .75% of final average compensation. In terms of the total benefit it may not exceed 26.25% of pay, that's 35 times the .75%. A further rule says that the reduction cannot result in a net benefit after the offset that's less than .5 what the benefit was before the offset. If you have a fairly low level of benefits, this could result in a little more integration than you could get in an excess plan; but if you have a fairly generous benefit plan (2% of pay per year of service with an offset at the maximum allowable offset) you won't get any more integration at all. For this purpose, the offset's .75% of "final average compensation," the final average compensation is a 3-year average and it's limited to a maximum taxable wage base each year. So if I were doing it in 1988, it would only be $43,600. That's the average of my taxable wage base in 1988 and 1987 and 1986. Just like my excess plan, I cut it back for early retirement, and I don't have to make any other cutbacks.

The law says that I am allowed to use less than the maximum allowable offset provided this doesn't tend to discriminate. When is it going to discriminate? Maybe Kathy will give us a little guidance.

One other thing as we think about offset plans, we might focus on disability offsets. Plans, even plans which are not integrated at all in the usual sense of the word, often have disability benefits offset by disability benefits under Social Security or Workers' Compensation, or your Long-Term Disability (LTD) program. And as I look at the statute, these appear to be offset plans because there's an offset. Offset is not limited to Social Security offsets. And, if you work with them a little, you will soon conclude, if that's the rule, there is no way that you can make a disability benefit in a pension plan (a pre-65 disability benefit) fit these rules of the statute. Answer: Get the pre-65 disability benefits out of the pension plan, put them in LTD, put them in an uninsured disability 501(c)(9) trust or something else.

Another thing, as I look at the statute, it would appears that an offset plan includes a floor plan. In a floor plan my benefit is offset by what the profit sharing plan or some other defined contribution plan can provide. Although that literally looks like an offset plan, I have been assured that that was not the intent of Congress and that it will not be treated as an offset plan.

As one last thing, I would like to focus just a moment on cap plans. You may have read about the provision that said that it's OK to have a plan that says your plan plus Social Security in effect aren't going to provide more than 100% of pay. Well, that's not quite what it says. The cap plans were developed in the steel industry in negotiations with United Steel Workers some years ago because their basic benefit formula, together with Social Security, appeared to be providing benefits more than 100% of take-home pay. So the Steel Workers negotiated with major steel companies to have a benefit that says in no case will this provide a benefit that's more than 85% of pay, which was a rough estimate of take-home pay, less your entire Social Security benefit. Congress looked at that, they didn't know quite what to do about this kind of plan and so they came up with their own rule for cap plans. It was one that cannot possibly work for any practical plan. It perhaps is related to 100% of final pay. It's offset by only the employer part of Social Security, not all of it. It might be half of it or 83.33% of it or something else that the IRS tells us and then only the portion attributable to this particular employer. An employee who has worked less than 35 years only gets a 35th of it for each year. And the total result is that you have a rule that is not workable, certainly for any cap plan of the old cap plan type. The moment this law passed, I recall speaking to audiences saying "This will never work, the steel industry will abandon it." A month later the steel workers and US Steel abandoned it and all the other major steel companies have too. I don't think there are any of those steel negotiated plans left. I predict that this is confusable that we will soon have a provision of the law which doesn't apply to any plan whatsoever by its effective date and we might as well delete it from the law. There's more I can say, but I've talked too long and want to leave time for Kathy.

MR. SCHREITMUELLER: I thought that Don's remarks on the regulatory process were particularly helpful because it is unusual in this case to find language, and I had not noticed it before he called it to my attention, that gives the Revenue

Service unusually broad powers to interpret both the statute and the intent. Perhaps I can be forgiven for having neglected to mention Don's other credentials: he is a lawyer (although he explains things much better than we would expect given that credential).

MS. KATHRYN G. MARTICELLO: I'm sure all of you, or at least most of you, had hoped that I would be explaining the proposed regulations issued by the Service on integration section by section. Unfortunately, that hasn't happened. Let me first of all say that the Service does intend, very shortly, to issue proposed regulations on Section 401(L) of the Code. They are very close to being issued now.

The issues that are not covered in those proposed regulations will be covered under a Revenue Ruling, which will be issued shortly thereafter and will replace Revenue Ruling 71-446 and Revenue Ruling 83-110, which dealt with integration.

Since I can't go through the proposed regulations with you, and since Don has done such an excellent job in explaining the basic mechanics of the new integration rules, what I would like to do is go through some of the issues that we have been wrestling with in trying to come up with the proposed regulations. That way when you actually get to read them, you can say, "Ah ha, I know why that's in there, Kathy explained that to me," and maybe you will have a little more sympathy with some of the things that you read.

The first issue I'd like to discuss is discrimination. Now discrimination is a new addition to the baggage of integration in Revenue Ruling 71-446 and prior Revenue Ruling 83-110. There is no discussion of integration levels that may or may not be discriminatory. The discrimination analysis is left to the pure analysis under Section 401(a)(4). There are two issues with respect to discrimination that we have been advised by the Committee reports to look into in integration. Basically, if you have an integration level that's less than the taxable wage base in an integrated money purchase plan or profit sharing plan, or you have an integration level that is less than covered compensation in an integrated defined benefit plan, or if you have an offset that is less than the maximum permissible offset in an offset defined benefit plan, then you could have discrimination problems. Now, Don has an excellent example in his outline of these concepts related to a money purchase plan. I can just give you the most egregious example of discrimination in setting the integration level in a money purchase plan, which I'm sure none of your clients would ever ask you to do. If you have a very small company where all of the non-highly compensated individuals are earning less than $22,000 and you set the integration level at $22,000 so that none of the non-highly compensated individuals gain any benefit from that lesser integration level relative to what they would have gained if the integration level were at the taxable wage base, the Service might consider that to be a discrimination problem. That's an easy example. When you get into defined benefit plans, offset plans, excess plans, it's not so easy to determine when you have more than five or six participants, whether setting the integration level below covered compensation or taxable wage base is discriminatory. The question that faced us was whether we should go into detail in the integration regulation in trying to establish just how setting an integration level at a certain point could or could not be discriminatory. The basic decision, I think, at least as far as I know now, is that there will be certain guidelines specifying just what a correct integration disparity is and what an integration level could be which would be automatically considered nondiscriminatory.

Now, some of you may have clients who have offset plans with a problem if they, for example, have a benefit formula equal to 50% of compensation, less 50% of Social Security. What they might wish to do is to retain the old formula and put a cap on the maximum offset -- the cap, of course, being the new permissible offset formula. You will not, at least as far as I know now, find guidance as to when that would be a problem in an integrated plan in the proposed regulation. However, that does not mean that you cannot do it. All it means is that in that case, we would not be saying that the disparity in your plan satisfies Section 401(l) and that you are automatically nondiscriminatory merely because of that disparity. What happens if you can't satisfy the rules in 401(l)? Well, you just have to satisfy the rules in 401(a)(4). You go back and do an actual analysis and you impute whatever permissible Social Security you can impute and you see where you come out. Basically, that's about all I have to say about discrimination.

The next issue I wanted to discuss is the issue of parity. As Don said, one of the purposes of the new rules was that excess plans and offset defined benefit plans would essentially provide the same level of integration. Now, Don also said that the Service does have some broad discretion in promulgating rules here based on what we perceive the purpose of the new rules to be. It is true that in some situations you can get a little more integration mileage out of an offset plan than you can get out of a similar excess plan. For example, if I have an excess plan that provides 1% of compensation above covered compensation, I have to provide at least .5% of covered compensation below that level. If I go to the mirror situation where I have an offset plan, suppose my formula is 1% of compensation, now what I am doing is the opposite. I'm carving out something below covered compensation. If I follow the offset rules, and if the individual whose benefit I am calculating has sufficiently high compensation, I can carve out .75% of that individual's compensation under covered compensation. Let me give you an example. If I have an individual with compensation of $80,000 and covered compensation of $40,000, if I apply my excess formula to him, 1% above $40,000 and .5% below, then I'm going to get $400 in compensation above covered compensation and $200 below for a total benefit of $600. If I go the carve-out route, I can give him 1% of his whole $80,000, which gives me $800, but then I could perhaps offset .75% of covered compensation, which is now $300 (.75% of $40,000 is $300). Accordingly, the individual's benefit is being reduced by $100. It's our position, or at least some of the thinking that's gone into it would lead us to the position, that this violates the basic rule and intention to have parity between these two types of plans. So that, when you measure the offset based on the .75% of covered compensation against the benefit which accrued under the plan for that year to see whether you're cutting off more than .5 you would only be measuring against the benefit formula applied to compensation up to covered compensation. In this case, when I went to do the offset carve-out calculation, I would say the individual can only be offset by the lesser of .5 of the 1% of $40,000, which is $200 or the .75 of 1% times $40,000, which would give him also a $600 benefit ($800 minus $200 in this case).

The next issue I'd like to cover is employee contributions. Under the old rules of Revenue Ruling 71-446, if you had a contributory plan, it could only help you. You were permitted to have an addition to the excess allowance, the 37.5% for example, based on the rate of employee contributions under the plan. The addition was a function of 1/6 or 1/8, depending on what kind of plan you were looking at. So that if you had a contributory plan, you got more integration. Now, the new rules state that the maximum permissible disparity is to be judged based on the employer-derived benefit, not the total benefit. There are some complicating factors in that it is not an easy task anymore to figure out just exactly what is the employer-derived portion of an individual's accrued benefit. On top of that, the employee-derived portion of an individual's accrued benefit has become much more important because it has become much larger, because it's now based on a projection forward, using a much higher interest rate. On top of all that, it's become more volatile, because the interest rate that you use to project employee contributions forward is not a constant interest rate for all years, i.e., 5%, it now changes based on an external index. We could have taken the approach that for purposes of integration for determining what the employer-derived portion of the benefit is, each individual would have a 411(c)(2) type calculation applied to him/her for each year. We thought that that would just be an administrative nightmare. We, of course, prefer to have some sort of level type of adjustment similar to the adjustment in Revenue Ruling 71-446 that individuals could use to determine what their employer-derived portion of the benefit is.

Now, it isn't as easy to come up with just an overall factor, because of the complicating rules under Section 411. It isn't as easy to simply say it's 1/6 for everybody. Because of the impact of the higher interest rates, if you have a constant benefit, individuals who enter at a younger age and have employee contributions credited to them through their whole service are buying a proportionately much larger portion of their benefit than individuals who enter at an older age. It's simply the result of the compounding of interest over the years to retirement. So it really isn't fair to have one simple adjustment factor. We really should have an adjustment factor that reflects somehow the age at entry of individuals into the plan, and so I think you should expect to see an adjustment factor for employee contributions that is level to a certain extent, but that does reflect also to a certain extent the average age of the individuals in the plan.

Now, I'll give you an example of how calculating the disparity or judging the disparity based only on the employer-provided portion of a benefit could make a difference. Suppose you have a step-rate plan that provides for 1.75% per year based on compensation above covered compensation and 1% for compensation below covered compensation. If I project forward using whatever factor the regulation will specify for the average with that plan or multiple averages for that plan, depending on the situation, and find out that the individual is providing 3% of the benefit, I subtract 3% from both the top and the bottom, I'm OK. When I do this procedure, I'm never going to fall out of the .75 of 1% differential because if I'm subtracting a flat amount from top and bottom, I'm never going to destroy the .75% differential. However, if the individual were to be determined to provide .5% of his/her benefit, which is not unlikely considering interest rates in Section 411, and I subtract that from top and bottom, I'm going to violate the 2 for 1 rule. So that under the new rules it is possible for employee contributions to hurt you integration-wise; and the way that it will hurt you is by pushing you down into the 2 for 1 rule and out of the .75 of 1% disparity.

The next topic is integration level in excess of covered compensation. As Don very well explained, under the old rules there were generally three types of levels that a plan would choose for the integration level related to covered compensation. If you picked covered compensation for everybody, no problem. If you do that under the new rules, if you pick covered compensation as your integration level, I think it's clear you have the .75 of 1% disparity -- no problem. Other plans in the past chose to use a flat dollar integration level for everyone. Now, there was a survey done and we looked at some of the integration levels for some of the very large plans in the United States. Some of those flat dollar integration levels are very small because they are based on prior Social Security law when the covered compensation level was very low. Some of them were as low as $4,000, $7,000, there were a couple at $7,500. I don't think that the Service is looking to be the one to tell employers who have such low compensation levels that, because these levels are less than covered compensation, the employer should rush right out and shoot the integration level all the way up to covered compensation. In Don's example, he shows that only a very low integration level is discriminatory. It is likely that these flat benefit integration level plans will be grandfatherly to a certain extent. In other words, there will be some flat level that will be acceptable and is deemed to be nondiscriminatory. You won't have to test whether it's discriminatory or not. Some numbers have been thrown around, $8,000, $10,000, half of the covered compensation for the oldest individual participating in the plan, etc. It's likely there will be some grandfather provision.

Assume then, that you are selecting a level dollar integration level for your plan. If it's less than covered compensation, there's no adjustment to the .75 of 1%, assuming it falls into this safe harbor area and it's nondiscriminatory. However, if that level is greater than, for example, the covered compensation of an individual attaining Social Security retirement age in the plan year, there would likely be an adjustment to the .75 of 1%. It is not desirable to have the employer have to go through the administrative hassle of measuring the level with respect to every individual's covered compensation under the plan and have a myriad of different replacements of the .75 of 1%. (1) It's too difficult to do, and (2) our basic purpose is to have uniformity -- to have a uniform level apply across the board to all individuals under the plan. Accordingly, there will most probably be some sort of a table in the regulations, where if you have a flat level integration break point, you would compare that integration break point, for example, to the covered compensation of the individual who was attaining Social Security retirement age during the year and there would be an adjustment to the .75 of 1% based on the difference between those two amounts. Everyone would have the same reduction to the .75 of 1%. The same reasoning would apply if a plan, for example, would have an integration level equal to 1 plus X times covered compensation. That's an integration level that is a formula that's uniform for everyone; however, it does exceed covered compensation for everyone. The simplest solution is to have a table: go into the table, your integration level is X% higher than covered compensation for everyone, then this is the reduced version of your .75 of 1%.

The next topic is early retirement reduction. Don mentioned there are some problems with early retirement reductions now, simply because there are different required disparities based on what your Social Security retirement age is. As Don indicated, it will be possible to go into the plan and specify the worst case basis. However, even though I just said that one of the desired results under the regulation is that there will be uniformity in the disparity applied to each individual under the plan, there may be a specific exception if the plan administrator really and truly wants to go to all the aggravation of having different disparities applicable to different individuals because they have different Social Security retirement ages; I don't see any reason why we should not say, "Be our guest." However, the adjustment should be carefully done. Take one example. The excess percentage under the plan is 2% and the base percentage is 1.5% for individuals whose retirement age is 65 and whose Social Security retirement age is 65. For individuals whose retirement age is 65 and whose Social Security retirement age is 66, however, the employer would have an excess percentage of 2% and a base percentage of 1.3%. The difference is .7%, and that reflects the fact that at 65 the .75 of 1% has to be reduced for this person, and the same thing would happen for individuals at age 67, but with a different reduction. Now that formula would be acceptable, because when you turn around and impute the actual disparity for each of those individuals, you would have 2% excess and 2% base. However, if the employer wanted to do the opposite, if he wanted to have the excess percentage be 2%, 1.95% and 1.9%, for example, and keep a constant base percentage, then there could be problems using that type of formula; because then when you impute .75% for individuals whose Social Security retirement age is 65 and if you impute .70% for individuals whose Social Security retirement age is 66, you don't come out with a level benefit for each one of those classes of individuals the way you did with my prior example. So, if you want to use different Social Security retirement ages, you should wait until the regulations are published.

There are only two other topics that I wanted to cover.

It's been brought to our attention that even though it's intended that there be no adjustment for form of benefit, some individuals may have come up with the idea that, "Gee, wouldn't it be nice if I make my normal form of benefit 10-year Certain and Continuous (C&C)." My benefit formula is 2% excess, 1.25% base. That's very nice if the benefit is paid out as a 10-C&C. However, if the individual under the plan can elect to have a single life benefit, and the single life benefit is the actuarial equivalent of the 10-C&C benefit, then the individual has effectively increased the amount of the disparity. This is not a desirable result, and I think that the proposed regulations will provide something on that point. It's possible that they will merely say that for any benefit paid in any form under the plan, the dollar amount cannot be calculated in a way that gives you a disparity in excess of the permissible disparity under the Code.

Target benefit plans have been a topic of discussion. I would just like to comment that there are problems with target benefit plans under the new integration rules that we did not have to deal with under the old integration rules. A target benefit plan, under Revenue Ruling 83-110, was integrated if the targeted benefit was integrated. And once you integrated the targeted benefit, you calculate an individual level premium to fund the targeted benefit, and you're fine. However, under the new rules, each year the benefit accruing is supposed to be limited to the maximum disparity, so you are not supposed to have an accrued benefit in any year where the accrual is based on a disparity in excess of .75 of 1%. If you do individual level premium (ILP) funding, suppose my targeted benefit is perfectly fine, on a cumulative basis over 35 years, I'm perfecto. I have exactly the .75 of 1%, excess disparity, no problem. If I'm using individual level premium and the individual terminates after 5 or 10 years -- don't forget individual level premium essentially loads your funding -- that individual is entitled to take as a benefit the amount his account can purchase. That benefit is not going to be correct based on the new disparity rules, simply because more has been funded than should have been funded and more can be purchased than should have accrued under the disparity rules at that point in time. If you could fund target benefit plans using the individual unit credit method, then this problem could be solved. Unfortunately, the Service has always described target benefit plans in terms of a target benefit with individual level premium funding, so we're hoist on our own pitard here and we do have a problem. Whether the problem will be solved in time for target benefit plans to be dealt with in the proposed regulations, I'm not sure. If they are not dealt with in the proposed regulations, they will be dealt with in the Revenue Ruling that will follow. It is possible that we will continue to have the individual level premium funding method with some sort of adjustment, or change the target benefit funding rule to some unit credit type concepts. Note the same problem applies to insured Section 412(i) plans, although they haven't been dealt with yet.

I had intended to say something about the transition rules, but basically I agree with everything Don said about the transition rules. So, I will just assume that I don't need to bother discussing that.

You should also bear in mind that any of the reductions to the .75 of 1% are cumulative, so all of the reductions need to be applied one on top of the other.

There was one other thing that Don raised that I want to address. He said that he hoped there would be a safe harbor for actuarial reductions below a certain age and I believe that we do intend to provide such a safe harbor. It isn't clear whether the safe harbor will be in the form of a table, which takes you from the actual Social Security retirement age -- 67, 66 or 65 -- incorporates the 1/15, 1/30 down to a certain point and then incorporates a specific interest rate and mortality table below that, or whether it will simply be a statement in the regulation that if you use, for example, 7.5% or 7% in your early retirement reductions, you will be OK.

MR. SCHREITMUELLER: In listening to Kathy go through that, I was reminded of the old saying about Congress that the average American taxpayer really doesn't like Congress very much at all, but if you ask about the individual Congressman he knows the best, oh yes, he's a very fine person. They'd vote for him again, and they usually do. I feel the same way toward Kathy. I don't necessarily have warm feelings toward the Service, but if they were all like Kathy, maybe that would be all right. I would like to summarize a bit what we've heard here without being very technical. It's seems as though the Service and the statute are going to carry out the idea that offset and step-rate plans will be on a par; therefore, you will look to your administrative considerations as to whether you prefer one or the other. You may find one easier to calculate, easier to explain, easier to deal with. So be it. But, in terms of getting a bigger offset, in terms of showing the benefits will be lower over the long run, there doesn't seem to be any advantage in offsetting. I think I side with Don that the offset looks like it has more disadvantages than advantages. For career average plans, it looks like an awful lot has been taken away, and they now seem hardly worth the effort. My employer recently decided that was true, and perhaps some others will too. For employee contributions, it's very hard to see how you could do something that makes very much sense having employee contributions in the usual way under a defined benefit plan. Defined contribution plans seem to come out pretty clean and perhaps Congress is trying to tell us something there. I hope not. Another thing that's pretty clean is just not having a qualified plan at all or not doing so much with one. Perhaps one should use some other route, either a nonqualified plan or cash; we could go on all day about that. So at this point, we'll take questions. In fact, comments are even more welcome than questions if anyone can shed some light on these things.

MR. GERALD F. BOULET: Question for Kathy. She didn't address Don's speculation that the three-year average would be at least three years instead of exactly three years.

MS. MARTICELLO: I think it's clear. I don't think I'm giving away any state secrets to say that the three-year average period will be expanded up to and including career average plans.

MR. JOHN A. TULLOCH: Some of the prototypes that are currently approved provide for a definition of accrued benefit which is the greater of the fractional rule or the ILP reserve. Are you effectively saying that in some way those are going to be restrained in the future?

MS. MARTICELLO: It is possible, yes. I've seen those plans.

MR. DANIEL M. ARNOLD: Would you, Kathy, please comment on the suggestion that mandatory employee contributions in defined benefit plans, if I heard it correctly, are going to be discouraged? Are those plans going to become very difficult to administer? Is that the intent of this statute? Is the IRS going to carry that out?

MS. MARTICELLO: Well, let me say this. When I was in any of those meetings, I certainly was not deliberately trying to outlaw contributory plans or to make them so difficult to live with that everybody would just hate them. However, given what Congress has told us under Section 411, about the basis of calculating how the employer- and employee-derived portions of a benefit are to be construed, yes, I think they are extremely difficult to maintain now. There may be counterbalancing advantages to be gained, especially by some small employers having contributory plans: 415 limit, for example.

MR. GRUBBS: I'd like to add that I certainly concur with Kathy. Most of us got rid of these contributory plans long ago. There's a relative handful of them still out there and I think certainly they're dead now. Maybe they should have died long ago. The question is, "Is there a problem with respect to plans, of which there are many, which had employee contributions in the past and still have them now?" Note the kind of tricky problem here. I said that, with the past, one of the options you have is to comply with Revenue Ruling 71-446. In that plan, if you amended to say that my accrued benefit as of January 1, 1989 is determined under my old formula, and my going forward benefits determined under my new formula to comply with my new law, I think I'm OK. But, if under that plan that had old employee contributions, I wanted to use my new formula for everything, I think I've got potential problems there. Would you agree Kathy?

MS. MARTICELLO: Yes, we definitely did consider that issue. You notice when I was speaking I limited myself to saying the rate of employee contributions and the current accruals. I tried not to touch on that issue. I should have known you would give me trouble! We are trying to deal with that issue, and you're right; it can complicate things quite a bit.

MR. J. REUBEN RIGEL: Is it clear with regard to the accrued benefit that we have as of January 1, 1989, that it's frozen and it can't be continued as a dynamic formula subject to the old integration rule with the new salary? Is it clear it has to be based on frozen salary? What's the situation on that?

MS. MARTICELLO: Are you asking, for example, whether if compensation increased then the percentage under the old formula at December 31, 1988 could be applied to compensation increases? And those would be grandfathered?

MR. RIGEL: Yes.

MS. MARTICELLO: There will be no grandfathering of the accrued benefit as of December 31, 1988 in the transitional rules. There will be no changes in the accrued benefit that would be grandfathered.

MR. RIGEL: So your benefit would be frozen at December 31, 1988 under the old formula and then the new formula would apply for all years.

MS. MARTICELLO: Well, depends on all years that you haven't used up, net of the 35.

MR. GRUBBS: Let me see if I can clarify the question. You're dealing with a question for my pre-1989 benefits: Do I need to freeze it in dollars to comply with the old law, or can I use my old formula that complied with Revenue Ruling 71-446 for going forward and allow for benefit increases and your answer to that, Kathy, again was?

MS. MARTICELLO: I do not think that you can use the old formula and apply it to compensation increases. I think that it would be frozen as the dollar amount. Now there are ways that you can provide increases. For example, suppose you wanted to apply the new formula to all years of service and give the greater of the new formula or the accrued benefit at December 31, 1988. You could do that. In that case you would sort of be giving some increase for those old years if you were underintegrated for those years.

MR. GRUBBS: I would just indicate that there is some statutory language which would indicate to the contrary and it's not entirely clear whether if the Service takes that viewpoint it would be upheld.

MS. MARTICELLO: I'll write that down. Any comments that anyone has, Don included, it isn't too late.

MR. RICHARD D. KUTIKOFF: Do you anticipate that a career pay plan may continue to have annual accrual based on a .75% integration disparity?

MS. MARTICELLO: Until Don raised the issue, I had not given it a lot of thought. If all you do is change the definition of the "n" years, (take average compensation into account and expand it to "n" being any number of years up to and including your entire career) then Don is correct in saying that it's an average. You calculate your benefits based on an average, your career average, rather than a year-by-year type of accrual. All I can say is that I will bring the topic up, but the way that things are constructed now, I think it would be an average.

MR. KUTIKOFF: The situation where you have an employee whose pay history, in some years, places him below the wage base in that year and in other years places him above the wage base in that year, might provide a different benefit using a 35-year or however many year average of the wage bases, rather than the individual years.

MS. MARTICELLO: Thank you.

MR. RALPH J. BRASKETT: Kathy, did I hear you correctly say that the standard career average accrual is not going to be permitted on the disparity? Is that what I heard you say? The traditional career average plan used to be and still is until the end of this year -- 1% of pay plus .25% of pay in excess of the wage base.

MS. MARTICELLO: That's correct.

MR. BRASKETT: Now, let's say I knock that 1.4 down to .75, you're saying that would not be acceptable? That's what I heard you say.

MS. MARTICELLO: OK, what I am saying is, let's take it one step at a time. As Don indicated, under the law as drafted, an integrated Defined Benefit (DB) plan has to be based on an average compensation and the period of averaging appeared to be three years closest to retirement -- the high three. If the only technical change made to accommodate periods longer than three is to say, for example, that average compensation has to be based on any period of "n" years, the "n" highest years in your career, then I think it would lead you to say that career average plans are based on an average over your entire career, because all you've done is expand the average. Unless further thought is given to specifically making sure that you can have this year-by-year accrual, it may not happen.

MR. BRASKETT: That will effectively eliminate at least the simple-minded career average plan, which hopefully employees can even understand, from consideration. I don't believe that was the intent of the law. I think now you're exultating form over substance.

MS. MARTICELLO: That's true, and I think the reason for it is it's possible that issue was not considered.

MR. BRASKETT: Yes, but I would also say that the Service has been given much broader guidelines in this legislation than has happened in other tax legislation.

MS. MARTICELLO: That's very true.

MR. BRASKETT: The other question I have is what's the rationale for the same disparity for career average plans and final pay plans? I can understand the final three and the final five being the same in an effort to have some simplicity, but why would a career average plan be permitted only the same disparity as a final pay plan?

MS. MARTICELLO: All differences on account of the averaging period have been eliminated. You could say the same with respect to form. You could say the same with respect to a plan that has a disability benefit, vis-a-vis a plan that doesn't. It's purely a simplification procedure that fewer and fewer things will be considered in modifying the .75%.

MR. BRASKETT: I see, I understand, but you have already taken that away on the form issue.

MS. MARTICELLO: I haven't taken it away yet. All I've said . . .

MR. BRASKETT: Cause it's a problem. The example you gave us -- you gave us a classic example -- when you have a nonsingle life annuity normal form.

You can go around the disparities and rules if you allow people to essentially take the actuarial increase up.

MS. MARTICELLO: But I thought I said that it's likely they will not be allowed to take the actuarial increase up.

MR. BRASKETT: Right. But I'm saying there's an example on a small issue, where you're going to be concerned about disparity on the larger issues not so much. I mean real issues.

MS. MARTICELLO: But see, that's why we are issuing proposed regulations. When we were sitting down going through these regulations, there are a myriad of issues, I'm sure, that didn't occur to anyone who was working on the regulations. Any input that I can get here, I'm very grateful for, and I can promise you, even if I can't do anything about it, I at least will go back and mention it and bring it up.

MR. BRASKETT: Do you believe that given the regulations are so late, won't they come out with what they call proposed and temporary?

MS. MARTICELLO: No.

MR. BRASKETT: And then the final regulations will come along in the same form two years later?

MS. MARTICELLO: Not likely. Right now I would certainly predict that they will come out as proposed regulations.

MR. GRUBBS: I think the Service, in this regard, is limited. One can argue from logic that there ought to be more disparity for a career average plan, but that would force them to say we're going to allow more than the .75 or more than the .65 per year, and I think that that would clearly be beyond anything they have authority to do. I think you need to go to Congress on that. I expect, though, that what we're going to see as a result is that we are all going to have to look at our plans and amend them anyway and think about all the alternatives. I think we're more apt to tell the person who has a career average plan, while this might have worked well in the past, maybe we ought to reconsider the issue of going to a final average pay plan.

MR. RALPH J. HEALEY: Aren't there certain groups of employees that should never be in a final pay plan? For example, sales forces who can wholly determine their level of income. Have you considered that?

MS. MARTICELLO: You mean individuals who have control of when their pay goes up and when it goes down? Yes, we have. I used to work for an insurance company and I saw how salesmen's income not only shot up at certain periods, but fluctuated; but I don't think that it's an issue we thought was worth actually modifying regulations to take into account.

MR. A. RICHARD LABOMBARDE: I have two questions that I guess are somewhat interrelated. I understand the proposed technical corrections had a provisions that called for reasonable interpretations to be used until regulations on which we could rely were issued. Do you have any comments on that relative to when the gentlemen who was talking about whether these were going to be interim or not and you said, "No they're proposed." Do you have some comments relative to that reasonable interpretation guide? And the second related question: We can hold off amending the plan until the end of the 1989 plan year, provided the plan is operated in accordance with the rules during the plan year. I have a particular question on that that's come to my attention on the funding for a plan during 1989. Don't we need to be at least aware of where the plan sponsor is going to go with the plan before we fund the plan?

MS. MARTICELLO: OK, I'll take your first question first. Traditionally, proposed regulations represent the Service's best interpretation of the law. Interpretations in proposed regulations are not required to be followed. If you come up with an alternative interpretation that you feel is reasonable and in accordance with the law, and it is not the same as the interpretation in the proposed regulations, you can implement that interpretation. However, you take the risk that if you implement an interpretation that is not in the proposed regulations, you do not have the reliance that you have on the position in the proposed regulations, in that if later regulations are more stringent, if you had followed the proposed regulations, you wouldn't be hurt because the final regulations are more stringent. If you follow your own interpretation, you don't have that protection.

With respect to your second question, many people are concerned because there will be a period -- maybe extended beyond the 1989 plan year -- when individuals can amend their plans retroactive to January 1, 1989 and comply with the law. In addition to funding issues, we're concerned with 411(d)(6) issues, especially with respect to integration, because if you don't just want to top off, if you want to redesign your entire benefit package, then there could be some lowering of individuals' accrued benefits. We are currently working on a notice. If you recall for purposes of Section 415, there was a specific proviso, I believe it was in Notice 87-21, that provided some relief with respect to Section 411(d)(6). I don't know how much relief will be provided. You always have the option of freezing your plan and then amending, retroactively, when you determine the new benefit formula. No matter what you do, there's going to be trouble. All I can tell you is we are going to provide some kind of relief. Your question about the funding, basically what you're talking about is a shift of costs between one year and the next. If you actually amend the plan within the 2.5 months before the end of the plan year, then of course you can take those amendments into account for your costs, but not more than based on the actual effective date of those amendments. If you don't amend until after 2.5 months after the end of the plan year, you're supposed to wait. Now, at the present time I do not think that those rules will be changed because of the situation. But I'm not sure. Those rules have been considered and discussed. We understand there's a problem. There may be some leeway given there, but right now you would have to follow Revenue Ruling 77-2.

MR. GRUBBS: I would ask Kathy the toughest question. Kathy, when do you think we'll get final regulations?

MS. MARTICELLO: How long was it between the 401(k)? You multiply that by 100 maybe. No, hopefully it won't be that long. What can I say?

MR. GRUBBS: That was an unfair question, I'll withdraw it. It does raise the problem of how the IRS is going to act in the determination letter process. Of course you don't have to have a determination letter and if they choose to sit on it for a long time, that is not an insurmountable problem, but I would anticipate that the determination letter process is apt to follow the proposed regulations.

Thus, if one wants to take some other position, which may well be one that's in accordance with final regulations, you're in a box because you would get either a negative determination letter or no ruling and your client doesn't want that. A lot of people do need to make decisions in advance, in part because of the 411(d)(6) problem, in part because of employee relations, and in part because of the decision-making process that relates to other things, like the coverage rules. I have a client with an hourly plan and a salaried plan that obviously is not going to pass the coverage tests, and now I'm asking, "Should we merge the plans, what should we do about this problem?" He's very interested in making that decision and that's a decision I have to make before the first of the year. Is it a practical matter? We have lead time problems in relation to when clients have to make decisions. I think we are often locked into a board meeting that has to adopt something several months before an actual effective date that you wanted to have. I have a client who felt he already had to make a decision and this is a problem. I don't know what else I can say.

MR. ARNOLD: I've been seething here over some earlier comments on employee contribution plans. One little comment, a particular client that has seven plans of this kind in the United States and Puerto Rico that I deal with, covering about 20,000 employees, and its United Kingdom plans are also contributory, its Canadian plans are contributory, and it has plans throughout the world, many of which are contributory. I would suggest to you that there are many, maybe not the majority, but there are many countries and there are many employers in the United States who deal throughout our shrinking world, where contributory plans are still in vogue. This will cause complications in transferring employees from one country to another. Some of these are union negotiated plans which were tied together with the salaried plans and the non-union plans. It's not a simple thing to make these things go away for those who are going to be administering them and will tend to cause anger when the messenger comes with this wonderful news, and I might add that 401(k) plans, which have become very popular, are contributory and the federal government's civil service plan, as I remember correctly, is a contributory plan.

MS. MARTICELLO: Most definitely contributory.

MR. GRUBBS: Another comment I would like to add deals with offset plans. One takes a look at the statute and reads it literally; you will find something reflected in my paper which you should not take too seriously. It says that for any individual whose final average compensation is higher than the covered compensation, the allowable percentage should be decreased and you will find that reflected both in my paper and in an illustration I have in there. That is a greatly complicated approach. As Kathy has indicated, the proposed regulations will take a different approach, which doesn't make you change the percentage participant by participant, as some of us had expected. I would just say that although what I wrote appeared correct in light of the statute, I'm not unhappy that the Service is going off in another direction on that.

If a plan does not cover any highly compensated employees, these rules do not apply at all. This happens because these rules only apply when you are complying with 401(a)(4) and 401(a)(4) deals with discrimination in favor of highly compensated employees. Now in the past that didn't get us anywhere, because a highly compensated employee was a very fuzzy notion and the IRS might take the position that someone who earned 2% more than the minimum wage was highly compensated in relation to the person who was earning the minimum wage. Now we have very clear definitions of who are highly compensated, and you may find there are integrated plans out there which do not include anyone who falls in that definition and therefore not affected by this section of the Act.

MR. BRASKETT: One last question, did I understand correctly that if a client is going to have an integration disparity that's less than the maximum permitted, he can therefore use an appropriate factor of the covered compensation? For instance, somebody wants to have a disparity of .5%, I can go up as much as .25, perhaps, on the covered compensation table?

MS. MARTICELLO: In other words, you want to go from the opposite end. Rather than setting the integration level at a certain percentage above covered compensation and then finding out what the reduced disparity is, you want to go for the reduced disparity and set the integration level accordingly. That's no problem, but you should remember there may be other things in the plan that could require adjustment and the adjustments are cumulative. Make sure your early retirement . . .

MR. BRASKETT: Well early retirement now is defined not as done traditionally, but early retirement is anything younger than Social Security retirement age.

MS. MARTICELLO: That's correct and the adjustments part of the career after Social Security retirement age will be different from the adjustments at a later point and as Don had said, you have the 1/15, 1/30 for part of your career and an actuarial adjustment thereafter. And we will try to provide a safe harbor for the actuarial adjustment, but you have to consider both of those.

MR. BRASKETT: Right, and it's still in effect as it was before.

MS. MARTICELLO: That's right.

MR. GRUBBS: Just a couple of questions for Kathy in relation to this. To make sure I understand this, Kathy, assuming that my arithmetic is correct, I can for the moment assume that this law was in effect in 1988, I could take this number $15,709 at the top of my table and put that in my plan as my break point. Is that right?

MS. MARTICELLO: Well, now you have asked me a question -- I don't know if you deliberately asked me a question that was going to cause me a problem or not. Depends on how you put it in your plan. If you put it in your plan as a specific dollar amount, then you can have the .75 of 1% in full, and if you were to put any other dollar amount in your plan and compare it to your $15,709 . . .

MR. GRUBBS: For the moment assume that the only dollar amount I have in my plan is $15,709, the break point for some reaching 65 this year. Is that OK?

MS. MARTICELLO: Yes, you can put that in your plan as a dollar amount. However, if you try to put it in your plan, I don't know how you could do it because it would be a different percent for each individual participant. But if you tried to put it in as a percentage of each individual's covered compensation, for example . . .

MR. GRUBBS: No. I'm thinking of a plan that says we have, say, 1% of all pay, plus .65% above $15,709, that is the formula.

MS. MARTICELLO: That would be OK.

MR. GRUBBS: Now, next year, when the covered compensation has gone up to let's say $17,000, for example, and I've got this number $15,709 stuck in my plan document, is that going to still be OK or do I need to amend my plan next year?

MS. MARTICELLO: It would probably still be OK because it's close enough to the covered compensation of the individual attaining Social Security retirement age in that year that you would probably, in the table, make an adjustment. But the thing I have to stress is I'm only talking here about amounts you can have in the plan without adjustment of the .75 of 1%. I'm not talking about any discrimination ideas.

MR. GRUBBS: But we cannot, as we did in the past, have a number as the break point which complied with Revenue Ruling 71-446, and because it was OK at the time, we put it in the plan, being assured that it's going to be OK in the future without amendment.

MS. MARTICELLO: No, but not because of the adjustments to the .75 of 1%, only because of a discrimination problem where if you have a dollar amount, a dollar integration level in your plan, and it's less than covered compensation for many individuals under the plan, and it's not less than any safe harbor that we would prescribe, then you would have to make sure that it didn't result in discrimination.

MR. GRUBBS: My second question: I'm drawing up a plan that says the integration level for any calendar year is the average taxable wage base for that year and the 34 preceding years, so that in 1988 it's $15,709 for everyone terminating employment in 1988 and 1989 it will move up, perhaps to somewhere around $17,000. Is that something that I can put into my plan and it's going to be forever OK?

MS. MARTICELLO: If I understand you, you will have an integration level which is a dollar amount arrived by formula to be equal to the covered compensation for an individual attaining Social Security retirement age in that year.

MR. GRUBBS: Yes

MS. MARTICELLO: That would be OK. That would be OK without adjustment to the .75 of 1%. I can't say anything about any discrimination issues though.

MR. GRUBBS: Question three: Can I put in my plan something that says covered compensation for any individual who terminates in any particular year is the average of the taxable wage bases for the 35 years ending with the year in which that individual attains age 65 and if the person is not yet 65, we assume that the current taxable wage base will continue into the future? Thus, for people terminating in 1988, that would result in a break point that moves from $17,009 for the old people to $45,000 for the young people and that would automatically change in 1989 to a table that maybe runs from $17,000 to $48,000 or something. Would that be OK?

MS. MARTICELLO: Wouldn't you have then, by formula, the covered compensation of the individual except, am I correct, that you stop at age 65 rather than Social Security retirement age? Is that what you meant?

MR. GRUBBS: No. I'm running up to normal Social Security retirement age is what I mean.

MS. MARTICELLO: So by formula you would be specifying covered compensation.

MR. GRUBBS: Yes.

MS. MARTICELLO: And you would be specifying it assuming that taxable wage base was frozen, etc., for future years.

MR. GRUBBS: Yes.

MS. MARTICELLO: Yes, that would be OK. And that wouldn't even be discriminatory. I wouldn't have to qualify that one because it's going to be covered compensation. If everybody used covered compensation, I wouldn't have any problems.

MR. GRUBBS: But then if I modify that in the manner I suggested, say let's limit it to the 35 years ending at 65, otherwise doing what I just described, then there is some question that there might be some further tests in order to prove that that's OK.

MS MARTICELLO: That's correct. There is no adjustment to the .75 of 1%, but then any time you are less than covered compensation, and you're not less than any safe harbor, you might have a discrimination problem.

MR. BOULET: I would like to take Don's analysis one step further. And the step further is required because we now have regulations that make us take care of credits beyond 65 and beyond normal retirement. What happens with the covered compensation for a person whose normal retirement age is 65, his Social Security retirement age is 65, but he works beyond that?

MS. MARTICELLO: I don't think there will be any change in his covered compensation. I think covered compensation is a specifically defined term which is equal to the average of the taxable wage base for the 35 years, including the year he attained Social Security retirement age and going back. I don't think it would change. Now, that hasn't been addressed, but I really don't think it would change. Why, do you think that it should?

MR. BOULET: Well, what it does, is it causes a problem with complying with the top-heavy rules under 416.

MS. MARTICELLO: In what way?

MR. BOULET: Because if the person retiring at 65 has a maximum benefit under the defined contribution fraction and defined benefit fraction, all of a sudden we have to give him a credit at 66, what will we do?

MS. MARTICELLO: I don't understand what credit you mean.

MR. BOULET: Because he has to be credited beyond normal retirement under the law.

MS. MARTICELLO: With accruals under the plan, you can't see accruals. Is that what you mean?

MR. BOULET: Well, we give them an accrual but it can't exceed its defined benefit fraction.

MS. MARTICELLO: You mean for 415 purposes?

MR. BOULET: 416, yes.

MS. MARTICELLO: The defined benefit fraction is only applicable for purposes of 415. You mean because it's top heavy there's an adjustment to the denominator of the defined benefit fraction?

MR. BOULET: Yes.

MS. MARTICELLO: Any future accruals that you would give in a defined benefit plan would, of course, be limited by what you are able to give without violating the requirements of Section 415.

MR. GRUBBS: The Age Discrimination in Employment Act of 1967 (ADEA) does not require you to credit benefits that exceed the 415 limits no matter what.

MR. BOULET: But under the rules, does the defined benefit fraction decrease because the defined contribution fraction increases beyond normal retirement age?

MS. MARTICELLO: It depends on what your plan says. There was a revenue ruling that was published after the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) that said that in a defined benefit plan you can have your defined benefit fraction for 415 purposes reduced when your defined contribution fraction in a companion plan increases -- provided that on the date that you institute that amendment you do not reduce the individual's accrued benefit. The individual's accrued benefit in the defined benefit plan can thereafter be reduced even below the amount that it was on the date of the amendment, but your plan has to specifically spell that out. And under current law, as under the Revenue Ruling, that would be permissible. If your plan provisions do not so state, then it would be a 411(d)(6) violation. Your plan according to 415 regulations must preclude any benefits accruing that would exceed the 415 limits, including the combined fraction limit. You have to find some way in your plans to preclude that from happening. This is an acceptable way, but it has to be in the plan. Any accruals that are required past normal retirement age are absolutely limited to 415 limits. There's no requirement that you give anyone an accrual over and above what his/her 415 limitation is.

MR. BOULET: That's right. But if the defined contribution fraction increases beyond normal retirement, which it does of course, and the credit is continued, then the defined benefit fraction goes down and it could cause a problem.

MS. MARTICELLO: Well, it would cause a problem if you haven't provided for that contingency in your plan document. If, however, that's the way you use to control the sum of the defined benefit and the defined contribution fractions, if you say that the defined benefit will decrease when the defined contribution fraction increases, then you don't have a problem.

MR. GRUBBS: Another question, Kathy, related to these people who work past 65 and the covered compensation level: it seems clear to me that if this law had been in effect for 1988, we had someone reaching 65 in 1988 that his covered compensation level was $15,709 and then if that person continued on the plan another five years, his covered compensation level would continue to be $15,709. It doesn't change because that's his 35 years ending when he reaches age 65. What about the individual who is already age 70 in the year in which this provision goes into effect? Do I need to look backwards at the average taxable wage base for the 35 years ending with the year when five years ago he reached age 65, or can I look at the 35 years ending with the year when this thing goes into effect?

MS. MARTICELLO: I don't think either the code or the regulation will say that you look at the end point being the later of the Social Security retirement age or the current age of the individual. My opinion is it would be the Social Security retirement age.

MR. GRUBBS: I didn't mean the Social Security retirement age, but take the person who is already age 70 on January 1, 1989 when this goes into effect. The question is, "Is that person's covered compensation level at that point the covered compensation level for someone reaching 65 at that date, or is it much lower because I go back to the year 5 years ago when that person would actually reached age 65 and therefore get a much lower covered compensation level?" It's something which I see some theoretical justification for, but I find quite troublesome.

MS. MARTICELLO: I think if you go by the letter of the law, it's the amount calculated five years ago.

MR. GRUBBS: This means that I could not put that age 65 number in the plan and say it applies to everyone and that worries me.

MS. MARTICELLO: That's a very good point. I will note that.

MR. SCHREITMUELLER: We have time for about one more question before our meeting is concluded. Ralph I think we have time for you.

MR. BRASKETT: Kathy, I want to go through this very carefully. The 415 issue: I've got a number of plans right now that were formally drafted and they have determination letters that would permit people to have benefits in excess of 415. I've told the participants involved that since 415 is a statute, that the 415 limits are absolute and override faulty draftsmanship even with a determination letter. I think I heard you say something different.

MS. MARTICELLO: OK, what you're talking about is the area of Section 7805B relief. If you have a plan that is incorrectly drafted and provides that an individual will be able to accrue or have a distribution of a benefit in excess of the 415 limit, and it was specifically in the plan when the plan received a determination letter, then you are entitled to certain relief because of that determination letter. You have to request it though. However, relief under that type of determination letter only lasts until there is a change in the facts or a change in the law. There was a change in the law recently with respect to Section 415, so you would only be protected to the extent you are operating in good faith reliance on the plan as blessed by the letter until there was a change in the law.

MR. GRUBBS: I would like to add briefly to that that it's only relief from the IRS. If I'm a participant in the plan and through faulty drafting your plan says I'm entitled to a $200,000 benefit and you say, "But the IRS doesn't let me have that." I say, "Too bad your plan's not qualified, get me my $200,000," and I've got a pretty good case.

MR. SCHREITMUELLER: Well we can't conclude on that note. I would like to just cast your minds back to a point that Don made. I think it bears repeating in that little Q&A session that he had with Kathy, and like a good lawyer he knew the answers to his questions before he asked them. I think he demonstrated that if you use a integration level which differs from covered compensation, there may very well be a problem. There's are no guarantees with it because if you go above covered compensation, you have to reduce the percentage. If you go below covered compensation, you may have a problem with discrimination. So the only place you can be really comfortable would be right at covered compensation, which some people find excessively complicated, but those are the trade-offs.