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

EFFECT OF TRA AND OBRA ON BENEFIT PROGRAM DESIGN

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Recorder: PAUL CHOW

- o Changes in benefit plan programs as a result of the latest round of law changes
- o Changes affecting qualifications
- o Discrimination and coverage requirements

MR. CHARLES E. DEAN, JR.: Our topic is the effects of Tax Reform, OBRA, and other legislation on plan design. Plan design is one of those topics on which everyone is an expert. You don't have to even be an actuary to be an expert about plan design when you listen to a lot of the clients. And for that reason I hope that we'll have some time at the end of our session for participation, and in this case that means not just questions, but also we hope that some of you will share your observations -- what companies are doing, what they're thinking about and what you're discussing with them in the area of plan design as we face the challenges of Tax Reform and OBRA.

Our panelists include Bob Cosway and Dan Sherman; I will fill in on defined contribution plans. Bob Cosway is a consulting actuary with Milliman and Robertson in Seattle, from the Great Pacific Northwest. He has been very active in looking at Social Security integration for Milliman and Robertson clients, and he also serves as a resource for FASB 87 and 88 issues for that firm.

Our second panelist, who will be our first speaker, is Dan Sherman, who is a consulting actuary here in Boston with Foster Higgins. He works with large public employer clients as well as corporate clients.

My name is Chuck Dean. I am a consulting actuary in Dallas, Texas, with Foster Higgins. Our recorder is Mr. Paul Chow, also from Dallas. Paul attained his associateship in the SOA last fall. This is the first meeting he has attended, so we're very happy to have Paul here.

Before we get started, let me ask a question -- let's see a show of hands here. How many of you are working with clients who are going through plan changes/ plan re-design with Tax Reform and other legislative changes? Everyone's hand should go up -- so you are awake and at least paying attention. How many would say that the majority of the companies you are working with have made the decisions they are going to make and need to make on Tax Reform and they have effectively completed their plan design decisions? We have some backward clients in this group, I think, certainly not backward actuaries. Well, then, our session should be on point and we hope it will be helpful for you.

Our first speaker is Dan Sherman who is going to look at the issues relating to defined benefit plans, particularly coverage, vesting, the compensation limit, Pension Benefit Guaranty Corporation (PBGC) premium and maximum benefit limitations.

MR. DANIEL WARREN SHERMAN: These are the topics I hope to cover extensively, with the exception of the Social Security integration, which Bob is going to cover in great detail.

COVERAGE REQUIREMENTS

The Tax Reform Act (TRA) of 1986 makes a number of significant changes to both the substance and application of the non-discriminatory coverage rules. In addition to replacing the pre-tax reform coverage tests with three alternative tests, the TRA redefines a prohibitive group and modifies the categories of employees which may be disregarded in testing non-discrimination.

The Fair Cross Section test has been eliminated. This relatively flexible test has been used often for satisfying the coverage requirements. With the elimination of this test, however, satisfying the coverage requirements has become a bit more difficult.

Prior to TRA, a prohibited group was an ill-defined group which generally included officers, shareholders, and highly compensated employees of the employer. Moreover, the prohibited group for certain discrimination tests varied from code section to code section. The tax reform simplifies the identification of the prohibited group. This new prohibited group, referred to as the highly compensated employees, is used in all non-discrimination testing and in several other compliance areas of the new law. In general, highly compensated includes any individual who during current or preceding plan year is (1) a 5% owner, (2) among the top 20% of all employees ranked by compensation and earning more than $50,000, (3) earning more than $75,000, or (4) an officer of the employer organization who earns more than 150% of the Internal Revenue Code limitation on annual additions to a defined contribution plan, or currently $45,000 indexed for future increases.

The determination of who is a highly compensated employee will be based on the entire employee population of the control group of employers.

The TRA also redefines who may be excluded in testing non-discriminatory coverage. Collectively bargained employees and non-resident aliens with no income from sources within the U.S. may continue to be excluded, as under existing law. Employees who do not satisfy the minimum age and service requirements of any plan maintained by the employer are excluded.

The three new alternative coverage tests generally measure the coverage of highly compensated employees against the coverage of non-highly compensated employees. Like existing law, the new alternative tests are applied on a controlled group basis, and plans which are comparable can be aggregated. The comparability tests are outlined in revenue ruling 81-202.

The three tests are as follows:

The Percentage Test: A plan will satisfy the percentage test if the plan benefits at least 70% of the employees who are non-highly compensated employees. Note that while this new test seems similar to the old percentage test, in fact, it is not. Under the new test, the plan must cover 70% of all non-highly compensated employees rather than 70% of all employees.

The Ratio Test: A plan will satisfy the ratio test for determining non-discriminatory coverage if the plan benefits a percentage of non-highly compensated employees, which is at least 70% of the percentage of highly compensated employees benefitting under the plan.

The Average Benefits Test: A plan will satisfy the average benefits test if it satisfied both of the following two-prong tests:

A. It benefits employees who qualify under a classification that does not discriminate in favor of the highly compensated employees, and

B. The average benefit percentage for non-highly compensated employees is at least 70% of the average benefit percentage for highly compensated employees.

The classification prong of the average benefit test is essentially the existing law Fair Cross Section test, except that the new highly compensated employees definition now applies. In addition, when testing non-discrimination, the employer may select to disregard those employees who have not satisfied the plan's minimum age and service requirements only if the lowest minimum age and service requirements of any plan maintained by the employer are used. The average benefit percentage prong of the test is more difficult. The benefit percentage is calculated separately with respect to each employee in the highly compensated group and non-highly compensated group, without regard to whether such employee is a participant in any plan. The percentage as expressed as a percentage of each employee's compensation is then averaged for the two groups. If the average benefit percentage for the non-highly compensated employees is at least 70% of the average benefit percentage for the highly compensated employees, then the plan will satisfy this prong of the average benefits test.

While the average benefits test seems to be straightforward, it may be very difficult to administer. Depending on the size of employee population, the task of computing the benefit percentage for each employee and then determining the average for each group will range from difficult to formidable. Remember that in converting the benefits to contributions, or vice versa, the conversion must follow the rules described in the IRS revenue ruling 81-202. That was modified in several respects by the conference report to the TRA.

Besides the three tests I've just described, each plan must cover at least 50 employees, or 40% of the total number of non-excludable employees if less.

In testing the minimum coverage requirements under the new TRA, there is relief granted to employers who operate separate lines of business or separate operating units for legitimate business reasons. If an employer is treated as operating separate lines of business or separate operating units, then the employer may apply the minimum coverage requirements separately with respect to employees in each separate line of business.

An employer may use this exception provided that by doing so no plan fails to benefit a non-discriminatory classification of employees. The criteria for determining whether there are multiple separate lines of business are outlined in a code.

A particular client of ours maintains four separate defined benefit plans. There is a plan for the salaried versus the hourly employees in the controlling corporation. Plus they own two divisions with their own plans; I refer to them as division A and division B. We determined that there are 55 highly compensated employees in the salary plan, none in the hourly plan, ten in the A division plan, and five in the B division plan. The participation figures are as follows:

The hourly, A division, and B division plans all meet the second test since in each case the percentage of non-highly compensated employees exceeds the percentage of highly compensated employees. The salary plan, however, does not meet the second test, since 24% is less than 70% of 79%. The average benefits test must be performed for employees of the controlled group and passing this test would require benefit improvement to the hourly employees. However, if the A division plan and salaried division plan are merged, the combined plan would cover 93% of the highly compensated and 69% of the non-highly compensated. Since 69% is greater than 70% of 93%, the combined plan meets the second test. This alternative means that no benefit improvements will be necessary for the hourly employees.

The company is given a difficult choice under these two rules: either make improvement in the hourly plan benefit or merge the essentially two different divisions for purposes of compliance.

NEW VESTING SCHEDULES

Tax Reform liberalized the vesting requirements for qualified retirement plans. Prior to Tax Reform a plan was allowed to use one of three minimum alternative vesting schedules -- ten-year cliff vesting, the rule 45, or the graded vesting from 5-15 years of vesting service. The IRS, however, could require faster vesting than the above schedules based on its general requirements to a plan not to discriminate in favor of higher-paid employees. In actual operation the IRS establishes a Safe Harbor provision referred to as the 4-40 vesting rule. Under this Safe Harbor provision an employer does not have to demonstrate that the plan is not discriminatory in operation if a minimal vesting schedule of 4-40 was used.

Tax Reform requires that a vesting schedule at least as fast as the two alternatives be used. One being 100% vesting after 5 years of service, and two, 20% per year graded vesting beginning after 3 years, increasing 20% per year.

It appears that the new Tax Reform vesting schedule would eliminate the IRS 4-40 Safe Harbor as an ongoing requirement. The long-term costs for the two vesting schedules are quite similar. The graded vesting schedule should have a slightly higher cost because employee turnover is largely a function of employee service. This effect is particularly pronounced during the first 5 years of employment. Also the cost of administrating the plan will be higher because of the increased number of participants terminating with a vested interest and higher PBGC premiums may be due unless lump sum distributions are the norm for short-service employees.

It should be noted that the difference in costs between the two vesting schedules is not accurately measured by most actuarial valuations because the employee turnover as scheduled is generally a function of attained age and not of years in service. It is also important to note that the more liberal vesting schedule is achieved at modest cost. For example, using the 5-year cliff vesting, the additional cost arises for employees who separate after 5 years of service but prior to 10 years of service. These employees are usually relatively young and with only a small accrued benefit, and therefore small present value of vested benefit.

So far, our experience has been that our clients with cliff vesting are maintaining cliff vesting because of its simplicity and familiarity to the participants of the plan. Likewise, those with graded vesting are, for the most part, staying with graded vesting. However, there has been additional administration necessary and PBGC premiums still applied for those graded vesting plans and some are seriously considering switching to a cliff vesting schedule. I might add that graded vesting still makes sense for programs which are linked to a defined contribution plan or certain cash balance plans.

SOCIAL SECURITY INTEGRATION

Bob is going to talk at length on Social Security integration, although a comment I might put in is that we have found that those who currently have an offset plan are looking at ways of getting around it so they can stick with it. An interesting note was that we have several plans that have a fifty less fifty offset plan prorated for less than 30 years of service, and also have a $12 minimum per year of service. For employees making less than $23,000 in pay we are finding that although they would fail the new integration rules, their minimum benefit kicks in and is no significant additional liability or cost to the pension plan. To maintain that modest cost, however, the minimum benefit must be updated occasionally.

BENEFIT LIMITATIONS

All qualified retirement plans must be revised to recognize only the first $200,000 of compensation for the pension formula. This $200,000 pay limit applies to all aspects of Internal Revenue Code to which compensation applies for qualified retirement plans. The $200,000 compensation limit is indexed for cost-of-living increases. There are no options available with respect to qualified retirement plans. The key alternative, however, is the establishment of a non-qualified Supplemental Executive Retirement Plan also known as SERP. This could take the form of a pure excess plan.

Under an excess plan or similar non-qualified arrangement the company receives its tax deduction at the time benefit payment is made and the employee is subject to income tax on these amounts at the time payments are made. There are no income tax effects prior to payment, provided the employee does not have a funded, non-forfeitable right to the benefit. An excess plan would require a plan document and expense accruals in accordance with accounting rules used for qualified pension plans, and a letter to the IRS noting that the plan does exist.

To date, we have not seen a great increase in activity toward SERPs; however, we do anticipate that with accommodation of the new integration requirements, the $200,000 limit on compensation and the new maximum benefit limitation will increase the number of SERPs in the market.

The new maximum benefit limitations I just alluded to are modifications by Tax Reform in section 415. In 1987 benefits payable under the defined benefit approach were limited to a maximum of $90,000 annual pension if paid at age 65, reducing to $75,000 at age 55.

The $90,000 limit to annual benefits payable under a pension plan was not changed. However, the age at which the $90,000 benefit can be paid was changed to be the Social Security retirement age rather than age 65.

The most significant change made by the TRA was to reduce the benefits that can be payable from a defined benefit pension plan for employees who retire before the Social Security retirement age. The $75,000 limit was eliminated except on a grandfather basis for accrued benefits as of December 31, 1987. A highly paid executive retiring at age 55 could be subject to a benefit limitation of less than $40,000 per year compared to $75,000 available prior to Tax Reform.

For those of us with professional retirement clients of just one or two lives, for example, a doctor with a nurse or administrator, the change requiring 10 years of plan participation can severely reduce the amount of tax-deductible contributions available. We have a number of clients whose deductible contributions reduce to zero because of the reduction of the 415 limits and the new full funding rules. Generally, these professionals are starting to find contribution plans to try to make up lost deductions if a plan does not already exist. In many situations that we've seen, however, the full deduction cannot be recovered.

PAYMENT OF BENEFITS AND LUMP SUM DISTRIBUTION

Under Tax Reform benefits are required to commence no later than April 1st of the year following the year in which the participant reaches age 70 1/2. For example, if the participant's date of birth was September 15, 1918, benefits must commence by April 1, 1990, even if the participant is still working. As we shall see, and probably talk about, this can raise some administrative headaches with the changes of late retirement benefits accrual requirement.

FROM THE FLOOR: Is the change for all participants or just for the highly compensated?

MR. SHERMAN: All participants. That's the change that used to be the 5% owners who were required to start payments at 70 1/2, and now it's all participants.

LATE RETIREMENT

The TRA of 1986 did not directly address the issue of benefit payments after normal retirement age. A separate piece of legislation, the Age Discrimination in Employment Act, requires changes in the late retirement provisions qualified retirement plans. Employees may not be excluded from plan participation based on age. This means that effective January 1, 1988, employees hired within 5 years of normal retirement cannot be excluded from qualified pension plans. Also, benefit accruals after normal retirement must continue. This means that service and salary increases after that age must be included in the benefit formula. It is not required, however, that service in excess of a specified limit be used in the benefit formula regardless of the age at which the employee reaches this service limit.

For those plans which do not have any kind of increase allowed after normal retirement, we have seen and recommend that they amend the plan to grant such increases. We consult on a few plans which grant actuarial increases for late retirement. Generally two different arrangements are being considered.

First, eliminate the actuarial increase by replacing the additional service and its salary accruals. For a typical 50 less 50 final pay offset plan with a 30-year prorate, we have found that this curtails the increase for participants with more than 13 or 14 years of service at normal retirement. It is not a desirable option for a number of employers.

The second option is to grant the greater of the actuarial increase or the service/salary accruals. The implementation of this approach has been relatively easy given the small number of late retirements of participants of less than 14 years of service the company has experienced. This particular company, as far as actuarial increases, uses 7.5% interest assumption.

A larger headache for these qualified plans is to determine the payments for participants who continue to work after they have reached April 1st of the year following the year in which they reached age 70 1/2. At this point benefit payments must commence even though they're still working. Technically each monthly payment could be increased from the previous for service and salary accruals. This obviously creates an unworkable situation. We are seeking a solution beyond granting the increases only once a year and I would love to hear some suggestions from the panel or the audience on how to get around this problem.

FROM THE FLOOR: What about 415 limitations on late retirement?

MR. DEAN: I believe the limit is going to be based on the date that the person actually retires, which would be after 70 1/2 in our example, and you would have the actuarial increases in the limit apply, so you'd be looking at a number that would be indexed for both of those things (actuarial and inflation adjustment).

FROM THE FLOOR: For a defined benefit plan, when you have people sitting in the plan who originally were excluded from the plan under the age 60 rule, do you have to give past service prior to January 1, 1988?

MR. SHERMAN: I don't believe you do, but I'm not sure.

MR. DEAN: My understanding is that you would not have to give past service to those employees before January 1, 1988, in the calendar year plan, but they would have to come in at that time and then their service would be prospective. The IRS regulations, as you probably know, for the people who have not been excluded, the IRS has taken the position that service would be retroactive. So you've got two different situations for the people who were in the plan already, and for those who come into the plan effective in 1988 solely because of that age 60 and higher exclusion.

FROM THE FLOOR: Do you have to give vesting in service?

MR. DEAN: The vesting service, I think, would generally be given based on the hours. It would have been effectively there anyway.

FROM THE FLOOR: The vesting service has to be retroactive but benefit accrual services hinge on the date of participation implying the 401(a)9 rule and the interpretation that deferrals have at the point at which you let the person into the plan isn't necessarily January 1, 1988.

MR. DEAN: I think that's a good explanation.

PBGC PREMIUM

MR. SHERMAN: We've seen a dramatic increase in the PBGC fixed premiums and it's highlighted the importance of lump sum distributions to terminated employees wherever possible. At $16 per participant, the expense of maintaining a terminated participant with $100 benefit payable in 25 years exceeds the value of the pension many times over. All plans for clients of mine now have a lump sum distribution being mandatory if less than $3,500.

The inclusion of a variable premium could make plan amendments which increase benefits, in a particular career average past service updates, a bit more difficult to swallow for the employer. It is difficult to explain to clients that certain amendments to their plan must be adopted and at the same time that these amendments could force them into a position where a variable premium would be required. When doing plan design or cost analysis don't overlook the possibility of additional premiums.

MR. DEAN: Our next speaker is Bob Cosway who will discuss Social Security integration and lump sum benefit payment issues.

MR. ROBERT GORDON COSWAY: I'm actually not going to talk about the integration rules in great detail because that will be covered in another session. I thought that I'd talk in general terms about the kind of problems that typical employers have and what they're doing right now to try to resolve them.

Tax Reform had one bit of good news in it which was that you didn't have to amend your plan until the distant future January 1, 1989. Unfortunately it's now October of 1988 and most integrated plans are going to have to make some change to meet the new requirements. These changes are going to have to be made by January 1st so that the 1989 accruals will meet the new rules. And even worse than that, if your plan change is going to involve a significant reduction in future accruals under the Omnibus Budget Reconciliation Act (OBRA), you have to have the plan adopted and communicated to the employees 15 days before the effective date -- in other words, December 15. So a lot of employers and consultants are rushing around trying to get these amendments done. The problem, of course, is that we don't have any regulation to work with and a lot of the portions of the code are fairly unclear as to how they'd actually work. I believe one of the speakers later is from the IRS and maybe she'll be able to give us some more information as to when the regulations will be out.

So in a typical case the employer might ask you, "What is the minimum compliance amendment? What is the least I have to do to meet the new rules?" And I think that is difficult to do without any regulations. We can take our best guess at what the regulations are going to say, but until they come out we won't actually know.

What if the regulations don't appear by the first of the year? I've heard some different possibilities; maybe you have some other approaches. One is to just scrap integration altogether and go to a straight percent of pay plan, or go to an excess plan which clearly meets the new rules if designed correctly.

Second approach would be to freeze accruals as of December 31, 1988, and then later go back and do your plan design work once the regulations come out, and adopt an amendment retroactive to the first of the year. And finally, you could top off your formula in 1989 to meet the requirements, but then realize that you might go back later and cut back the formula during 1989 once the regulations come out.

Some employers that I work with have taken a little different approach to all of this. They said that given the fact that the IRS is forcing us to look at the details of our plan, let's step back a little bit and take a look at our whole plan design and see if it's really doing what we want it to do. Many times employers haven't done that for a number of years and they're using this as a good excuse to do it. Many were never really too happy with an offset plan because of the complexity and difficulty of communicating it to the employees. And now that we conceive offset plans as not having as much as an integration benefit as they used to, relative to an excess plan, they're thinking of either going directly to a non-integrated plan or going to an excess plan.

Let's talk a little bit about the various types of plans and some possible solutions. First, an excess plan under the new law of the maximum excess allowable is 0.75% of pay. This has to be adjusted for early retirement, and the early retirement is defined in terms of the Social Security normal retirement age instead of age 65. So for example, if you have an unusual plan that provides unreduced benefits at age 65 that takes the 0.75 right down to 0.65, at least for the group of people who were born after whatever date it is that gives you an age 67 normal retirement date.

I've heard some people talk about wondering if you could have a different excess percentage for different classes of birth years. I'm not sure if you can do that -- hopefully the regulations will address that. I've got a few examples that might be worth talking about. One case would be, what if your excess percentage is okay but your long-service employees may exceed the maximum excess for the lifetime benefit and the 0.75 factor is the maximum excess in any given year and for the entire benefit the maximum excess is 0.75 times years of service up to 35? If your plan is running into that problem, a very simple answer is to put a limit of 35 years on the excess benefit portion.

Another fairly common case would be your excess percentage is too high, but you have a very low integration amount. Maybe you haven't changed it for a long time and it's $4,800 or $6,600; then you have two pretty good choices. One, you can just drop that small integration amount and go to a straight percent of pay plan. The other is that at the same time that you raise your base rate to meet the new rules, you can also raise your integration amount. And if you do it the right way it's possible to exactly reproduce benefits for everyone making more than your new integration amount.

Just for example, if you had a $5,000 integration amount and a 1% excess spread, if you drop your excess spread to 1/2% and at the same time raise your integration amount from $5,000 to $10,000 you'll get the exact same benefits for everyone making over $10,000.

A third case is the messiest one, and that's if your integration percentage, your excess percentage is too high and your integration amount is covered compensation so you don't have any leeway to work with. Then you either have to top up by increasing benefits for lower-paid employees or cut back on the excess percentage and so reduce the benefits for the higher-paid employees. I think it's just a question of benefit needs versus cost which each employer has to look at based on his own situation. I've heard a lot of employers talking about cutting back as opposed to topping up.

With regard to offset plans, I haven't personally worked with too many but a lot of the other consultants have talked with their employers who seem to be going towards dropping the offset altogether. Many of them were never really too happy with it and this is a good excuse to get rid of the offset plans. The critical factors in the one plan I have looked at seem to be how the 0.75 factor is reduced for employees making more than the covered compensation amount. Under an interpretation we used as to how that factor will be reduced, the benefits went up fairly significantly for mid-range salaried (say $30,000) employees. The cost went up quite a bit, so because of that analysis, this employer decided to move toward an excess plan. When you move toward an excess plan what you find is that it's very difficult or impossible to match benefits that an offset plan produces with an excess plan. Because if you reproduce the benefits at the high-paid level you're going to have to significantly increase benefits to the low-paid level. And then if you decide that you want to keep costs about the same you're probably going to end up having to cut back benefits for the higher-paid employees. So it's the same kind of benefits versus cost trade-off. Hopefully we'll learn a lot more about some of the details of integration plans at a later session.

I want to talk a little bit about lump sum issues as they've been affected by recent legislation, and then regulations. I've divided this into four questions. One, does the employer want to pay lump sum? Two, given that he wants to pay lump sum, who in the plan is eligible for a lump sum? Three, what benefit optional form is the lump sum based on? And four, what is the interest rate basis for the lump sum calculation? Each of these questions has been impacted by recent legislation and regulations.

First, "Does the employer want to pay lump sum?" This has always had arguments on either side of the issue. There are two recent changes which possibly added more ammunition to the argument that you should pay lump sum, at least small lump sum. Dan mentioned both of them. Five-year vesting is going to produce a large increase in the number of young, short-service employees, or terminating employees with small benefits, and I think employers don't want to have the increased administrative hassle of keeping track of these people during the deferral period, tracking them down when they're 65. Also realize that there is some marginal cost involved with having the actuary include them each year in his or her work. Second, PBGC premiums just add a more noticeable annual charge to keeping these people on the rolls. So, from what I've seen, employers have expanded the cases in which they pay lump sum distributions, especially in the under $3,500 range.

Second, "Who is eligible for a lump sum under a plan?" This has been affected by the recent 401(a)4 regulations which prohibit discrimination in the availability of optional forms, including lump sum. So you cannot discriminate in favor of the highly compensated group in the availability of lump sum distributions. As a corollary to that, in the regulation it makes it clear that you can no longer have employer discretion in your plan. That would make it very difficult to test for discrimination if the employer has the right to deny any individual having a lump sum. It wasn't uncommon in the past to have a statement like, "If the employee elects to have a lump sum, the employer in its sole discretion shall direct the trustee to pay the lump sum." That kind of language has to be taken out and replaced by some objective criteria as to who can have a lump sum.

I think the most common types would be to say, if the lump sum was under $3,500, it will be paid without consent. If it's over $3,500 then either anyone can have a lump sum, or possibly lump sum up to some dollar limit, like say $10,000 or some monthly benefit would be allowed, and anything over that would not be allowed. You can also have other conditions as long as they don't act to discriminate in favor of the highly compensated. One example would be to have the requirement that the employee demonstrate good health through a physical exam, as long as you made it very objective criteria.

Third question is, "What benefit form do you take into account when you value a lump sum?" By that I mean, what if the plan has subsidized early retirement factors or subsidized joint survivor factors? Do you have to take those into account when you do a lump sum calculation or can you take those into account? The final Retirement Equity Act (REA) Regulations speak to that question, and the conclusion there is that there is no requirement that each optional form would be the actual equivalent of each other optional form. In particular, there is no requirement that a lump sum be the actuarial equivalent of any of the various optional forms. So it's okay to have your lump sum be the actuarial equivalent of the age 65 Straight Life Annuity amount, if that's what your plan provides. On the other hand, your plan could provide any other basis for lump sum -- could take into account early retirement or joint survivor factors. So the point there is it's important to spell out in your plan exactly how you are doing your lump sum, because from my experience most of the plans are not too clear on exactly how you do a lump sum calculation.

Finally, "What interest rate do you use for these calculations?" Before Tax Reform the limitation was, your interest rate could not exceed the PBGC immediate rate in effect at the date of the plan termination. After Tax Reform as amplified by the committee reports, it's clear that they don't mean immediate rate, but it's immediate and deferred as appropriate. The effect of that for young people is to significantly increase the amount of lump sum they will get because of the long deferral period in which you'll use 4% discount rate. So in terms of plan design, the only issue there is to make sure you have in your plan this new maximum basis, because even if your current plan basis produces lump sum higher than that today you still have to have in your plan this maximum PBGC basis.

To conclude on lump sum, even if employers didn't pay lump sum at all, most employers that I'm working with are starting to pay more lump sum, especially to the under $3,500 group.

FROM THE FLOOR: Are the actuarial assumptions for lump sum to be the greater of the plan assumptions or the PBGC assumptions?

MR. DEAN: Yes. I would mention that depends on how the plan assumptions are drafted, or if we're referring to specific assumptions other than the plan document, it can define lump sum as being totally calculated on a PBGC basis.

MR. WILLIAM E. NEAL: Can you amend a plan on integration to simply refer to the code section to say, despite what your plan says, the offset will not exceed that by law, or something like that?

MR. DEAN: I think a lot of people are operating under the presumption that you can build in a "notwithstanding provision" into your plan if you wanted to continue to use a formula, particularly an offset formula that you could say that the offset would not be greater than the maximum allowed. Is your question that, "Can we simply do that by reference rather than by describing?"

MR. NEAL: Yes. The point is in our offset there will be a few cases where we'll probably exceed this limit, generally lower-paid, shorter-term employees at early retirement. A simple way to take care of this is to say, "We won't offset them more than we can allow by law," and then most cases won't be affected.

MR. DEAN: I think you're going to have to let the IRS review it. They would certainly become much more liberal than allowing incorporation of code sections by reference. At one time it was forbidden and those walls have broken down. My guess is that you will be able to do that but the first one reviewed will answer the question, at least in your district.

I had a couple of observations regarding the comments thus far as to PBGC premium. Sixteen dollars a head or perhaps even more is a significant amount and not something to be ignored. One thing that you might look at in plans, it's an easy thing to do, is to make sure that you have eligibility requirements that exclude people until the last possible date. If you are making a PBGC premium based on December 31 participant count, you want to have a January 1st entry date and you want to exclude people under age 21 or less than one year of service. Then the service credit can be totally retroactive so that there is no change in the benefits ultimately paid to people. Because you have 5-year vesting it is really a distinction without a difference except that you would pay a smaller premium.

Another comment regarding Social Security integration in defined benefit plans -- our firm recently redesigned its retirement program and as part of that the president was visiting offices and discussing other matters, asking for informal opinions on what kind of plan provisions we should have. I volunteered the comment that we should have a totally non-integrated plan based on career average pay with updates and he seemed to take immediate exception to that. I thought, how could you think of a plan that isn't integrated with Social Security? I noted that recently we received the communication as to what our revised retirement program is and it does in fact have a future service, non-integrated, career average formula, but it provides an immediate update on a final average pay basis as of December 31, 1988, on a step-rate integrated basis. It occurs to me that's pretty good plan design because you have a plan that's effectively going to be integrated. It's going to be effectively final average pay to the extent that there are updates, it's going to be integrated on a step-rate basis that's fairly understandable to people. But in the meantime you don't confuse people with a complicated benefit accrual pattern under the career average pay formula. You simply specify that it's X percent of pay for each year of service starting in 1989 and forward.

We're also going to cover here in the time remaining some of the changes on defined contribution plans.

FROM THE FLOOR: How do you do the average benefit test? What benefits do you average?

MR. SHERMAN: We've seen two approaches to this. One is to take the approach of the 81-202 where we look at the accrued benefits and the projected benefits without salary scale, average the expected retirement benefits for each of the two groups. We've also seen and had some limited success with a salary scale included in the determination of retirement benefits.

FROM THE FLOOR: Do you include salary scale for conventional benefits when dividing by the resulting final salary both for hourly and salaried employees?

MR. SHERMAN: In the particular case I'm thinking of we had an hourly plan which was based on dollar per year of service. We obviously did not include a salary scale for that, but we were able to show comparability.

MR. DEAN: The issue of comparability has been important in the past, but it's going to become very important. The IRS really has a mandate to lay out and define what these rules are. And they have a mandate to make some changes and refinements in the rules for comparability. Under the new coverage test it becomes very important to look at line of business distinctions and what that really means, and to look at comparability. There's going to be a lot of combining of plans in qualifying retirement plans in the future. I've been interested in this subject because comparability pays a part under current IRS rules as well, and I've always been frustrated with 81-202 because while it tells you how to do a comparability test if you have two plans, each of which has one participant in it, I couldn't see how it really told me how to do the test when you had real plans. And I did a little telephone survey of actuaries to find out what their experience was in comparability and found that a lot of people had done comparability tests -- a wide, wide variation in how these tests were done from as simple as taking the average participant in each of two plans (or whatever the number involved was) and calculating the effective benefits or contribution rates under 81-202, to elaborate grids. But in every single case in this survey, the IRS accepted whatever the presentation was. Now if you think about that, that means we've had a kind of fiction of a comparability rule or else I just haven't figured it out. That's another active option I suppose. But I don't think that's going to continue in the future, because it becomes too important in the qualification of these plans. We have new coverage rules and I think there will have to be specific demonstrations of these things, and the rules will have to be much more clear than in the past. So I just suggest you be prepared for that.

FROM THE FLOOR: (Inaudible)

MR. DEAN: The comment is regarding the portion of the code on the average benefits test -- it was pointed out that there was a specific reference to current year pay, or at most the average over three years, which is true. Now how exactly you wind up using that in the average benefits test we will find out by regulation. This is related to the issue of comparability although it's not synonymous. The average benefits test is a kind of comparability test, but there will also be comparability tests under 81-202 and whatever refinements and changes there are to that for purposes of combining plans for qualification under some of the other rules -- the 70% non-highly compensated rule, or the 70% ratio test rule.

We've been talking about the defined benefit plans so look at defined contribution plans and their relationship with defined benefit plans. There have been changes in Tax Reform, particularly to defined contribution plans. The changes essentially become limits on the amount of money that can be put into these plans, and limits on the conditions under which the money can be taken out. The limits are constrictions so the defined contribution plans are somewhat less a flexible vehicle than they've been in the past. They are more of a retirement program, less of a credit union type arrangement than they've been in the past. As you probably know the annual addition dollar limitation of $30,000 was frozen until such time as the defined benefit of 415 dollar limit increases from $90,000 to $120,000. This is going to also affect plans through the combined plan limit. There is a $7,000 limit to the pre-tax contributions an employee can make to a 401(k) plan that's indexed, as you probably know, $7,313 for this year. Starting in 1989 plan years there is a $200,000 compensation limit for all qualified retirement plans for all purposes -- whether it's a test or use of compensation of benefit formula, the compensation is limited to this amount. These first changes then effectively mean there will be less money in these plans. It also means that plans that have been designed on the assumption that greater amounts of money would be put in need to be modified. And there's an interaction between the defined benefit plans and the defined contribution plans for companies that have both.

The discrimination tests were modified significantly. Instead of testing the top one third and lower two thirds of the payroll against each other, the new definition of highly compensated employee is used in the test. Importantly, the tests are now tougher. Generally speaking you had a 3% of pay differential in the average deferral percentage for the higher-paid employees compared with the average deferral percentage for the lower-paid employees under the prior rule. Now that 3% rule is 2% starting in 1987, and that's going to put increased limits on the highly compensated people. Also a new test, 401(m) or average contribution percentage test, was added to the code, and this test applies to employer matching money and applies to voluntary after-tax money contributed by the employees. The effect of this on plan design is to make it very much less feasible to allow a lot of after-tax employee money into the plans. That's been cut back.

This summer we had both final and proposed regulations dealing with defined contribution plans. The terms of financial hardship withdrawals have been defined better than they have been in the past. Part of that involved adding Safe Harbor provisions. One of the Safe Harbor provisions would require that in order to use the Safe Harbor, the plan would penalize the employees for 12 months after a financial hardship withdrawal. So this meant that someone who withdraws money couldn't contribute to the plan for the next 12 months and they would have a further limit when they did begin contributing based on the unused portion of their $7,000 contribution amount.

Also an interesting change is something called MUAT, which I think is a kind of French champagne, or is it California? What this amounts to is an explanation to the cryptic references in the law in the code to not allowing multiple uses of the alternative test. The alternative test that's referred to here is that 2% differential. The 401(k) and 401(m) tests are really two discrimination tests. One is based on the highly compensated employee not putting in more than 125% on average, as the deferral percentage compared with the non-highly compensated employee. And one is based essentially on a 2% spread.

The idea is now that you cannot use both. Both regulations specify that this would be effective in 1989, so whatever you were doing in the last two years is probably okay, but in 1989 interpretation will be different and is going to impact quite a few plans. There's an illustration here that compares the average deferral percentage. This is the so-called K test, and the average contribution percentage, the so-called M test. In this particular plan the spread between these average percentages is 2%. So for 1988 this plan would pass both the Average Deferred Percentage (ADP) test and the Average Contribution Percentage (ACP) test because we're using that 2% spread for both of the tests.

Starting in 1989, the ADP test is passed using the 2% spread, the difference between the 6% and the 4%, but we can't reuse the 2% spread on the second test -- on the M test or the ACP test so that the plan will fail. Now if you do not fully use the 2% spread, there is a procedure you can go through which is illustrated here that allows you to use whatever is left of the 2% spread from one test and apply it towards the other test. It results, in this case, in calculating a maximum aggregate percentage of 11% for highly paid employees which is compared with the 12%, which is the sum of the ADP and ACP for the highly compensated employees. So in this case the plan fails. If that had been a 5% match, which would be a lesser match, in this case then the plan would have passed.

We've seen some activity in attempting to design plans that will meet these tests and to do advanced testing during the year rather than waiting till the end of the year to repay excess amounts out to the highly compensated employees. There's a desire not to surprise people.

FROM THE FLOOR: The ADP is based on the employee's money and the ACP is based on the match. Can the 2% be used on the ACP test?

MR. DEAN: Yes. You can use the 2% on either side, but you can only use it one place.

FROM THE FLOOR: The other one has to be done on the 125% basis.

MR. DEAN: That's right. Now in this case, this plan had fully used the 2%, but if you had not fully used the 2% -- if you go through the illustration at the bottom, you get some kind of credit on the second test. So it's more adverse than the test has been or at least in most, people have actually been operating the test, but it's not quite as bad as it might have been.

Let's look at the issue of defined benefit versus defined contribution plans -- a long-standing debate. I think this debate will be around until they finally kill off defined benefit plans. Some of the issues that are concerning employers as we see them are legal and administrative complexity, and there are a lot of complaints about these -- one change after another, some of them so highly technical you have to have actuaries and advisors to help figure these things out and it's very wearing. If you have an employer that has an employee benefit staff they are perfectly happy sometimes to sit down and spend enormous amounts of time talking about detail. If you have an employer where it's the finance officer or director of human resources who is making decisions and this is just part of their job, their patience is much, much more thin about these kinds of issues.

PBGC premiums are becoming a considerable irritant. These amounts of money are significant. Considering that you can do record keeping on a defined contribution plan, if you are not doing monthly allocations, for perhaps $20 per person, paying $16 a person or more for PBGC premiums in our defined benefit plan, where the employees get nothing and the employer gets nothing seems to be unattractive. The new method for calculating this PBGC premium is based on a market rate of interest. I think we are going to see in the future how irritating this is -- the fact that the PBGC premium can be $16 one year and $25 the next year and you really don't know from one year to the next year what it is going to be.

We're also willing to see plans that were able to escape additional PBGC premium this year by using assets prior to the drop in the stock market are not going to be able to do that next year, and they're going to see a higher premium. The OBRA rules, particularly the rules on full funding limits, the rules for which we're waiting regulations, have the effect of making some contribution patterns of employers close to this limit, very unpredictable. And of also limiting the tax planning flexibility that's been built into the defined benefit plans, so it is a considerable negative aspect to employers looking at defined benefit plans.

FROM THE FLOOR: Is the relative impact of all these rules perhaps to make the actuarial judgment or opinion totally irrelevant? It seems like you came in and have done your accounting rules and done IRS rules and if there is any kind of actuarial evaluation or judgment, it's irrelevant.

MR. DEAN: That's right. On that full funding limit, that's true. The benefit and contribution limits -- now one of those contribution limits is OBRA full funding approach -- have been squeezed again. The limits referred to on the maximum benefits that can be paid upon early retirement of an executive have a substantial effect.

In defined contribution plans the tightened rules on hardship withdrawals and the rules on loans have led a lot of employers in the past who have not wanted to administer loans at all, to avoid that complexity, to thinking that they will, or that they will have to in the future. After tax money is being squeezed out of plans and there's adverse tax consequences in taking a hardship withdrawal -- you've got taxation of the money, the 10% excise tax on top of that and a 12-month penalty, it hardly seems worth it to provide for hardship withdrawals in a plan when you can allow an employee to borrow the same money and simply repay it on a payroll deduction basis, perhaps adjusting his contribution. So defined contribution plans are going the route of allowing for more loans although not too many people are really enamored with the idea of administering it.

All this is a terrific boon for non-qualified retirement plans. Most large employers already have non-qualified plans. They may have a combination of a pure excess plan. That's pretty common. Also special arrangements for individual executives as a second matter. With these plans you're going to see change, for example the $200,000 limit is important to a company that has a pure excess non-qualified plan because that excess plan will not automatically make up for the $200,000 limit. That has to be done by amendment to the excess plan, and after it's amended it won't be an excess plan anymore, it will be a top hat plan. There's no crucial difference. It's a legal distinction and there's not a great deal more to do with the top hat plan than the excess plan.

So we have more plans. In fact I think by the end of 1989 when all this sinks in large employers will probably have non-qualified plans except where they are actually philosophically opposed to this idea. And we have seen examples of that. And there will also be more plans for smaller employers. The plans that exist will provide more in benefits. Part of that is the $200,000 compensation limit or the effect of the 415 limit on employees who retire early. We've also seen a lot of interest in non-qualified plans to make up what's lost or assumed to be lost in defined contribution plans. This includes the $7,000 limit. Plans that effectively make up for the contribution that an employee might have made if there weren't such a limit. Now these would be plans for executives. They can also be plans that make up the company match. Quite a bit of that. And with fictitious accounts created for these non-qualified defined contribution plans and fictitious earnings on the accounts credited to the employees and executives who hope one day to get real money from all of this.

The reason for this increased activity in non-qualified plans is simply that it is a very straightforward way to solve a lot of the problems created in the design of qualified retirement plans. Everything that is keeping you from doing what you want to do you can make up for in the non-qualified plan arena. What you give up are the tax advantages of the qualified plan.

Some of the trends -- I just put this down as some personal thoughts. It's the kind of thing you can debate and disagree with. But some of the trends that I think are out there that you can almost feel are issues such as, instead of career average pay plans, indexed career average pay plans. The new example of that is the cash balance plan. It is a kind of indexed career average pay plan. Instead of a final average pay plan, a synthetic final average pay. That's a plan that's not legally written as a final average pay plan although it's intended to operate that way. This can be done by using an updated career average formula where the updates happen regularly, or it can be done by providing a final average pay formula that's got a sunset provision in it so that everyone retiring or leaving in the next five years receives a final average pay benefit and after that time it's not guaranteed that final average pay formula would continue. That's been done.

I think there's a swing away from offset type integration to step-rate integration. The biggest appeal to offset plans has been to actuaries. It's a very academic kind of plan. You have a situation where the employees have no possible hope of figuring out their own benefit and they won't know what it is except that somebody gives them a report or tells them what it is. Very hard to explain. Very nicely behaved as far as changes in Social Security benefits are concerned. And it used to be under the old rules you could integrate more heavily under an offset plan than under a step-rate plan. Evidently that aggravated some of our friends on the staff in writing Tax Reform, and so with the exact eleventh hour there were provisions written into the integration rules to try to set essentially the same rules for step rate and for offset plans. I have heard people say that you cannot integrate an offset plan any more than a step-rate plan. Today I don't think that's quite true. It's simplest in an offset plan to build in the limitations of the new integration rules and have them automatically reflect an employee's Social Security retirement age so that the people with age 67 are treated differently than people with retirement age 65. In a step-rate plan, unless you want to really confuse people and aggravate people, you're probably going to design to the lowest common denominator and you're going to design the plan based on Social Security retirement age 67, even for the people who have a retirement age before that.

One of the trends that I perceive is the trend for defined benefit plans to adopt some defined contribution plan features. That's things like paying lump sum, the cash balance, the close integration of a floor plan with the defined contribution plan. One feature that we've been talking about with clients and that has been adopted, that has a lot of interest, is the idea of using the cash balance approach as a feature to a traditional defined benefit plan rather than a replacement. In other words maintain the defined benefit formula but add the cash balance feature to it. And part of the thinking is to look at the advantages and disadvantages of traditional defined benefit plans. Here's a list of what they are and you'll recognize some of the things (Exhibit 1). Past service is easy to handle in a defined benefit plan. On the other hand you've got the

EXHIBIT 1

THE TRADITION APPROACH:
DEFINED BENEFIT PLANS

Advantages	Disadvantages
Employer	
Funding flexibility	Unknown long-term financial commitment
Funding waivers possible	PBGC premiums required
Important to career-minded employees	Not meaningful to young and short-service employees
Can be updated	Difficult to communicate
Least costly approach to targeted retirement income	Cost cannot be shared by employees through pre-tax 401(k) contributions
Past service can be recognized	
Employee	
Known commitment	Hard to understand
Meets real need for retirement income	Slow vesting
	Not portable
	No employee pre-tax savings on 401(k) contributions

long-standing problem that these plans don't seem meaningful to young employees. Even young employees who may stay with the company, and to whom that defined benefit plan will ultimately be very important and very appreciated at the end, it doesn't mean it's meaningful during the employee's career.

You have, of course, tax planning flexibility. On the other hand there are pros and cons of defined contribution plans to both the employer and employee (Exhibit 2). They're much easier to understand. Easier to communicate for the employer. Very difficult to provide adequate benefits for older employees through these plans. And not the cheapest way to provide retirement income because it does not target to the exact level of retirement income as the defined benefit plan would.

The question is: wouldn't it be great if we take all the advantages of defined benefit plans, combine them with the advantages of defined contribution plans and eliminate all the disadvantages of either? Can we do that? The answer is no. But you can extend that list of advantages and cut down some of the disadvantages by combining the retirement formula with the cash balance. Still

EXHIBIT 2

THE TRADITION APPROACH:
DEFINED CONTRIBUTION PLANS

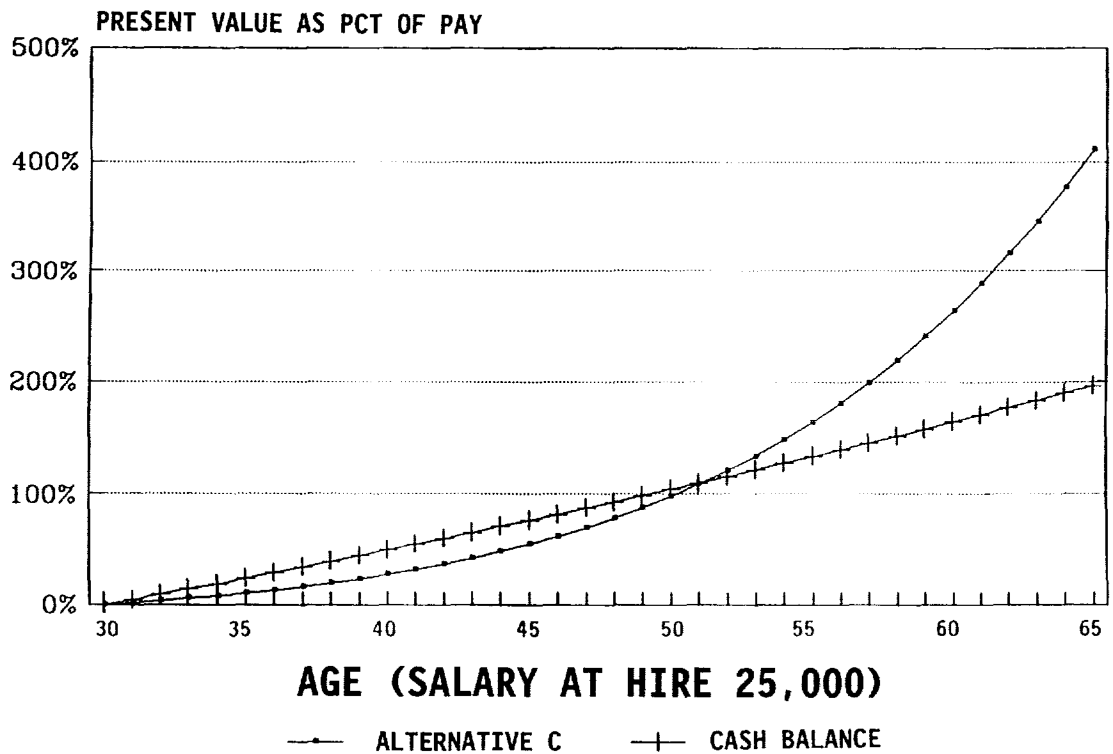
Advantages	Disadvantages
Employer	
Known long-term financial commitment	No funding flexibility
No PBGC premiums	No funding waivers
Popular with young, short-service employees	Not adequate for older
	Difficult to update
Easy to communicate	Contributions for younger employees often in excess of actual requirements
Cost can be shared by employees through pre-tax 401(k) contributions	Difficult to recognize past service
Employee	
Easy to understand	Unknown commitment
Rapid vesting	Inadequate for older employees
Portable	May use up lump sum
Pre-tax savings on 401(k) contribution	Investment risk
Investment options	

the defined benefit plan, must pay PBGC premiums, but now a plan where the employees receive information about the value of their plan. And the idea is that the employees would receive the greater of the value of their cash balance account and pension formula. The cash balance account, for example, might be the accumulation of some percentage of pay, let's say 3% of the pay or 4-5% of the pay, with interest at a guaranteed rate. And that would be compared with the retirement formula.

Graph 1 illustrates this approach. This is a sample employee over his career, hired at 30 and retiring at 65. The two lines show the accrual of benefits, and in this case benefits are measured as lump sum value age by age. And in fact, to take inflation out of this equation the lump sum value is measured as a percentage of current pay. So the point on that part at age 50 represents the lump sum value of accrued pension benefit at age 50 divided by the person's annual rate of pay at age 50. The curved line is the accrual pattern of a defined benefit pension formula, which is an offset type formula. And you see that it's curved and note that this is not a plot of dollars, but a plot relative to pay, so it has the element of inflation and even pay increases removed but it's

GRAPH 1

FORMULA ACCRUAL VS CASH BALANCE



still a highly sculpted curve to this accrual pattern. Now what this means is the young employees who think that the defined benefit plan is not very meaningful are quite but intuitively correct. It isn't very meaningful and it's not worth very much. And that's why it was mentioned that 5-year vesting doesn't necessarily have a great cost. It doesn't because the benefits aren't very good. The value of those benefits isn't very much. The straight, or almost straight line in Graph 1 represents a cash balance account. By using the cash balance as a feature to the defined benefit plan what the employer is saying is, "We'll give you the higher of those two amounts, not both but the higher of the two." And it has the effect of actually improving benefits for people at the younger ages and also of greatly improving the communication of the plan because employees will know what the value is. It will be very predictable and will do nothing but go up in a nice orderly fashion. This particular line happens to cross at just a little bit before early retirement age, which could be a nice feature of this sort of plan.

MR. NEAL: We have these changes to the law which say you can't exclude employees within 5 years of normal retirement age. Also we have changes, or have a rule, that says you have to commence benefit payments by age 70 1/2 following the April 1st following the year in which the employee attained age 70 1/2. So if you are hiring an employee at age 68, what are you going to do? And don't laugh, it happens.

MR. DEAN: You probably won't have the defined normal retirement age. If that is still age 65, then that person hired at age 68 is immediately vested. There isn't going to be anything but a mechanical problem in paying him after age 70 1/2.

MR. NEAL: So what happens if he continues to work beyond age 70 1/2? He's paid retirement benefits and salary at the same time. He's continued to accrue retirement benefits and it keeps going up every month at the same time.

MR. DEAN: That's right. The issue that was mentioned earlier was, how do you actually administer that. At one end of the spectrum you might say we figure the benefit initially and pay it, then when he finally retires we figure a final benefit and true up. Now you're allowed to deduct the value of the payments already made and in realistic scenarios you find that, except for very short-service employees, probably the benefit won't change at retirement. For short-service employees it will actually jump up. But some people feel that's not enough to calculate the benefit at age 70 1/2 and then at final retirement that you'd have to do a recalculation every year and adjust the benefits. I don't think that's a closed issue.

MR. NEAL: Then you are saying that someone that's hired beyond your normal retirement age is vested immediately? They work for you 6 months and you are going to pay them retirement benefits?

MR. DEAN: Yes. Now you could require 5 years of participation in the plan. So you could change the normal retirement age. If it was just 65, you could change it prospectively for people brought into the plan to be the later of 65 or 5 years of participation.

MR. NEAL: In that case he would be vested immediately but we wouldn't have to commence benefits until after 5 years or 70 1/2 had occurred first?

MR. DEAN: Yes, I would think you wouldn't have to commence until -- I don't know, because the two are conflicting. I don't think there's supposed to be an allowance that you don't start benefits after 70 1/2, so that might imply that you'd have to vest people at that point.

FROM THE FLOOR: I think that one of the things that was left out of the advantages and disadvantages on defined benefits versus defined contribution is the impact of inflation. In fact, a final average step-rate plan does a pretty nice job of automatically adjusting for inflation. And now think about medium-sized or small employers that don't have a benefit staff to sit around and worry about updating every third year or forms of supplements to defined contribution plans. And I think that although there are probably not a lot of examples around, there are people who are retiring from defined contribution plans even after substantial years of participation. You will find that during inflation on the natural economic cycle -- and I don't think you can overlook inflation, even though the people in Washington do, we're going to find that laws on the defined contribution plans will not be providing adequate benefits at retirement time. Then those employers who have abandoned the defined benefit plans totally will be doing an awful lot of ad hoc supplements at 65.

MR. DANIEL M. ARNOLD: The direction that I'm seeing in New England is that employers are putting in more of these SERP plans and more non-qualified plans. These plans are providing substantial portions of benefits for the executives and higher percentages. And as time goes on, the number of employees who are affected by them are increasing and will in the future increase dramatically. These plans can have, or may have, bad boy clauses and the direction of planning is, now we're seeing a whole class of employees who are not protected by ERISA. They're open to a variety of devices and manipulations of their benefits and we've got a very unhappy group out there. And I think that group is going to grow dramatically in the years ahead. It will provide a lot of opportunity for us to try and unravel this and come up with something that is going to please the stockholders and the owners of these companies and yet also please the employees that something is coming out that is going to provide for their retirement and have some security.

MR. DEAN: Was that an Amen?

MR. O. DAVID GREEN, III: Am I correct in assuming that in the average benefits test that the test is met if the benefits of the lower-paid employees are at least 70% of the highly compensated counting Social Security?

MR. DEAN: The test makes no reference and the code makes no reference to Social Security in that particular test. Now Social Security is included under 81-202 for comparability purposes, but those really aren't exactly the same thing, they're just similar.

FROM THE FLOOR: Is the test exclusive of Social Security?

MR. DEAN: Yes, that's my understanding.

FROM THE FLOOR: We have been interpreting the principal differential to be 70%. But the 70% is already in the other coverage test.

MR. DEAN: I think there was a numerist attraction to 70 here involved in the code. They seem to like to use that number, but some of these 70% figures just don't mean the same thing as the other. It doesn't always tie together.

FROM THE FLOOR: So the consensus is that without regard to Social Security.

MR. DEAN: Yes. I think if you look at the code, you'd have to be expanded by regulations in order to use that because it just doesn't say a thing. And it does define all the terms that you are talking about -- benefits as a percentage of pay, and it's that one year -- three year. . .

FROM THE FLOOR: Any reference to other use of method 81-202 and also there are references in the law that use integration. Why would that even be relevant? If you don't include integration and don't include Social Security benefits, what is your new integration limitation?

MR DEAN: Yes. The 70% benefits test is a coverage test. There are separate tests for integration and rules on integration, and there are separate rules as to comparability for purposes of combining plans for some other purpose. You could be combining plans and proving them comparable to look at either of the other two coverage tests or to look at the basic 401(a) qualification requirements.