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SOCIAL SECURITY INTEGRATION UNDER TRA 1986

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- A discussion of the effect of the Tax Reform Act of 1986 and proposed regulations on Section 401(L).
  - Effect on plan design
  - Effect on replacement ratios
  - Effect on cost
  - Discrimination considerations

MR. EDWARD W. MARONI: What we're to talk about is integration according to the Tax Reform Act of 1986 which we all diligently reviewed to some degree with a certain amount of frustration and wonderment. I would like first of all to comment on the differences between what the old system was and what the new system is as I see it. This is a personal opinion. It is not a Towers, Perrin Forster & Crosby opinion, it's just my own reviewing of the situation.

Some years ago, I think about 10 years ago, I was at a meeting, and there was a seasoned attorney giving a speech in a room that was actually bigger than this to a larger audience. He had been in private practice for nine years in Pittsburgh. Prior to that time he had been with the Internal Revenue Service, and he made mention of the fact that he had worked up a system for integrating pension benefits with the Social Security system which would provide that the employee got credit himself for at least 50% of the Social Security rather than getting those big reductions the remainder of the 83-1/3% that was in 71-446 or whatever it is.

At any rate, the idea was an excess plan would have a rate of benefit accrual below the integration level and a rate of benefit accrual above the integration level which was no greater than twice the one below the integration level or 50% below. As I said, he was in private practice in Pittsburgh for nine years, and he went back to the Internal Revenue Service, and he went to the same file that he put the stuff in nine years before in a big study, and it was still there in the same position in the same moldy drawer. Maybe it was well taken care of, but it hadn't been moved one inch. Now this is a meeting that took place in the late 1970s.

When I first saw what was being said in Tax Reform Act 1986, it kind of frightened me. I have the impression that the new rules that we're faced with under Tax Reform Act 1986 do stem from attorneys and other people who are staff members of the legislature, rather than the legislators themselves.

I can remember when TRA 86 first came out and a few people were talking about it. What they said in characterizing the new rules was that the regulators have reduced the size of the playing field rather dramatically, but they've greatly simplified the rules. At that time, I felt that made some sense because the rules under 71-446 and 69-4 and whatever preceded that from 1942 on through 71-446 were rather complicated, but at least they had some rationale. As I say this is just an opinion I'm giving you before we get into some of the details.

It does seem to me that the older system took into account all of the aspects of the Social Security benefit provisions (an 8/9 reduction for preretirement death benefit, and another one that was seven divided by seven plus 2K if it was a preretirement spouse's benefit, and a series of about 10 different percentages that you had to reduce your otherwise applicable offset or excess percentage, whatever it was). For instance, if you had a plan that had no bells and whistles and it was an excess plan meeting the rules, and you had a five year certain and life annuity as a normal form of benefit, you had to reduce your excess limitation by .973%. Then there is a provision in 71-446 that does that for all sorts of annuities. So it did take into account everything that was in the Social Security system when it was developing the integration rules. But it did allow you to go so far as to integrate out people.

What's meant by integrating out is where you have a strictly excess plan. Let's say you have a plan that a few years ago might have been 0% of earnings below $5,400 and 1% of earnings above $5,400 on either a career average earnings basis or a final average earnings basis. For those people who made less than $5,400 (of course, we're going back to the 1960s or early 1970s), they were in effect integrated out, and therefore the employer was not deserving of tax benefits.

I'm all for benefits and I'm all for benefits for people who are deserving of them at the lower end of the pay scale and sure I'd like to have them. But I think this system and anybody who takes that position that you shouldn't be able to integrate out or you shouldn't be able to integrate to the degree that you could in the older system under 71-446 is completely ignoring the fact that number one, the Social Security system is, in itself, a highly discriminatory system and especially discriminatory toward the lower-paid people. If you're going to give them full credit for their contributions, and in effect the way it works (I think we're giving them credit for more than their contributions) under the new rules if you want to set up an offset plan, for instance, the only Social Security years you could take into account were the Social Security years working for that particular employer.

As an example, if a person worked for 15 years, it would be 15 times .5 times whatever the number was that was going to be used for an offset for that particular individual, and I think that ignores the fact that employers do pay Federal Insurance Contributions Act (FICA) taxes on behalf of employees who do not stay to get benefits from their pension plan, so that they're not completely getting a free ride under the current system. Although if the employee changes jobs in midyear, he gets any excess FICA taxes back, the employer doesn't. So I think that the employer is still paying more than 50% of the FICA taxes, and coupling that with the fact that the system is discriminatory toward the lower end, I think this new system ignores that.

At any rate, we have this new system that is a much smaller playing field with far less complicated rules which are becoming more complicated every day. We are seeing rather large regulations on Section 401(l) and also Revenue Rulings that have amplified that and have extended the time periods. We have heard rumors going around.

I'll share with you a couple pieces of verbal information that we've heard at my company the past 10 days. Early last week, there was a strong rumor to the effect that the 1.401(l) regulations were going to be rewritten in their entirety.

By the end of the week somebody had listened to Jim Holland who was speaking at the Conference of Actuaries in Public Practice Meeting down at the Homestead, and he said he wouldn't count on that. In other words, the actuaries apparently in the Internal Revenue Service don't feel that there is any likelihood that those regulations will be changed. However, there is a new Revenue Ruling extending the period of time for another year, up until January 1, 1992, I believe.

I wanted to go through some of the technical parts of the new rules. These are some of the things that were covered by the most recent notice, Notice 89-70, and then Judy and Paul will take you into some detail on everything.

Notice 89-70 was an update to the Regulations that was published in November 1988, and it provided for a definition of compensation. The definition of covered compensation differs a little bit from the one that was in Tax Reform Act 1986, and the proposed regulations which went to the year born plus the Social Security Retirement Age minus 1. Notice 89-70 has gone back to the plus Social Security Retirement Age, which is simply an attempt to get back into the old way that the covered compensation was calculated. You may use the old law definition through 1994. The question why just indicates that if you're age 65 in 1994 you would have been born in 1929. That's the first year of birth where 35 years goes into the denominator in the Social Security calculation. If you were born in 1928, its 34 years, etc. The two tables will be available (which wasn't clear at all before, it looked like just the unrounded value of the covered compensation calculation as defined in TRA 86 would be available), but Notice 89-70 does say that you can use that 600 Table. I've also said that you can keep it constant for five years. The table for Year X may be used through the Year X+5.

Notice 89-70 addresses defined contribution excess plans both from the law and Revenue Rulings. We had the understanding that the only integration level that could be used was the FICA wage base level of that particular year. Notice 89-70 said, you can use something different than the FICA wage base. If you do, you have to make a change in your maximum excess allowances provided for under the defined contribution plan. I'm assuming you know the original rule which said 5.7%, which came from the old OASDI percentage for FICA. The new rule says we're going to use just the old age percentage for FICA which is around 5% and then it allowed for using the greater of the current 5.7% or the old age rate. The Notice also made the comment that the old age rate of 5.0% probably would not exceed 5.7% in the near future.

The Notice made some changes in that and allowed you to use something other than FICA wage base. If you want to reduce it to use 20%, you can still use the 5.7%. That simply means you're getting practically everyone covered by the excess allowance and 5.7% is okay. In the middle areas, they've reduced it a little bit. Back up at 100%, it's back up to 5.7%.

Then the Notice provided some additional alternatives on the integration levels of excess plans. Under proposed regulations, we're okay with no reduction on the .75%. The covered compensation is a maximum fixed dollar figure of $10,000, or 50% of the covered compensation for the person who is retiring in that year, or an amount greater that goes above certain demographic tests that were met. Those demographic tests were in 1.401(l) Regulations, if you recall.

No alternative would allow you to use an amount up to the wage base in an excess plan without meeting the demographic test if you use the .75%, or whatever other applicable limit you had and, you reduce it to the smaller of limit based on a demographic test, or 80% of .75%. Also, consult the Covered Compensation Table for any earlier year, provided a table for Plan Year X is not used beyond Plan Year X+5. That means that you can keep $15,709 (this year's covered compensation), and you can use it through 1994. As we said before if you want to change it to whatever covered compensation is in 1995, you can keep that through 1999, and you're not having to explain in your summary plan description (SPD) a change in covered compensation every year.

A RELIANCE ON DEMOGRAPHIC DATA

If the integration level was justified on the basis of demographic data, then the determination letter could be relied upon until such time as you made a major plan change affecting the permitted disparity. I've assumed that you know what "permitted disparity," "maximum excess allowance," and "maximum offset allowance" are.

Or if you have a significant change in the material facts, such as a big change in the age and service mix of workforce. If you've looked at the way those demographic tests in 1.401(l) work, you can certainly see that it would be logical that you'd have to make some other tests at a time when you change your workforce, like closing a plant that might be made up of a very young group of people because it's a new plant or something like that.

There was some concern as to whether TRA 86 and 1.401(l) Regulations permitted a career average plan. Notice 89-70 says yes, and the integration levels are the same as for the final average plan, which is a little different than under excess plans via 71-446 method. Also it clarified and liberalized the early retirement penalty that you had to take on that .75% maximum excess allowance. Before 89-70, I think we used what most of us refer to as IRS standard where you have an early retirement factor table that is a reduction of 1/15 per year for five years, 15/15 at 65, 14/15 at 64, 13/15 at 63, etc.; the 1/30 reduction from 59 down to 55 which cuts you down to a 50% early retirement benefit at age 55. It will allow you to use that IRS standard on excess plans and also on offset plans. It also made it clear that you can use an early retirement factor on the nonintegrated portion of the formula that's better than the integrated portion of the formula. In other words you could subsidize.

Let's say you had an excess plan that was 1% of pay up to $10,000 with a final average earnings or career average earnings and 1.5% in excess of $10,000, you could have two different early retirement factors. You could have an early retirement factor below the $10,000 applicable to the benefits accrued on behalf of compensation earned below the $10,000 and another for the compensation earned above the $10,000. The lower one had to be better than the higher one.

Here is an example: .01 final average earnings times accrued total service at 65; this is the age 65 benefit. I don't think those are the numbers I used, but .01 and .0075 above the covered compensation which is being used as the integration level in this example, then the age 60 benefit could be the .01. In other words, this would be 100% subsidized early retirement under the nonintegrated portion and the IRS standard early retirement factor on the integrated portion. That is about as much as 89-70 changed the rules, and Judy Latta is going to discuss excess defined benefit plans in a little more detail.

MS. JUDITH E. LATTA: One of the things that maybe I'll tell you in advance is that I practice in the New York area and as a result, most of my clients tend to be very large, well established, mature clients. I think each of us comes from a bias of our own practice when we discuss an issue, and so I thought I'd at least let you know my bias and that way you can temper some of my generalizations.

I'm going to back up initially and just run through how we got to the present state of affairs which I don't think any of us are too happy with. At the end of 1986, TRA 86 was passed making sweeping changes in the Social Security integration rules. Now the sweeping changes were so large that the law acknowledged that, and said, "OK, it's not going to be effective until 1989," so there was a two year implementation period that was enacted. These changes did reduce the amount of recognition of integration with Social Security and also were designed to reduce the disparity between the benefits provided for nonhighly compensated employees and highly compensated employees.

I'm less indignant, and maybe that's reflective of my client group, with the fact that you're not allowed to integrate out. I think that a lot of bad press came from integrating out because people did not understand it, and I do think that there were those practitioners out there who basically abused it. So the thought that there should be some sort of benefit for everybody in an employer-provided plan on the surface is not unreasonable when you're talking about the tax qualified status of the program and the different benefits that go with it. The other thing that the regulators did was they tried, not necessarily successfully, to eliminate differences between the form of your plan. That was basically an honorable objective. It was very difficult because of the basic nature of the formulas to achieve that. So it took two years before we got proposed regulations. Now we're talking about November 1988, and amendments are supposed to be made as of January 1, 1989. Worse than that, the regulations threw us for a loop in a couple of things they did.

For instance, consider the early retirement reductions. No one ever anticipated that the one 15th, one 30th reduction would be changed; but all of a sudden we had more stringent requirements. Those of us who had taken a leap may have gotten burnt. The main issue, I guess, is that uniformity was introduced in a major way to effectively prohibit Primary Insurance Amount (PIA) offsets in the standard format. Whereas before, I think when the law was initially passed, we looked at these permissible disparities as maximums; and therefore, we thought that our PIA formulas could continue.

Then what happened was they said, no, these offsets have to be uniform as a percent of people's compensation of the integration level. That of course means, with Social Security being front-end loaded as Ned has mentioned, you can't use a PIA offset and achieve a uniform reduction. That was difficult to digest, and in the acknowledgment of that, we got Revenue Ruling 88-131. That was in December 1988 that said, oh well, we know you can't amend your plans in time, so you can have relief, and you can either freeze benefit accruals for everybody, or allow for some employees your current benefit formula to continue with the prospect of having to go back and recalculate every one of those benefits once you figured out what your actual formula was. So it was relief, but there was a price that was being paid for this relief.

We saw 89-70; I think it really did give us some relief. It came out in June 1989 and undid some of the things that were done in the proposed regulations, brought that covered compensation formula back to the one that we were more accustomed to and changed the early retirement reductions. So we did get some relief, and as well it allowed for some of these uniform dollar level of integrations that hadn't been easily permissible under the prior regulations.

You think that here at the end of 1989 I could say that these are the rules and we could just go forward, but we're still hearing about changes that are going to be made. The latest I heard was that the remedial amendment period was going to be extended to the end of 1991, which will allow us to operate our plans for a full three years under these old formulas with the prospect of being able to go back and recalculate benefits for three years of activity. It's not really relief and you really wonder whether our regulators and legislators have any business sense at all with regard to the administration of these plans. I think most of us continue to support defined benefit plans, and yet we understand that they are becoming very onerous for people to administer.

Another relief provision that is expected, and again I don't know how this is going to work, is with regards to the transitional rules. The final pay plans effectively were only able to amend the entire formula, and that was the only alternative they had under the regulations. That's because the other alternative required a freezing of benefit accruals as of December 31, 1988. My understanding is that there is going to be guidance though that will permit us to effectively let the final pay float, freeze service and let the final pay and the PIA float. Again, I don't know how much we'll end up using that because if we go away from an offset type of formula then, we'll still need to calculate offsets. Nevertheless, it makes more sense from a transitional rule and a final pay plan that you could effectively eliminate integration prospectively but not have to cover the offset from accruals prior to December 31, 1988.

Then we have the prospect of the 401(a)(4) regulations which are due earlier than December. The latest word seems to be that it's getting to be really early 1990. These define our general nondiscrimination rules, and there's always been this carrot stuck out there that says, "Well, maybe you can't meet these rules, but when you see 401(a)(4) and the general nondiscrimination rules, you might be able to meet those, so maybe you don't have to amend your plans at all."

How many plans that have been amended, have actually eliminated the integration in their plans, by a show of hands. Ok, that's less than I would have anticipated. Just a smattering of hands. Terminated their plans? Now there are more people terminating their plans than eliminating integration. That's kind of a statement, isn't it? Not a very positive one.

What I've found is that most companies right now are looking at defined benefit excess plans. Mainly because I think offsets have been ruled out by proposed regulations, and who knows if we get different regulations, maybe we'll get back into exploring offset formulas. Is that generally as well the consensus of the group? Are most of you working with your plan sponsors evaluating excess plans? By a show of hands. Ok.

Let's just focus on the excess plan and discuss the integration requirements for excess plans. I don't think I need to explain the concept of integration with Social Security with you. It's basically you can have a plan that discriminates in favor of higher paid employers as long as it's limited to no more than what Social Security discriminates in favor of lower paid employees. Now the amount of "discrimination or permitted disparity in benefits between nonhighly compensated employees and highly compensated employees," really is key.

In considering the difference between the base percentage (the percentage up to the integration level) and the excess benefit percentage, the larger that difference is the more the disparity. Likewise, the integration level is the other key component. The higher the integration level is the more the disparity. So when you look to a plan and you want to maximize integration, you've got two vehicles to vary. You can either vary that disparity between the two levels (which I keep calling the maximum permissible disparity, but it's also the maximum excess allowance), and as well, varying that integration level.

The uniform disparity requirement for an excess plan really isn't a problem because by definition everything is uniform as percent of pay. However, this was, we've already mentioned, the problem for PIA offset plans.

Getting on to the maximum excess allowance which is the first component we talked about that effects the level of disparity. TRA 86 has ensured that every participant will have some sort of benefit under an integrated plan. The regulators have done that by saying that the base benefit percentage up to the integration level has to be at least a half of the excess benefit percentage. You can't make it zero if you're going to have a nonzero excess benefit percentage. They've effectively eliminated the zero benefits for the nonhighly compensated employees. Then, they also said that the difference cannot exceed .75% of covered compensation for each year. Now we know that .75% gets adjusted many times before we actually get to throw it into a formula, but it starts at .75%. Most of the regulation is built around adjustments from .75, so one thing you should be aware of is most of the time I switch all those things to percentage reductions and just successively apply the percentage reductions because typically you have more than one reduction to make.

As well, there's a maximum of 35 years that can be applied to the offset. My understanding is that the IRS has said that it is going to look at this maximum as kind of a number 26.25%, and if you wanted to use a 40 year maximum, for instance, you'd be able to prorate down your .75% by 35 over 40 so that after 40 years you'd be at 26.25. I don't think that's written anywhere, but it doesn't seem to be inconsistent either in that it's a lower level of disparity between the base percentage and the excess percentage.

Let's compare, then, these rules with the old rules just to confirm what we've been saying. The impact of the new rules has been to lower the overall level of integration permitted in pension plans. Let me explain Chart 1. The new rules, by the older line at the bottom, represent .75% a year of covered compensation up to 35 years of service maxing out at 26.25% of covered compensation. Now the old rules, as you are all aware, were different for all the different plans, so I've shown two of them. The two that used an integration level of covered compensation are the flat benefit plan and the final pay plan. The final pay plan is represented by the dotted line that goes from one corner of the graph to the other corner and that's for final pay; 1% per year used to be our permissible integration and for each year of service. The flat benefit, on the other hand, was maxed out at 37.5% of covered compensation, but if you had less than 15 years of service, it was 2.5% per year of service.

It's hard to compare the career average benefits with the new rules or the old rules, and which was better. It's clear because they use the taxable wage base that the shorter service employee was allowed larger benefits under the new rules -- the disparity there was 1.4% and, because we use the taxable wage base for the shorter service employees whose career average salary is somewhat close to their final pay salary now to be constrained to .75% from 1.4 and also to have brought that taxable wage base down to the covered compensation level which is an average of all Social Security wage bases. For the longer service employees, it's less clear. It depends on how the final pay actually ends up relating to the career average plan. In general, on the face of it at least, these rules were restricting the ability of a plan to recognize Social Security.

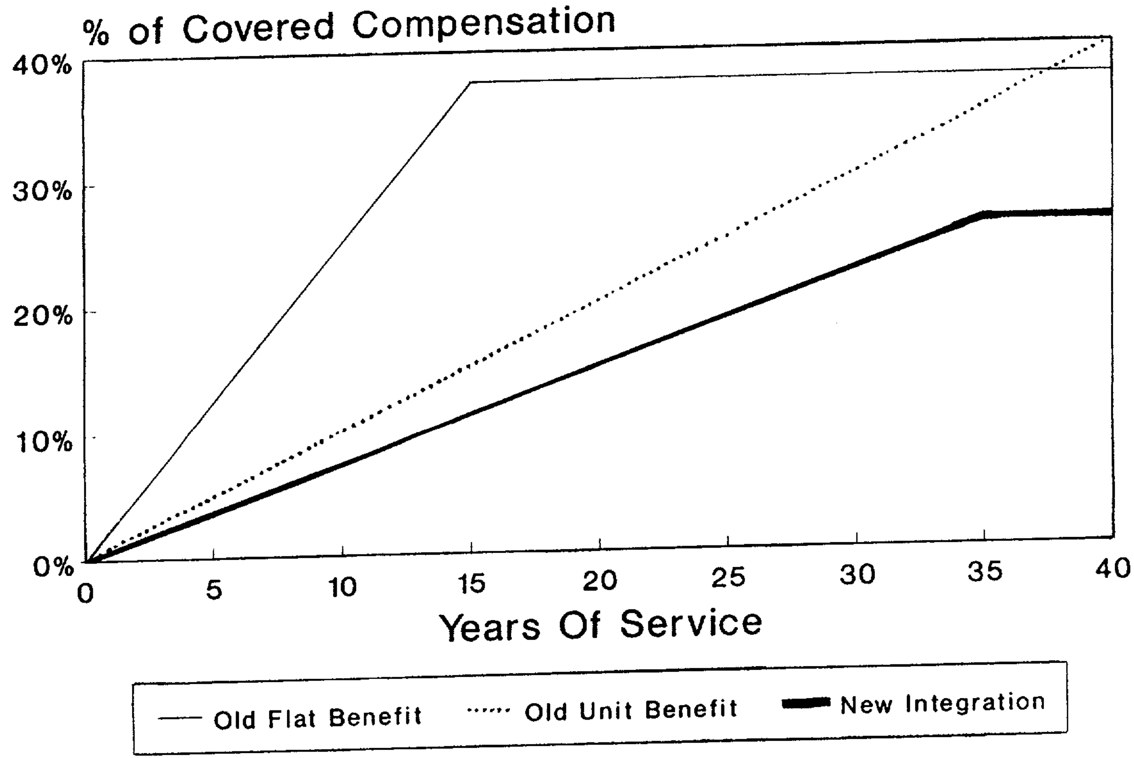
As I mentioned, the .75% is adjusted for early retirement. It's also adjusted for some other things that we'll go through later, and it's tied to Social Security retirement age. If you have a Social Security age of 67 (that's for people who were born in 1955 or later) then you're not talking about .75%, you're talking about .65%. It's my experience that I'm not adopting more than one formula for each plan so that it turns out that the Social Security retirement age of 67 rules tend to dominate. I guess there's got to be situations, particularly union negotiated, that you would negotiate with three different formulas. By show of hands is there going to be a wide spread practice of varying early retirement reductions for Social Security retirement ages? Anybody?

Have you also seen a movement in your normal retirement ages in your plans? All my clients are still at 65, and if anything, they are still making amendments that will encourage early retirement as opposed to go to deferred retirement. Have any of you seen plan sponsors seriously considering moving up that retirement age? By a show of hands? Ok. Are you, as a group, seeing the trend still towards early retirement as opposed to late retirement such as I am? By a show of hands? Ok. It's interesting. It'll be interesting to see how the forces work over the next ten years, and whether Social Security will be successful in pushing us to encourage employees to work longer. I haven't seen it happening in practice yet.

In Chart 2 I've shown the actuarial reductions in 89-70 mainly because that's what is going to show up in the final regulations. Just for information purposes, the regulations would have had the permissible disparity of .28% for a person whose retirement age is 55 with a Social Security retirement age of 67. So, it doesn't seem like a lot, it's just that we were so surprised when they didn't use the one 15th and one 30th rule. People who had taken the plunge to make some amendments, particularly with union negotiated plans, found themselves with a little bit of egg on their faces, saying, "Oh no, the regulations came out and it has to be less." As well as the old rules, you don't have to memorize every table. You know, it's kind of comforting that 5/15 is 1/3. I can take 2/3 of .75% and kind of work out the table in my head. Likewise, that another 5/30 is 1/6, which nicely brings you down to half of the .75 ten years earlier than Social Security retirement

CHART 1

IMPACT OF NEW RULES



age. That is just a little bit of comfort for me when I'm in front of a client when I'm trying to figure out what the disparity is at a different age. It's nice to have a formula opposed to those varying numbers that weren't even consistent retirement age to retirement age.

CHART 2

Maximum Permissible Disparity

Retirement Age	Social Security Retirement Age 67	66	65
67	.750%		
66	.700	.750%	
65	.650	.700	.750%
64	.600	.650	.700
63	.550	.600	.650
62	.500	.550	.600
61	.475	.500	.550
60	.450	.475	.500
59	.425	.450	.475
58	.400	.425	.450
57	.375	.400	.425
56	.344	.375	.400
55	.316	.344	.375

It's my understanding that the IRS is taking the stance that if you are going to use three different formulas that it should be your excess benefit percentage that should be kept constant. Therefore, if you've got a formula with a 2% excess benefit percentage, it would be the lower, the base benefit percentage, that you would vary. My understanding of how that's rationalized is that, when we get back to comparability types of testing, we'll be able to say that Social Security has replaced the permissible disparity which varies based on Social Security retirement age, so by adding a varying amount to a bottom level, we'll all come back to this excess percentage. I think that's been said at quite a few meetings, and there seems to be general consensus on that. Again, I'm not sure how many people are actually going to use it.

Another point that we've seen and we've only done very small surveys because a lot of our clients are still in a hold mode so far as not wanting to go forward in case they really don't have to amend their plans. But of the ones that have moved forward, there seems to be a large number of clients using .5% for their disparity, a huge grouping there. Is that also the experience of the group here? Have you seen more plans using .5%? Anybody? By show of hands? Ok. I would have expected there to be more.

I'm also not seeing any permanent disparities. The lowest one I've seen is .3%. Has anyone used a disparity that's lower than .3%? I think what happens is that you get to a point and you say why are we integrated if we're at .2% or .1%, but I have seen a few .3%s.

Now we'll run through some integration levels and we'll go through each one in Chart 3. Right now the regulations are set to use a covered compensation level. You never can go higher than the maximum taxable wage base, $48,000 in 1989. Then there's a lot of rules about using uniform dollar amounts and we'll go through those really quickly. I'm curious as far as any plans you had prior to any amendments. How many plans are currently using a covered compensation integration level? Ok. And you amend them every year, I mean you come up with a new covered compensation table every year? Ok. How many are using this every year, covered compensation table? Ok.

So there are some people who are doing that who have already addressed the communication issue as to what's covered compensation. I've seen clients say, "I don't want to deal with covered compensation, that's not real to an employee, I want to look at the Social Security wage base if I'm going to do anything and let it index off of that as opposed to covered compensation other than I guess you can just present it as a number, but that's not terribly meaningful." It was comforting that 89-70 allowed you to use a covered compensation table for up to five years. I think that is going to help with the administration of plans.

Chart 3 is the 1989 covered compensation table after all is said and done using the new 89-70 rules, i.e., taking into account the year that you attain Social Security retirement age. I've selected the ages just to make sure you see my pattern. It's every five years, but it's also showing the ages at which the Social Security retirement ages change. If your year of birth is 1937 or earlier, you have a Social Security retirement age of 65, but if it's 1938, then you're switching to the Social Security retirement age of 66. Likewise, there's a changeover between 1954 and 1955, between 66 and 67, so we have somewhat of a discontinuity at those ages.

CHART 3

1989 Covered Compensation Table

Year of Birth	1989 Covered Compensation Table II	1989 Covered Compensation Table I	Year of Social Security Retirement Age
1924	$16,968	$16,800	1989
1925	18,228	18,000	1990
1930	24,444	24,600	1995
1935	30,612	30,600	2000
1937	32,988	33,000	2002
1938	35,280	35,400	2004
1940	37,572	37,800	2006
1945	42,648	42,600	2011
1950	46,284	46,200	2016
1954	47,616	47,400	2020
1955	47,904	48,000	2022
1956 or later	48,000	48,000	2023 or later

The Revenue Ruling, although it gave us the relief of using the covered compensation table that we're more accustomed to, also recognizes that some companies may have already used the covered compensation table from the regulations and, therefore, permitted the use of that transitional table for up to five years as well. That was necessary because of the regulators' whole set of demographic tests that you have to satisfy if you're anywhere between the safe harbor level and the covered compensation level, so they had to give specific relief for that frozen table that you would be using.

To cover the safe harbor, I guess the regulators figure we can't discriminate too much with an integration level of $10,000 or one-half of the covered compensation for an employee who is attaining Social Security retirement in the current year. Currently it's $10,000; ultimately it will phase into being one-half of the covered compensation level.

Now we get to the fun stuff, but painful. I was amazed when I tried to amend one of my plans that had an $18,000 integration level that was clearly not discriminatory. I did my percentages and figured this is the percentage I can use, now I should be able to use $18,000. This was in a plan that had employees' average salaries about $30,000-35,000. They were all going to be getting some of the excess benefit percentage. However, in the preamble to the proposed regulations, they go to great lengths to explain that flat dollar integration levels "may create a significant potential for discrimination in favor of highly compensated employees."

As a result, the regulators have said there are a lot of tests that you have to use to prove that you have somehow or other figured out an integration level that allows you to discriminate even though you've met all the other rules that they've applied. Under the prior rules if you used a level lower than covered compensation, you didn't have to make any adjustments. Now you have to make adjustments as long as you're between the safe harbor and covered compensation. We're going to go through those real quickly.

Just to run through Chart 4, we always had to adjust if our integration level was over the covered compensation level, so the maximum disparity is reduced from .75 to .69% if you're between 100 and 125% of the covered compensation level, and so on. I've shown the percentage adjustments, because in practice you end up using a percentage adjustment as opposed to the straight permitted disparity amounts.

CHART 4

Integration Levels

- o Uniform dollar levels between safe harbor and taxable wage base

- o Integration Level as a

Percentage of Covered Compensation	Maximum Disparity	Percentage Adjustment
100-125%	.69%	92%
125-150%	.60	80
150-175%	.53	71
175-200%	.47	63
over 200%	.42	56

It certain demographics tests are satisfied

- o Unless tests are satisfied, no more than 80% of the maximum disparity is permissible.

However, you have to meet these certain demographic tests shown in Chart 5.

CHART 5

Demographic Tests

- o Attained Age Requirement
  Average Age of NHCE's $\leq$ Greater of Age 50 or HCE's Average Age + 5

- o Nondiscrimination Requirement
  - -- 50% of NHCE's earn at least 120% of integration level
  - -- % of total NHCE's who are participants earning at least 120% of integration level is greater than 70% of % of total HCE's who are participants
  - -- Integration level > 150% of covered compensation for employee currently SSRA ($16,968 x 1.5 in 1989)

The 89-70 gave us some relief, but when we go through the tests I would encourage you not to necessarily trade in testing for the demographic tests and trading 20% of your permissible disparity for that relief. Under 89-70 the IRS said that no more than 80% of the maximum disparity is permissible.

So effectively, it's also pretty much a limited type of relief. As well, you should be careful of flat dollar amounts because then you think you're looking at the covered compensation levels of all of your employees, and by definition you're somewhere under a Social Security wage base, so I think you're probably going to have some people who are dropping into this less than 125% of the covered compensation table. You may still want to use the demographic tests.

It's a two-phase test. There's an attained age requirement and a nondiscrimination requirement. The attained age requirement, I haven't found any trouble with. The average age of your nonhighly compensated employees has to be less than the greater of age 50 or five years more than your highly compensated employees' average age. In most of my plans, that is not really an issue. At least one of the nondiscrimination requirements also has to be satisfied.

What happens is the first requirement which is known as the minimum percentage test where 50% of nonhighly compensated participants in the plan earn at least 120% of the integration level. That works very well if you have a low integration level. So if you've got a low integration level, that seems to be the first place to go to see whether you get relief and can satisfy that. Certainly in my case where I had an $18,000 integration level I very quickly proved, since my average salary was $30,000, that more than 50% of my nonhighly compensated employees earned at least 120% of the integration level. Then I didn't have to trade "any of this disparity relief" that was under the regulations for this 80% of the maximum permissible disparity under 89-70.

Then we'll go to the third test which is called the high dollar amount test. I haven't quite understood the rationale, and if anyone cares to share it, I'd be interested. I've heard it, I just haven't comprehended it. I think it's one of those things that if I hear it ten times I'll get to like it. So, that's called the high dollar amount test, and effectively if your integration level is more than $26,000 then you've met your nondiscrimination test. If you're in between a very low level and $25,452, 1.5 of 16 (it's 968), then you have to start to play with the ratio test which is the middle test. Basically look at the participants in your plan, group them between nonhighly compensated employees and highly compensated employees, and then in your nonhighly compensated employees figure out how many of those employees are earning more than 120% of your integration level. If that percent of nonhighly compensated employees is greater than 70% of the highly compensated ratio, then you will meet this nondiscrimination requirement.

It's lengthy, it's hard to look at just on the surface and say "I can do that, or I can do this or the other," but there is some relief here. I think you can adjust sometimes slightly an integration level to move it such that you'll just pick up enough nonhighly compensated employees earnings more than 120% of that level and, with minimal change in your plan formula, maintain your current integration levels. Any comments or questions on that? How many of you have actually applied these demographic tests? When you applied them, did you find that you were in fact able to satisfy one of them? In general you can.

Plans with a fair number of part-time employees are hard hit plans because that half rule as well hits those plans pretty heavily and all of a sudden those part-time employees who probably aren't long term and you really don't have a lot of interest as a plan sponsor in providing huge benefits to these employees, are the ones who are actually getting substantial increases. The good news is that it tends not to be too costly, and therefore, we say the costs haven't changed substantially, but there is a question as to whether that is achieving your plan design objectives by providing these somewhat transient part-time workers with proportionately higher retirement benefits.

Also, I want to remind you that there is a maximum benefit that is permissible under the law. It does help with some of these lower paid employees in particular. It is a little backwards, though. It says under 401(a)(5) you can put a maximum on the excess of the final pay over 50% of your PIA projecting it to Social Security retirement age. However, what happens is that your long service employee, you can stop there, that's the maximum. Your short service employee, you end up prorating say 10/35 of that 50% of the PIA, and you actually have a higher maximum benefit for your shorter service employees than for your longer service employees. So again this is where this feeling that you shouldn't be offsetting by all of that Social Security benefit, because you haven't contributed all of those years for the employee, results in an unintended result.

Has anyone used the maximum benefit provision to limit benefits for the lower paid employees? Anyone looking at it? Show of hands? I think the problem right now is that we're not thinking we're going to have to continue with PIAs, and so the administrative relief of eliminating the PIA isn't enjoyed if you leave this maximum benefit provision in place. It is a way, though, when we get to 401(a)(4) and if we're able to show that PIA offset plans integrate, that we may also be able to lower the benefits for those low paid employees who really are being satisfied by Social Security by a great extent.

We'll just run through quickly some other benefit provisions. We've been talking about this as if everyone's normal form is a life annuity. If it isn't a life annuity, the rules say that you effectively test it on the life annuity, cutting through the way they get there. One thing that I've found that's helpful with a plan that is encouraging early retirement, which I think most of our plans continue to, is using early retirement supplements effectively. You can extend those either to go to 62, 65 your normal retirement age, or your Social Security retirement age, if you've implemented that and argue reasonably so that your plan is not integrated until the supplement stops. That assumes that your supplement is exactly equal to your disparity such that your benefit formula just becomes a flat percentage times years of service up to the date that your early retirement supplement ends.

This only works if your terminated vested employees are still getting actuarial reduced factors. Therefore, you're not having as much trouble passing for those employees as you are for a rule-of-85-type provision. These tend to be not terribly costly because they're temporary benefits. They also are consistent if your plan sponsor is encouraging early retirement with maybe the current objectives of the plan.

You are also allowed to have a qualified disability benefit. There is no reductions as long as you satisfy the requirements set out in the regulations. Preretirement death benefits are permitted. Employee contributions is another issue that there's a lot of controversy about, because basically the regulations didn't anticipate having integrated employee contributions that would provide benefits that are integrated as well. So the question is, is there an employer-provided benefit with respect to those employee contributions? Regulation 411 would tell us that there is, but the regulations did not anticipate that, and there are a lot of plans in the past that had those type of provisions. Have any of you worked with employee contributions and found any good rationales that will support the continued use of your employer contributions in integrated plans that you'd like to share?

Employee contributions are a difficult issue, but one thing I find us doing as actuaries is we're tired, we've been beaten on. All I do is compliance now, I just need to memorize rules and make sure I haven't forgotten one that's going to kick me in the head sometime when it gets pointed out to me, probably by a competitor. I think we're going a little bit too far to the simplifying side of the spectrum. I know I hate to have employee contributions in any of my plans.

What we should be lobbying for is those employee contributions should be tax deductible to the employees, and become another source of retirement income that can increase those benefits and increase the long-term retirement income of those employees. The regulators have just made it so difficult to leave the employee contributions in the plan that most of us have said I don't need it anymore, and most of our plan sponsors as well have said I don't need it anymore.

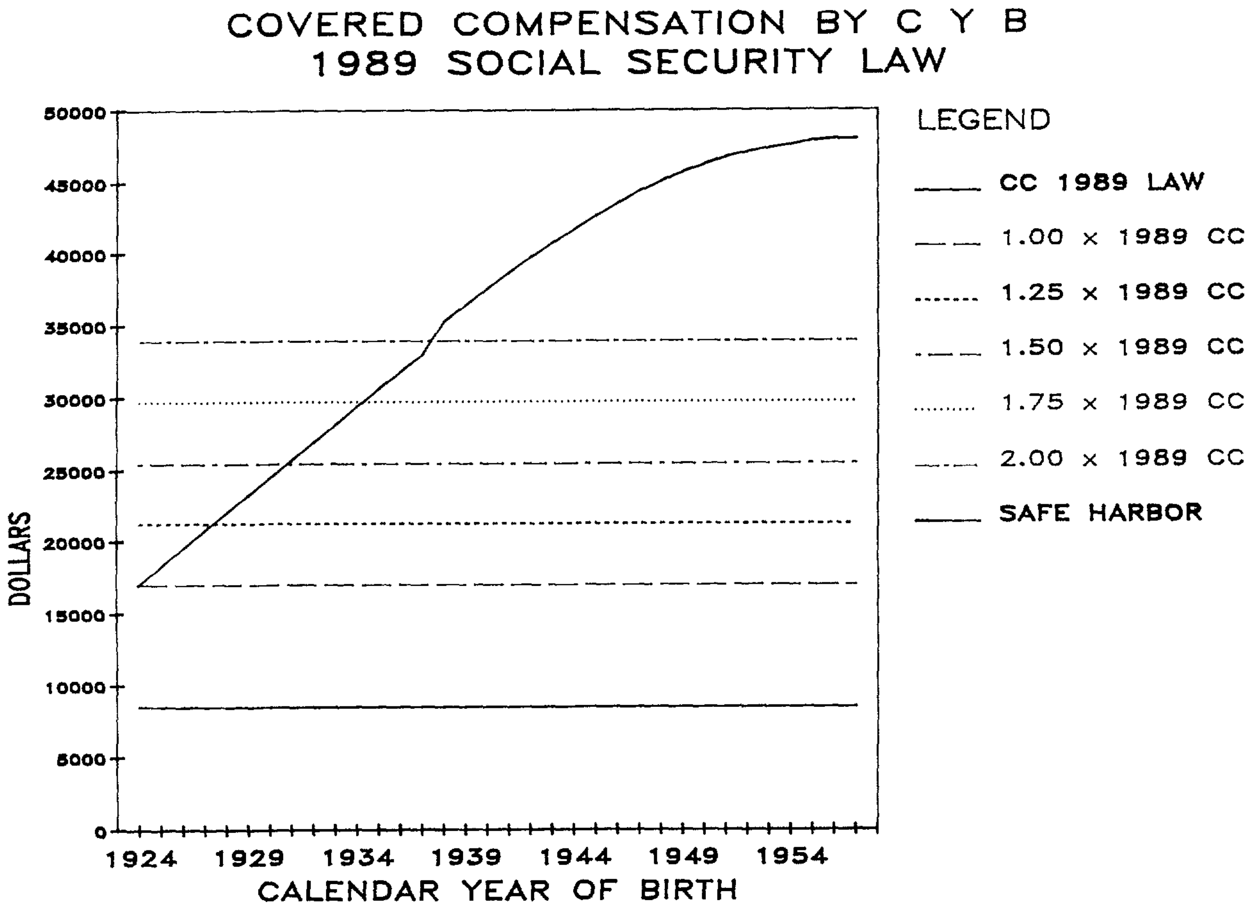
On the PIA I hear a lot of people who support it -- I'm originally from Canada, and there the plan designs more often are integrated on this type of indirect rather than a direct offset. When I moved to the United States, it was clear that there was big support for direct PIAs. Yet I've heard an awful lot of actuaries recently say that we were going to simplify the plan, take that PIA out of there -- like that's a good reason for doing it. I think we've got to look back to what our original objectives of those plans were and decide whether we really want them out or not.

The last thing I'll talk about is effective dates. These things get out of date very quickly. The effective date was April 19, 1989. Model amendments provided interim relief, and now we're talking about that relief being extended to the end of 1991. Again, something that we might want to lobby for as a group of actuaries in our various communities that we work with or with our clients, is legislative relief. I mean, this law just should not be effective in 1989. There's no doubt about that, and yet the regulators say that they don't have the authority to move the date. It seems to me that we'd be doing our plan sponsors a lot of good by lobbying for a 1992 effective date if we could go that far. It doesn't seem to conflict with our tax objectives right now, because if we go back and have to recalculate those benefits, there's just going to be more benefits that will be payable. Maybe we can get some relief through the legislators.

MR. PAUL W. BARKER: I'd really like to take a moment to grumble, work an aggression out here. I typically like to start out with a concept slide (Chart 6) and I think I have one here that will illustrate several of the points that we've been attempting to make in using tables and that is just exactly what the excess integration level looks like. If you follow the rules straight on, it's that line that kind of slopes up, and if you notice a little hitch about in the middle of 1937 and 1938, that's when you change Social Security retirement ages from 65-66. You can't see the hitch that's up at the top near 1954 where it also occurs, but it kind of gives you a sense of how you might want to choose an integration level. I would suspect that most of us are probably going to choose the line that slants up because that is perhaps the most effective integration you want to use.

The rules allow you to chose several other integration levels which are multiples of current compensation. I've used a 1989 static table to illustrate how you might want to choose it. The safe harbor level is all the way down at the bottom. I don't know whether anybody would want to choose that or perhaps a level below that, but if you did, you avoid the demographic test and some other nasty things, and you get to use pretty much the four rates as they exist without adjustment. As you work your way up the scale, you begin adjusting the .75, the .7 and the .65 rates.

CHART 6


COVERED COMPENSATION BY C Y B
1989 SOCIAL SECURITY LAW
LEGEND
CC 1989 LAW
1.00 x 1989 CC
1.25 x 1989 CC
1.50 x 1989 CC
1.75 x 1989 CC
2.00 x 1989 CC
SAFE HARBOR
DOLLARS
50000
45000
40000
35000
30000
25000
20000
15000
10000
5000
0
1924
1929
1934
1939
1944
1949
1954
CALENDAR YEAR OF BIRTH

In corresponding adjustments to your maximum disparity or your maximum excess allowance, your maximum offset allowance, the idea is that you may not want to use some of the things that Revenue Notice 89-70 allowed us to use simply because they are going to dilute the integration that you're going to be able to have in a benefit formula that you might want to use.

Particularly if you're interested in pretty heavy integration which I think is the rationale for having an integrated plan in the first place, you want to get the maximum shifting of benefits from the low paid, very highly beneficial from Social Security to the other direction and diluting your ability to integrate a plan may not be the way to go. It also gives a rationale for why the demographic test exists in the first place.

The attained age test says that if your nonhighly compensated folks are too old, they're probably down towards the lower level of integration. If you were to chose a higher level of integration like two times your integration level for 1989, you would be integrating out the lower paid folks and the demographic tests are designed to not allow you to do that very effectively. If you had perhaps a cadre of nonhighly compensated people who were not paid very much, shifting to a higher integration level also has a tendency to penalize them, so the demographic tests, when looked at with a chart like this, generally give you a hint as to why they were designed in the first place and why you just might want to avoid a uniform integration level so that you don't have to deal with those kinds of things, and by default, dilute your integration.

With that in mind, let's look at Chart 7, depicting Case 1, an Offset Plan, defining the base benefit as pretty substantial for the first 25 years of service. Then they tack a tail on it. The offset that goes with that is a pretty heavy offset if you do the arithmetic that's 65% after 25 years. So this particular benefit formula before the integration change is pretty heavily leveraged. We're shifting a lot of benefit from the low paid to the high paid. The new benefit offset, is significantly complicated. If anybody needs a good reason to avoid offset style integration in the future, this is a good example. If we can't explain it effectively to the people we work with day to day -- the average plan participant probably is not going to get it either. So, just sheer weight of trying to explain it to the uninitiated will perhaps drive you away from the offset style of integration.

You essentially have a choice between the smaller of two items: one based on the maximum offset allowance, which in this case is roughly 5/8 of 1% times some compensation variable which I've called high three star, which is actuarial notation for the final average pay concept -- the final average compensation concept that's defined in the regulations. The idea is a development of the three-tired Social Security retirement age of excess allowances or offset allowances that have been adjusted for, in this client's case, two things. First is the desire to have a uniform benefit for everybody regardless of Social Security retirement age. Since there is a whole bunch of people who have a retirement age from Social Security of 67 by default, you get .65 as a starting point.

Second is early reduction factors. This client used the 1/15, 1/30 rule. If you want to use any kind of early retirement subsidies or adjustment factors, in particular the 1/15, 1/30 rule, starting at age 65, instead of the Revenue Notice 89-70 mandated starting point of 67, for those people with Social Security retirement ages of 67, then when you get down to the lower ages, you find a mixture of things where you violate these rules. You're stuck with adjusting the .65 maximum offset allowance, or in this case, also to a maximum excess allowance to something a shade lower. In this particular case, this client wanted to use the 1/15, 1/30 early retirement reduction factors, so we adjusted it to 5/8 of 1%, or .625%, as a way of defining an allowance we can actually use in developing a benefit formula that might satisfy these rules and regulations. The nice part about doing that analysis on the 5/8 of 1% is that it also works in an excess situation.

This particular client decided that the offset was just a little bit too cumbersome to talk to its plan participants about. It wanted to go to a more simplified formula so it's going to choose an excess method of integrating its pension plan, and it will use the same 5/8 of 1%. The client has elected to use the covered compensation table as defined in the picture by that diagonal line that's going upwards. That's pretty much what it's going to do.

A couple of things you might note about this is, since it is a very heavily leveraged type of formula, you're going to get some strange things happening in terms of how people benefit from this style of formula. If you just compare offset to offset for a minute and segment your census by pay and service categories, short service, lower paid folks get a pretty heavy benefit increase inventing a statistic which just divides the new benefit under the new offset formula by the old

NEW FORMULA AS A PERCENTAGE OF OLD FORMULA
CASE I: SOCIAL SECURITY OFFSET

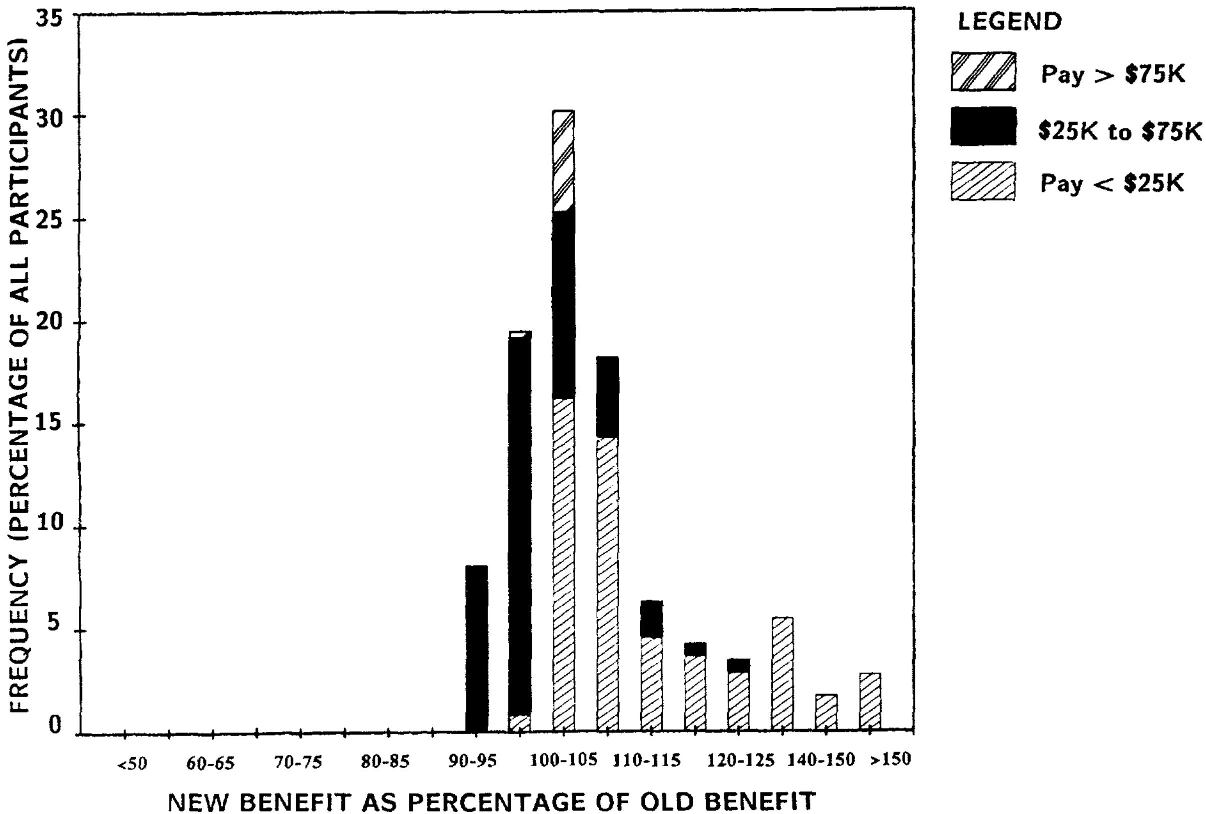


CHART 7

benefit under the old offset formula. Since we're very heavily leveraged for short service people, it's pretty easy to see that, if you're taking an awful lot away and you change to a significantly lower level of loss of integration, the benefit's going to shoot up pretty high for those folks. As you stretch across the service tiers to mid-range service, 25-35 years, and then potentially your longest service folks with retirement over 35 years, you can see that the effects kind of dilute. For that particular pay category, the average is roughly a 20% increase in benefit, 118%.

If you have the majority of your people concentrated there in most pension plans, which seems to be the case where I come from, you're staring at a pretty hefty increase in contributions just to adjust to a new offset style of benefit. Take a look at the mid-range folks, you've got some of the same thing going on. Short service people are getting benefit increase as service extends. All of a sudden benefits go the other way. Whenever you see a number up here that is less than 100%, benefits have gone down. For the higher paid folks there's not much movement at all, short service or long service. So the effect of changing to a new offset leaves the higher paid folks perhaps in neutral territory whereas the lower paid folks, which is where a bulk of people are going to get a benefit increase.

Another way of looking at this, to get a sense of what is going on is if you draw a picture to get a dispersion, averages are sometimes deceiving, but if you plot it where you have a frequency or percentage of all participants up one side, and the number of times that a certain frequency occurs by pay level, you can see that the lower paid folks sometimes get more than 150% in benefit increases. Very rarely do you find a low paid person who is going to get a benefit decrease. As pay level goes up, it shouldn't be surprising, the statistics support a backing down. If you do something like this, you get not only a picture of what the new benefit formula might be doing to plan participants, but also how it's going to affect plan costs. One other thing I might point out in doing this is that they appear to be very sensitive to the projection assumptions that you would use to project like Social Security wage bases, covered compensation and payroll. You could find yourself projecting into some rather bizarre situations. If you're not careful about your projection assumptions, you could find yourself designing a benefit that produces something that you don't really intend to have. With that admonishment, let us move on.

In Chart 8, we've got a step-rate benefit formula that was integrated in the old style with a somewhat modest basic benefit rate with, at this particular point, a pretty sizeable excess benefit on a low dollar amount. Right away there are perhaps two ways that you're going to have to look at the integration. In Alternative 1, we're looking at a move to a 6/10 of 1% maximum excess allowance. Once again, this is engendered by the need to have a simple benefit formula, so you pretty much choose the .65. Since they were also in love with their early retirement reduction factor which has a little more subsidy built into it than our old friend the 1/15, 1/30 rule, we're dragging that .65 down to .6. So we're not going to get much of a kick in terms of adding an integrated benefit onto a base benefit.

Chart 9, Alternative 2 keeps the $4,800 frozen integration level which is eminently doable. Under the new regulations, if you use a very, very low level, in this particular case, since the $4,800 is below the safe harbor limit, it's possible to use that without adjustment in the factors. That may produce a little bit better of a benefit, but I think what you're going to discover is that, without an adjustment in the basic benefit, the results on the average benefit for this particular formula are going to be somewhat anemic.

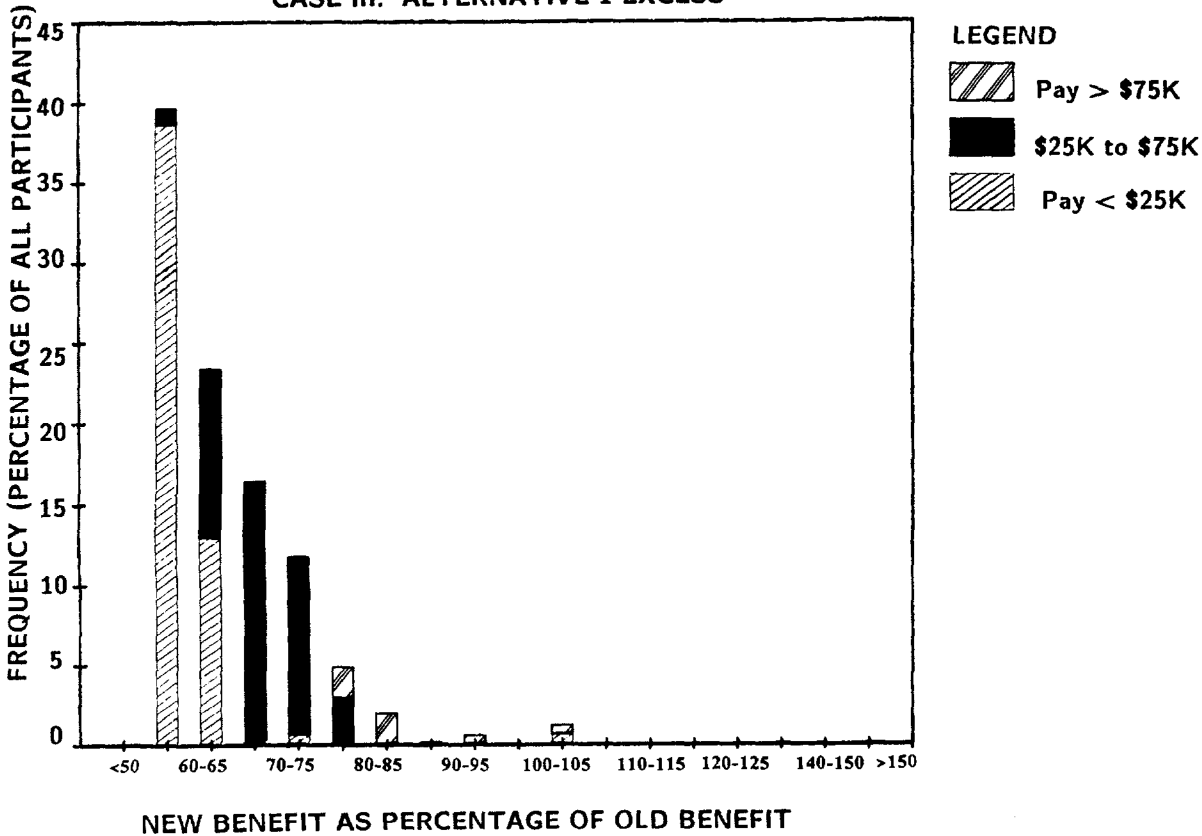
If you just take a look at the dispersion, once again you'll find that in this particular case, if you don't adjust the basic benefit allowance, you have a reverse of the offset situation where the low paid got the benefit boom. In this case the low paid pay a penalty because you have moved the covered compensation level up and the benefit percentage down on the excess benefit; you're really cutting them back faster than you are the high paid, and you get a ripple effect down the line.

If you were to take a look at Alternative 2, you'd find a situation where the benefits are going to improve pretty much across the board simply because we've cut the integration level back down from a covered compensation amount to a flat dollar amount. If you recognize that we are in fact projecting benefits, we have some projections in these, it's pretty easy to see.

The last case is a career average case where perhaps we've been using an ultimate integration. That's a word that Judy didn't particularly care for, but I use it anyway. The idea being that in

CHART 8

NEW FORMULA AS A PERCENTAGE OF OLD FORMULA
CASE III: ALTERNATIVE 1 EXCESS

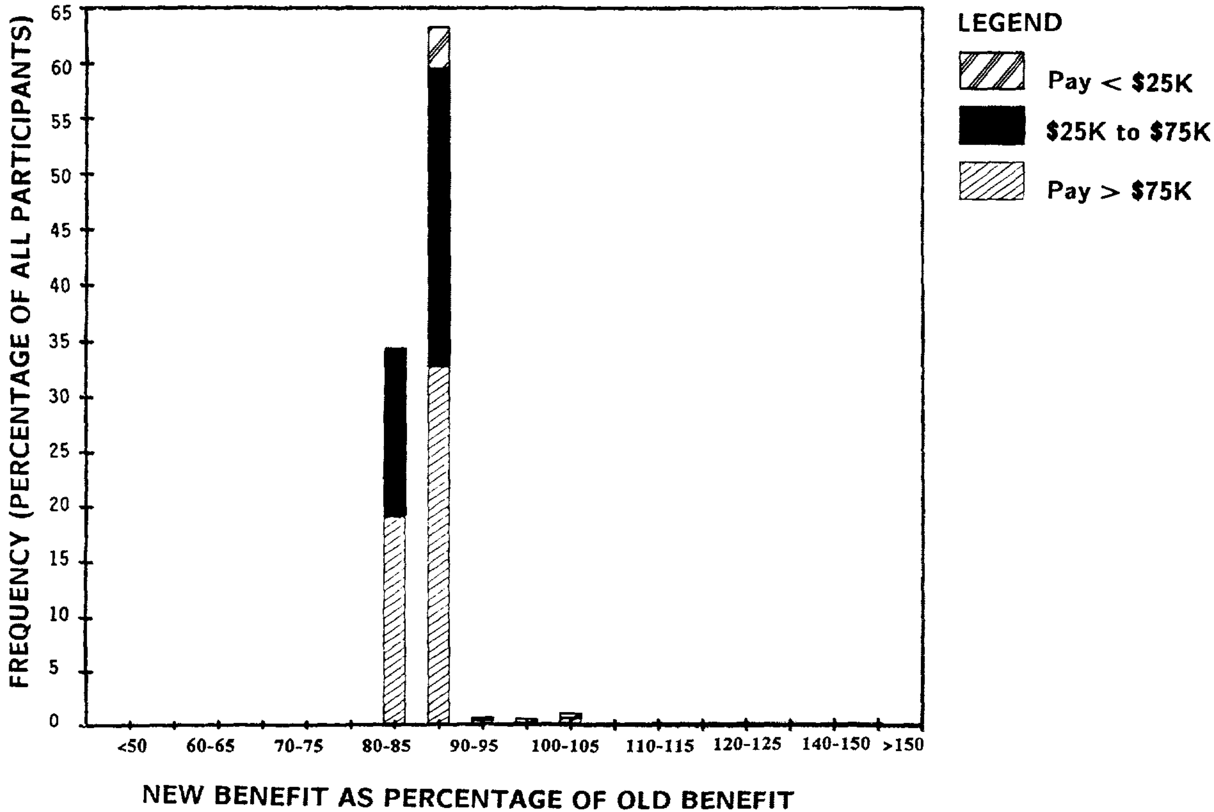


PANEL DISCUSSION

CHART 9

NEW FORMULA AS A PERCENTAGE OF OLD FORMULA

CASE III: ALTERNATIVE 2 EXCESS



this case since it is a career average plan then we're right at the taxable wage base. The plan goes all the way into the old integration rules.

Initially, we thought this formula was going to be over and done with simply because it didn't appear as if the integration regulations even thought there were such things as career average plans. However, Revenue Notice 89-70 came to our rescue and allowed us to at last have an integrated plan. Once again, we've opted for a simplistic benefit formula and the two alternatives that we've considered, using the higher Social Security retirement and a .65% benefit amount. These folks, alas, were not in love with subsidized early retirement benefits, so we were able to go all the way and use the .65.

However, we would be stuck at a significantly lower level of covered compensation for a lot of folks in the plan. So, that perhaps is not terribly palatable to the plan sponsor. They like the old taxable wage base. Well, if you want to move to the taxable wage base, you're going to have to make the adjustment in the .65 factor by much the same percentages we had. Since this one goes all the way up to the taxable wage base, we've got to adjust the .65% using a 56% factor. If you take 56% of it, you're sitting at .36%, and you really won't have much of an integration in the first place. Since there weren't terribly many people in this particular plan that were highly compensated, their decision here was in its entirety just completely done away with integration.

It seems like that is the attitude of most of the clients that we deal with. They really are questioning the idea of whether or not they should use integration. As you sit back and think about it, perhaps you'd be initially inclined to agree with that. I don't think so. I think in my own practice, I'm inclined to integrate, to take an aggressive stand on integration and to try to get the most out of what the regulations will allow us to get. Sometimes that is a little easier than in others. But you do find situations where perhaps a client is a little reticent on integrating the plan and needs a little bit of help in moving forward.