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INTEGRATION

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Recorder: STANLEY H. TANNENBAUM

- o What are we now?
- o What are practitioners advising their clients?
- o Are integrated plans going the way of the slide rule?

MR. TANNENBAUM: Our two panelists are Norman Misher, a partner with Roberts and Holland in New York, and Irwin Rubin, a partner with Gilbert, Segall and Young in New York. Norman will present ideas on some of the regulations that underlay all kinds of permitted disparity and other issues of qualification of plans. Then he will proceed to discuss specifically how we can use permitted disparity in defined contribution plans. After that we will stop to allow questions and answers on defined contribution plans. Then, Irwin will commence talking about defined benefit plans, followed by questions specifically on defined benefit plans. If there is any time and interest remaining, we will then open the floor to other questions that relate to permitted disparity, possibly 401(a)(4), 410(b), or other things.

Without further ado, I'll invite Norm Misher to discuss regulations as they relate to Section 414(s), what is compensation, and the regulations under 401(a)(17), what are the limits of compensation.

MR. NORMAN J. MISHER: As Stan indicated, what I'd like to do is to go through two sets of regulations which came out as part of the 401(a)(4) package back in May, that is temporary regulations under 414(s); the proposed regulations in the 401(a)(17), the $200,000 limitation on compensation; and then the last part of my discussion is about defined contribution plans and permitted disparity with particular emphasis on the relationship between the permitted disparity rules for defined contribution plans and the various safe harbors and general rules for such plans under the 401(a)(4) regulations.

Regarding 414(s), back in February 1988, the IRS came out with temporary regulations defining compensation as part of the highly compensated employee package of regulations. Those rules were restrictive. In many ways they did not provide the flexibility needed from an administrative standpoint. So, in conjunction with the 401(a)(4) regulation package, what the IRS basically did is completely revise those regulations by

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issuing a new set of temporary regulations as part of the 401(a)(4) package. These regulations essentially alter the rigid approach taken in the regulations and provide, I think, much needed flexibility in this area.

For 414(s), the Tax Reform Act of 1986, the IRS decided to introduce a statutory definition of compensation, which is essential. It represents the nondiscriminatory definition that must be used in applying many of the nondiscrimination rules. Your 401(k) testing is based on a 414(s) definition. Regulation 401(a)(4) is based on a 414(s). For 401(l), you basically need a definition of compensation in applying those rules. The regulations are liberal from one perspective. A plan is not required to use a 414(s) definition for contribution and benefit purposes. A plan could basically use whatever it wants to determine its contributions or benefits, with one important caveat. When you test for nondiscrimination, and similar rules, you must use a 414 definition. So although it does give you some flexibility, I think from a practical standpoint, unless you're comfortable that you have a nondiscriminatory type of definition, although it doesn't technically fit within 414(s), you may have some problems in complying with the 401(a)(4) rules. In particular, the safe harbor rules under 401(a)(4) key into a 414(s) definition. So if you are going to use your safe harbors, you're going to have to use a 414(s) definition.

The regulations have additional flexibility regarding the use of 414(s) when, for example, you have more than one plan. You can use different 414(s) definitions for each of your plans. You can change your definitions each year. So, you're not necessarily locked into anything. The only thing that the regulations do require you to do is to have a definition that is applied uniformly to all employees in a particular plan. So, although different plans can have different definitions, as long as it's a 414(s) permissible definition, and we'll get to what 414(s) permissible definitions are soon, you have to apply that uniformly to all employees in a particular plan with respect to applying the nondiscrimination rules to that plan.

I guess the best way to characterize the regulations is they structure a three-tiered approach to the 414(s) definition of compensation. The first tier is a 415 definition. That means if you use a definition that is in compliance with the 415 benefit and contribution limitations, you will automatically be using a definition that complies with 414(s). A second tier involves a safe harbor rule under the regulations, which also is geared to 415 but has some differences, and we'll get to that. The third definition is a very flexible one. Basically, any reasonable definition that doesn't discriminate and that satisfies a nondiscrimination test may be used as a 414(s) permissible definition of compensation. So, you have the three tiers. You have the 415 rule, you have a safe harbor, which is geared to 415 with some modifications, and third, you have kind of a catchall, any reasonable definition, so long as it's not discriminatory. And any of those three, if you meet the requirements of that definition, will be automatically in compliance with 414(s). You can run your integration rules and your discrimination rules on that definition.

The first tier is 415. A definition of compensation that includes all of the 415 inclusions and excludes all of the 415 exclusions automatically satisfies 414(s). Basically, 415 compensation is wages, salaries, and amounts received for services rendered in the

course of employment with the employer maintaining the plan that is includable, that is taxable to the employee in the year in which it's received. When you go through these rules on 415 compensation from the 414(s) regulations, what you get is a concept. Under the 415 regulations, if you get something, property or anything that's taxable currently, where there's no deferral of the tax on it, that item can be considered as 415 compensation in the year in which it's received. If something is not taxable currently, it results in a tax deferral, then it's not considered as 415 compensation, although it's taxable in a later year. An example is a nonqualified stock option. In an executive compensation setting, an executive will receive a nonqualified option. It's not taxable in the year in which he received the option, but it's going to be taxable in the year in which he exercises the option. Even though there is tax in the year in which you exercise it, under the general 415 rules, that taxable income is not 415 compensation, because there was an item of deferral, a tax benefit, in terms of the option not being taxable in the year in which it was received. So, that's the basic definition of compensation.

Now, in an attempt to make things a little more simple, the 415 regulations were modified as part of the 401(a)(4) package. What the modification did, basically, was to add two type of definitions which are also OK under 415. These definitions are, in effect, wages for Social Security purposes, and wages for income tax withholding purposes. These definitions are helpful because an employer has that information available to him, or it's readily available from existing payroll practices. This was a good approach from the Service's perspective. Instead of using the 415 rules, your plan may define compensation to be W-2 wages for Social Security purposes, or income tax withholding purposes, and will automatically be in compliance with 414(s), because it's a permissible definition under 415. One interesting note is that when you're using W-2 wages for this purpose, that can tend to inflate the testing compensation for highly compensated employees. Let me use my nonqualified stock option example again. Under the general rule of 415, when the option is exercised, and there's a spread between the cost of the option to the employee and the value, which is what the taxable income spread is, that's not 415 compensation. On the other hand, that is wages for W-2 purposes. So, if you do use the alternative definition of wages for income tax withholding or Social Security, you have the ability, perhaps, to inflate the compensation for highly compensated employees. Although, as we all know, that's somewhat tempered by the $200,000 limit. It may give you some additional flexibility, so keep that in mind. In any event, that's the first tier. 415, which has three type of definitions, the rule under the regulations, and the two W-2 wage definitions for Social Security purposes or for income tax withholding purposes.

The second tier provides a little more flexibility for a plan if it uses this definition. Also, it will be in automatic compliance with 414(s). The second tier is essentially 415 compensation, but excluding such items as reimbursements, noncash fringe benefits, moving expense payments, deferred compensation, and welfare benefits. In other words, you can have your normal salary, wages definition, but you could exclude all these items. In effect, you exclude most forms of noncash compensation, even though these items are includable in income. I think it was the government's recognition that maybe it's difficult to determine what noncash compensation is. Also, it makes plans a little more complicated. Basically, cash compensation is a second tier, a second permissible alternative definition, which automatically will be deemed to comply with 414(s).

The last tier, and the most flexible approach, deals with any reasonable definition that doesn't discriminate and satisfies a special nondiscrimination rule. There are a couple of pieces to this definition. It is relevant because many plans do not necessarily gear in automatically to 415. They have certain exclusions or certain inclusions which are perhaps broader than 415 would have permitted. What does reasonable mean? There's no clear-cut answer. As you can imagine, it's a facts and circumstances type of analysis. If you go through the preamble, the introductory material to the regulations, you get kind of a flavor as to what the government was looking at when they talked about a reasonableness concept. I think the best way to summarize it is that it permits an employer to use a definition of compensation which is designed to exclude amounts that fluctuate from year to year or which are difficult to take into account in connection with the employer's pension accounting system.

So, to the extent you have this type of compensation and it's difficult to account for, or it tends to fluctuate, I think you probably would be comfortable in saying that it's reasonable to exclude this particular item in your definition for testing.

The main point that has to be satisfied with respect to this flexible definition is that it must meet a nondiscrimination test. The way the nondiscrimination test works is that you take a ratio of the compensation under the plan over, in effect, total compensation for your nonhighly compensated. You do the same thing for your highly compensated employees. And to the extent that the difference on a percentage basis is no more than de minimus, whatever that means, between the two groups, then your alternative definition would probably be viewed as nondiscriminatory. In making this test, you can use one of two approaches. Right now we're in the midst, with a client, of doing it, and it turns out one is better than the other. You could either do it individually, like you're doing a 401(k) test, in effect, and just add up percentages for the lower-paid employees and for the higher-paid employees, or, alternatively, you can approach it from the perspective of taking aggregate plan compensation for your lower-paid employees over total compensation for your lower-paid employees and get a percentage, and compare that with the higher-paid employees. The latter approach tends to be more favorable in certain cases. Those are probably the only two methods. You're not going to find those in the regulations; you're going to find it in the preamble. The regulations speak about any method. I haven't thought of any other methods, so I think those are the two you're probably going to have to use, but they do give you some flexibility. Now, as to what is de minimus, I don't really know. It's a facts and circumstances test. Maybe if it's less than a 3% differential I just throw that out as a guess. For example, if your lower-paid employees include 94% of their total compensation for plan purposes, and your higher-paid employees include 95% for compensation purposes under the plan, maybe that's sufficient. You have to have a rational basis for doing it. It's more than just numbers. It has to be a rational basis. There has to be a reason why you're excluding certain things from compensation that otherwise might have been required to be put in. Basically those are your three tests. They give substantial flexibility, a lot more than existed under the prior temporary regulations. You have to understand them to know what definition a plan is able to use to make sure that you're in compliance with the nondiscrimination rules.

There are two last points on compensation before we move on. One is that the regulations have special rules for 401(k) plans. The regulations indicate that when you determine the availability of an elective deferral or a voluntary contribution, you can use any reasonable definition. The government kind of says, "I don't really care what you use with respect to availability." The reason government could say that is because, when you actually sit down and do your average deferral percentage testing, or your average contribution percentage testing under 401(k) and 401(m), you must use a statutory definition under 414(s). Although you can use any definition you please with respect to what's available to make deferrals out of, when you actually do your nondiscrimination testing, you're going to have to use something which complies with 414(s).

The last point deals with the concept of what do you do with elective deferrals under a 401(k) plan? What do you do with deferrals that are made under a cafeteria plan, a flexible spending account? The regulations require that under the two safe harbors, it's an all or nothing approach. You either have to include all 401(k) deferrals and elective contributions under a cafeteria plan or exclude them in your definition. If you're dealing with the third tier, the alternative approach, the nondiscriminatory definition, you have a choice. You can put in elected deferral if you want for 401(k) plans, and you could exclude the cafeteria deferrals. You can pick and choose. But that choice is not available if you're using a safe harbor and you want that safe harbor to continue to be a safe harbor. 414(s) is a definition that's used for nondiscrimination. You have to understand it even if your plan's not using it, because the tests are going to have to be run on a 414(s) basis.

A second item related to 414(s) deals with another limitation that was put into the law by the Tax Reform Act of 1986. That's the $200,000 compensation limitation, as adjusted for cost of living increases. The regulations under 401(a)(17) of the code were issued in proposed form, as part of the big 401(a)(4) package that came out May 10, 1990. The annual compensation limit essentially applies in two ways. Firstly, and the main way, the plan may not base contributions or benefits on amounts in excess of the annual compensation limitation. It's a plan qualification requirement. The plan must contain provisions which specifically provide for this limitation in order to retain its qualified status. In effect, it's something which top-heavy plans have been living with since 1984. Second, the annual compensation limit must also be used in applying the various nondiscrimination rules. When you do your 401(k) testing, your 401(l) and your 401(a)(4), you're limited to the annual compensation limit. Any compensation in excess of that amount gets ignored for purposes of applying the nondiscrimination testing rules.

As I'm sure you're aware, the $200,000 limit moves for cost of living. It's $209,200 in 1990. One little interesting note is that if your plan year does not coincide with the calendar year, if it's a July 1 plan year, the increased compensation limit applies for the plan year that begins within the calendar year. Let me give you an example. A July 1, 1989 year goes through June 30, 1990, but since the plan year begins within the calendar year, you look to that limit, you're limited to $200,000 in that case, even though you do have six months in a 1990 year when the limit has gone up to $209,200. This is different than the 415 rules, which go the other way. This approach, looking at the plan year beginning in the calendar year, is seemingly the way the government is going whenever you're dealing with a dollar number.

As I indicated, the contributions and/or benefits under a plan may not be based on compensation in excess of the annual limit, $209,200. There are three basic rules here.

First of all, benefits accrued in plan years prior to 1989, in other words, prior to the effective date of 401(a)(17), are protected by the anti-cutback rules of 411(d)(6) and are thus not subject to the annual compensation limits. So, accruals prior to 1989 based on compensation in excess of the annual compensation limit need not reduce or affect an employee's accruals in subsequent years. The examples under the 401(a)(17) regulations illustrate this point. The examples illustrate that a plan is specifically permitted to lock in a participant's pre-1989 accrued benefit, the benefit that was accrued based on amounts in excess of $200,000, and provide for an additional accrual, going forward, based on the $200,000 limit. In effect, a plan can provide that a participant's benefit is equal to the sum of two things, his accrued benefit as of December 31, 1988 in a calendar year/plan year scenario, and that's without regard to the limit on accruals based on amounts in excess of $200,000, future accruals subject to a $200,000 limit. I think it's a very helpful rule. There was a lot of speculation as to which way the government was going to come out. What it doesn't require, which it had been feared, is that you have to freeze your pre-1989 accrual, which was based on amounts in excess of 200,000 until it was worn away by post-1988 accruals. You don't need to do that.

The second basic rule, which is kind of a variation of the first, says in determining accruals for post-1988 years, the years to which the $200,000 compensation limitation is in effect, if you have to use pre-1989 years, assuming you have a three-year average, then the pre-1989 years, the compensation for those years, cannot exceed $200,000. Let me give you an example. Assuming someone's compensation in 1987 was $200,000, $250,000 in 1988, and $300,000 in 1989. In determining what that person's accrued benefit is at the end of the 1989 year, assuming it's a high three-year average plan, you have to use the last three years in this example. The compensation for each plan year of the calculation, including pre-1989 years, cannot exceed $200,000. It's a little bit confusing. I think this rule is assuming that you're not locking in the 1988 benefit. If you're not locking in the 1988 benefit and just going forward with 1989, but instead you have a plan benefit formula which requires pre-1989 years to be taken into account, then and in that case only then do you have to limit yourself to $200,000 of compensation, even for years prior to 1989. You're dealing with accruals after 1989, which bring back into play the earlier years.

The last point is that any cost of living increase in the annual limit, the $209,000 number in 1990 or future increases, applies only to compensation for the year of the increase, and you cannot go back. Each year's compensation is limited to the annual compensation limit in effect for that year. Let's work with those same numbers here. For 1989, a participant's compensation is $200,000, for 1990, it's $250,000, and for 1991, it's $300,000. The annual compensation limit is $200,000 in 1989, $209,200 in 1990, and let's assume it's $220,000 in 1991.

If you're determining your accrual for 1991, let's assume there's a high three-year average again. You cannot say, "Since 1991 is now $220,000, I want to go back and use $220,000 for the prior two years." You can't do that.

What you have to do is look at each year's limit in effect for that year. So, in this case, it would be the average of $200,000, $209,200, and $220,000 in determining the accrual for 1991, the year in which you had the $220,000 limit.

Those are the three basic rules. I commend you to look at the examples under the 401(a)(4) regulations, because they're very, very helpful in illustrating these rules. I think you don't get it when you only read the regulations. Going through the regulations and the examples highlights for you these three concepts that we just talked about. The regulations, with respect to the other 401(a)(4) rules, are proposed to be effective beginning in 1991. Prior to 1991, for the 1989 and 1990 years, good faith reliance on whatever the law was and is at this point in time, is sufficient. You can rely on proposed regulations, even though they are only proposed.

The last point I want to go over deals with permitted disparity, in defined contribution plans, and section 401(a)(4). As you are aware, effective for the plan year beginning after 1988, the permitted disparity rules for qualified defined benefit and defined contribution plans were modified. For defined contribution plans, under the revised rules, the percentage of compensation contributed by an employer, with respect to the portion of compensation in excess of the integration level, can't be more than two times the percentage of compensation contributed with respect to that portion of compensation below the integration level, with a maximum 5.7% differential. If you're putting 4% in for compensation below the integration level, you can go up to 8% for compensation above the integration level. If you're putting in 6% for compensation below the integration level, you can't go up to 12%, even though that's double. You're limited to the 5.7% differential. You can go five -- 11.7 for compensation above the integration level in that example.

When the 401(l) regulations came out at the end of 1988, they specifically mentioned that it is the taxable wage base that has to be used as the integration level, which in 1990 is $51,300.

If you don't use the taxable wage base, you're not in compliance with 401(l). Under the IRS position stated in the preamble, the use of an integration level lower than the taxable wage base would, "create a significant potential for discrimination in favor of highly compensated employees." That was their rationale. I guess due to various complaints and the fact that they overdid things a little bit, in Notice 87-70, the IRS retracted their inflexible approach taken in the regulations and permitted different integration levels to be used in lieu of a taxable wage base. This is broken up into several options. If your integration level doesn't exceed the greater of $10,000 or one fifth of the wage base, for 1990, $10,260, you can continue to use the 5.7% factor. If your integration level is greater than 20% but less than 80% of the wage base, roughly between $10,000 and $41,000, then the 5.7% factor has to be reduced to 4.3%. Let me give you an example. We've said before that if you contributed 6% for compensation below the wage base, you can go up to 11.7% for compensation above the wage base.

If you're integrating at $30,000 and contributing 6% below, you can go up to only 10.3% above, because your 5.7% factor gets reduced to 4.3%. If your plan's integration level is greater than 80% of the taxable wage base, but less than 100%, the 5.7% factor is

reduced to 5.4%. So, in the prior example, if you go six below, you can go up to 11.4 above when you're using something between, in effect, $41,000 and $51,000 as your integration level. It's helpful from the standpoint that you're not locked into the taxable wage base. IRS Notice 89-70 sets this forth.

Before moving on to 401(a)(4), I want to point out what happens if you have a plan year that is not the calendar year. Once again, you have to use the taxable wage base in effect as of the beginning of the plan year. If you're on a July 1 plan year, July 1, 1989 through June 30, 1990, you can't use $51,300. You have to use the 1989 number, $48,000, when you integrate your plan for that plan year.

Section 401(a)(4) affects permitted disparity for defined contribution plans. When the regulations were issued in May, they provided three alternative rules for determining whether a defined contribution plan satisfies the 401(a)(4) rules of having a nondiscriminatory contribution formula. You have one design-based safe harbor. You have a second rule which is a safe harbor but it's not purely design based. You have the general catchall rule of being nondiscriminatory.

First, the safe harbor or simple rule. If a plan allocates all amounts under a single uniform formula that provides for an allocation of the same percentage of compensation or the same dollar amount to every employee under the plan, 401(a)(4) will be satisfied. Your basic profit sharing plan, where you allocate your contributions and forfeitures based on total compensation, will automatically satisfy 401(a)(4). The regulations go one step further and say that a plan would be considered to be under the safe harbor even if the formula takes 401(l) permitted disparity into account, so long as each employee under the plan has the same integration level, the same percentage for compensation above the integration level, your excess contribution percentage, and the same percentage contribution based on compensation below the level, your base contribution percentage. What the regulations specifically allow you to do is have a plan formula that will automatically satisfy this safe harbor, and will not fail to be uniform if permitted disparity is taken into account, according to the 401(l) rules.

The second defined contribution safe harbor applies to a plan which provides for a single uniform allocation which is weighted for age and/or service. Such a formula would allocate to each participant the same percentage of compensation or the same dollar amount if each participant had the same age and years of service or participation. That's the basic concept, a uniform formula weighted for age and service. This is not purely design based. The first safe harbor says if your formula allocates uniformly across the board based on compensation, you're automatically OK. You don't have to worry about what the various percentages are. This safe harbor plan design also has an operational rule. In order to fall within the second safe harbor, the average of the allocation rates for highly compensated employees cannot exceed the average of the allocation rates for nonhighly compensated employees. There's an averaging technique which is permitted in determining if you can use this particular safe harbor. Though you do get averaging, in determining allocation rates for purposes of this test, permitted disparity, whether actual permitted disparity in the plan or imputed permitted disparity, may not be taken into account. When you determine if the nondiscrimination averaging concept is complied

with, you must do so by actual allocation rates. You can't use any of the integration rules.

Before I move on to the general rule, as I'm sure most of you are aware of, in September of this year, the IRS came out with a set of amendments to the 401(a)(4) regulations. There are a couple of little interesting rules which the regulations provide for, that permit a plan which otherwise meets a safe harbor to continue to meet it even though it has these rules in it. The regulations now indicate, or clarify is a better way to put it, that if you require last day of the year employment as a condition to get a contribution, or if you require a thousand hours as a condition to get a contribution, or both, that in and of itself will not preclude a plan from being under the safe harbors. Also, a plan formula that limits allocations in accordance with 415 will not preclude a plan from satisfying the safe harbors. There are a couple of helpful little rules which I know a lot of defined contribution plans use. It's nice to know that they won't necessarily knock you out of the box, for the safe harbor rules, and require you to go into the much criticized general rule. For a defined contribution plan, if you can't meet the safe harbors, your 401(a)(4) requirements will be satisfied only if no highly compensated employee in the plan has an allocation rate that exceeds the allocation rate of any nonhighly compensated employee. This very rigid, inflexible rule, has been harshly criticized because of the inability to use an averaging technique, which I think most practitioners had thought was available when you tested plans for nondiscrimination prior to the issuance of the 401(a)(4) regulations. The one liberal concept of this rule is that you can use actual or imputed disparity in determining someone's allocation rate, which provides some degree of flexibility.

To impute disparity in a defined contribution plan, you refer to regulations 1.401(a)(4)-7. There are a series of rules which tell you how to impute disparity. Very generally, you adjust someone's original allocation rate in the plan to reflect the permitted disparity. You get to the adjusted rate by determining an excess contribution percentage under a hypothetical formula for an employee, that he would have received had the plan been integrated at a maximum rate. Let me give you a simple example. Assuming an employee has compensation of $30,000 and receives a $1,500 allocation under a profit sharing plan. His allocation rate, based on the contribution, is 5%. In taking into account permitted disparity, the regulations allow you to say, if the plan had been integrated, you could have gotten an additional 5%, or 5.7, whichever is less. In this case, his adjusted allocation rate, by imputing disparity, comes out to be 10%.

It is the 10% number that you use in applying the general nondiscrimination test. It's helpful, but, the test is going to be failed if there's one highly compensated person out there who has a higher adjusted allocation rate than any nonhighly compensated employee. We're not going to get into this here, but that's when the concept of restructuring or aggregating plans comes into play. If you can't meet any of the safe harbors or if you can't meet the general rule, you must change how you look at your plans.

The last point I want to briefly touch on is that in the amendments to the regulations, something has been clarified that had been a very interesting question before these September amendments came out. Under the original 401(a)(4) regulations, compensation was compensation for the plan year, with the ability to use compensation for the

calendar year ending within the plan year. The question that came up was, can you limit compensation, for 401(a)(4) purposes, to compensation earned as a participant? The amendments to the regulations answer that in the positive.

Compensation can be considered to be compensation only for a period while the person is participating in the plan. That's somewhat of a helpful rule, because if you think about it in practice, it is your nonhighly compensated people that generally turn over and come into a plan during a year, assuming you have mid-stream entry dates. When you determine their allocation rates, you look at the percentage of their compensation that they actually received under the plan, and do not have to go back and consider compensation for the whole year. It's a little rule which, to the extent your turnover for the nonhighly compensated employees is greater than for your highly compensated employees, and you have an entry date other than the beginning of the plan year, may give you some comfort or some help in complying with the 401(a)(4) nondiscrimination rules.

MR. TANNENBAUM: I think we'll jump right into defined benefit plans. Here is Irwin Rubin of Gilbert, Segall and Young, who will discuss defined benefit plan permitted disparity.

MR. IRWIN N. RUBIN: Thank you, Norman, for that excellent discussion on defined contribution plans. As you know, Section 401(a)(4) of the code provides that qualified pension, profit sharing, and stock bonus plans may not discriminate in favor of highly compensated employees with respect to contributions and benefits. Section 401(a)(5)(c) of the code, though, provides that a plan which provides benefits or contributions that favor such highly compensated employees will not be considered to discriminate in favor of highly compensated employees merely because the contributions or benefits favor the highly compensated employees in a manner permitted by Section 401(l), which is permitted disparity. Thus, prior to the amendments made by the Tax Reform Act in 1986, the old code and the old regulations provided that such plans could be integrated or coordinated with employer-provided benefits under Social Security. Section 401(l) provides rules that limit the permitted disparity, as it's now called, between the rates of contributions and benefits that may be provided, under a qualified plan, to take into account employer-provided benefits under Social Security. Separate sets of rules are promulgated under 401(l) for defined contribution plans and for defined benefit plans. With respect to defined benefit plans, there are separate sets of rules for excess plans and for offset plans. The IRS issued the proposed regulations under 401(l) in November 1988. Under the preamble to the regulations, the IRS indicates that plans that do not satisfy the permitted disparity rules under Section 401(l) may nevertheless satisfy the nondiscrimination rules under Section 401(a)(4). Conversely, the preamble stated that plans that satisfy the 401(l) permitted disparity rules may nevertheless fail to satisfy Section 401(a)(4) because of other reasons.

First, let me go into some of the definitions under Section 401(l) with respect to defined benefit plans. Social Security retirement age is defined as the age at which an individual is first eligible for full Social Security benefits. For individuals born before 1938, the Social Security retirement age is 65. For individuals born between 1938 and 1954, the Social Security retirement age is 66. For all others, the Social Security retirement age is 67. Average annual compensation is defined as the average annual pay over three or

more highest consecutive 12-month periods, or if shorter, over the entire period of service.

Final average compensation is defined as the average pay in three consecutive 12-month periods, or such shorter period, ending with or within the plan year, excluding any pay above the Social Security wage base. The integration level is the level at which the benefit rate steps up or is the dollar limit on final average compensation in computing an offset. Covered compensation is defined as the average Social Security wage base over the 35-year period, ending with the year in which the employee attains Social Security retirement age. Defined benefit plans, which generally are either flat benefit plans or unit benefit plans, are integrated using either an excess or offset method.

Flat benefit plan provides an employee with a specific benefit such as a benefit of 20% of average compensation or one that may provide benefit of something like $2,000 per month. A unit benefit plan's formula is based on a unit, usually years of service, such as 1% of average compensation times years of service. An excess plan is one under which benefits are provided at a specified rate both above and below the plan's integration level. Defined benefit excess plans are integrated based on upon what's called an excess benefit percentage. The excess benefit percentage is percentage of compensation at which employer-derived benefits are accrued with respect to compensation above the integration level. This excess benefit percentage cannot exceed the base benefit percentage by more than the maximum excess allowance. The base benefit percentage is a percentage of compensation at which employer-derived benefits are accrued with respect to compensation below the plan's integration level. A maximum excess allowance, then, is the difference between the excess benefit percentage and the base benefit percentage. The maximum excess allowance cannot exceed the lesser of the base benefit percentage or three quarters of 1%. With respect to total years of service, this would be .75 times participant's number of years of service, not to exceed 35. Since only 35 years of service are taken into account for the formula, the maximum permitted disparity for total benefits under a defined benefit plan is 26.25%.

Let's take some examples to see how the rules work. Let's say an employer maintains a noncontributory defined benefit plan, and it provides a benefit of a 0.25% of a participant's average annual compensation in excess of covered compensation times years of service. The plan provides no benefits at all with respect to average annual compensation up to covered compensation for the plan year. Thus, this plan would provide a benefit that exceeded the maximum excess allowance, because the excess benefit percentage, which is 0.25%, exceeded the base benefit percentage, which was zero, by more than the base benefit percentage, which was zero. In other words, this is saying that you cannot integrate someone out of a plan, which prior to the Tax Reform Act, we all knew was commonly done.

Another example: let's say an employer maintains a noncontributory defined benefit plan, providing a benefit of 1.5% of compensation up to covered compensation for the plan year, times years of service not in excess of 35. So, that's 1.5 times 35. There's a benefit of 1% of average compensation in excess of covered compensation times years of service, but for this purpose there is no limit on the number of years of service that may be taken into account above the integration level. So, you have 1.5 times total years of

service, up to 35 then 1% of compensation in excess of covered compensation times all years of service, including years beyond 35. So, under this benefit formula, the plan should pass, since someone would have to have 79 years of service in order to fail the cumulative percentage limit. However, this plan really doesn't pass. You're taking into account years of service in excess of 35. You really have a situation where in the 36th year, you have 1% of compensation above covered compensation, and 0% below covered compensation, so that should fail. So, this formula really should fail the tests.

Let's take another example. Let's say you have a plan that provides a 0.25% of average compensation up to covered compensation for the year, times years of service, not in excess of 35, and 1% of average compensation in excess of covered compensation times years of service. Once again, this plan would exceed the maximum excess allowance because the excess benefit percentage, which is 1%, exceeds the base benefit percentage, which is a 0.25%, by more than base benefit percentage. Even though there's only 0.75 between the 1% and the 0.25%. Disparity between the excess benefit percentage and the base benefit percentage must be uniform with respect to all participants. However, the general rule does not apply to differences in disparities that result solely from differences in the employee's Social Security retirement age. Thus, a plan would be deemed to provide for uniform disparities for all participants if it provided for a uniform disparity rate of 0.65% for all participants. Essentially, by providing a base benefit percentage of 1.35%, and an excess benefit percentage of 2%, 0.65% would be the maximum excess allowance under the plan for a participant who had a Social Security retirement age of 67 with a 65 normal retirement age. The 0.75% maximum has to be reduced where the integration level exceeds covered compensation. And this reduction is based on a table which appears in the regulations. Thus, if the plan specifies an integration level of 110% of each participant's covered compensation, the 0.75% factor in the maximum excess allowance is reduced to 0.69%. And the table goes on from there. If a plan specifies a specific dollar amount integration level, the reduction is determined by comparing the integration level to the covered compensation of an individual attaining Social Security Retirement Age in the plan year. Thus, if a plan specifies a dollar amount integration level of $50,000, which applies uniformly to all participants, and the covered compensation of an individual attaining Social Security retirement age in the plan year is $30,000, the 0.75% factor would have to be reduced because the integration level is more than 100% of covered compensation. In this situation, since the percentage of 50 in excess of 30 is 166%, the 0.75% rate would then be reduced under the table to 0.453%. This 0.75% factor is also reduced if benefits are payable before Social Security retirement age. Thus, assuming there is an employee who reached normal retirement age of 65 under the plan, and the Social Security retirement age is 67, the adjustment is to 0.65%. Thus, it is very likely that you may have more than one reduction, that is, a reduction because benefits are payable under the plan before the Social Security retirement age, and another reduction if you used an integration level which is in excess of covered compensation.

If there is more than one reduction, how is it computed? Well, it's not really very clear under the regulations, how it's computed. Most practitioners suggest that what you do is multiply the two factors. For instance, let's say you have a benefit payable at age 65 and a Social Security retirement age of 67, so you know that reduction is going to be to 0.65%. Let's also say that you have integration level that exceeds covered compensation

by 110%, so on the table, that would be 0.69%. I think some practitioners suggest that what you would do is, you would take the 0.65% over the 0.75% and multiply it by 0.69% to get the double reduction of the maximum amounts.

As discussed above, a plan can no longer be structured to provide no benefits below the integration level. Let's take an example, though, of a plan that provides all employees a benefit of 1% of compensation up to covered compensation, except that there is no benefit at all for employees earning between $100,000 and $175,000.

All other employees, whether below that compensation or above that compensation, also receive an additional benefit of 1.5% of compensation in excess of covered compensation.

Should this plan qualify? I think the answer is yes, because only the highly compensated employees in this example are being discriminated against. The only people who are receiving no benefit at all are people earning between $100,000 and $175,000; I would submit that this plan should qualify, even though those people are excluded.

For defined benefit plans, the integration requirement will be met only if any optional form of benefit or ancillary benefit or other right, provided with respect to benefits attributable to compensation above the integration level, is also provided on the same basis, or on at least as favorable basis, with respect to benefits attributable to compensation below the integration level. Thus, a single sum optional form of benefit for benefits with respect to compensation above the plan's integration level must also be provided on at least as favorable basis with respect to benefits provided with respect to compensation below the integration level.

For offset plans, I think the basics are very similar to excess plans. An offset plan is a defined benefit plan that provides that each participant's employer-provided benefit is reduced by an amount specified in the plan or by a specified percentage of the participant's final average compensation. Under the rules, the maximum offset allowance taken into account must be the lesser of 50% of the benefit that would have accrued to the participant without regard to the offset reduction, or for total years of service, 0.75% of the participant's final average compensation times years of service not in excess of 35. Generally, under an offset plan, the offset must be based on average annual compensation not to exceed the participant's final average compensation. If the offset is based on final average compensation, it must not exceed covered compensation without having a reduction in the 0.75 maximum. In calculating final average compensation, of course, wages in excess of the Social Security wage base are disregarded.

For an example, let's say a defined benefit offset plan bases its benefits on average annual compensation not to exceed final average compensation. It uses covered compensation as its integration level. The plan provides a benefit of 50% of average annual compensation, and offsets that by 25% of final average compensation up to covered compensation. A participant retires with 40 years of service. This plan should integrate with respect to the participant, because the offset that applies, 25%, does not exceed the maximum offset allowance. In this case, the benefit was 50% of average annual compensation, so 0.50 of 50% is 25%, and if you took total years of service,

which was 35, times 0.65%, that would be 26.25%, so the lesser is 25% versus the 26.25%.

Now, the regulations do provide that any offset in a defined benefit plan must be uniform with respect to participants. However, similarly, as in excess plans, you may take into account differences in the Social Security retirement age, and also you may take into account service in excess of 35 years for accrual purposes, as long as only 35 years is used for the offset. The rules on optional forms of benefits, as discussed for excess plans, also apply with respect to defined benefit offset plans. The reduction of the 0.75% maximum also applies with respect to offset plans, both for payment before the Social Security retirement age, and with respect to compensation used in excess of covered compensation.

Now, let's look at an example of, if a benefit under an offset plan commences before the Social Security retirement age. This was an example that was set forth in IRS Notice 89-70, which states that the benefit provided under the formula before the application of the offset must be reduced by an amount that is not less than the amount by which the offset must also be reduced because of the early payment under the plan. In this situation, an employer maintained a noncontributory defined benefit plan with a normal retirement age of 65. Let's assume that 65 was also Social Security retirement age. The benefit at 65 was 2% of final average compensation, offset by 0.75% of the participant's final average compensation. The plan provided an early retirement benefit at age 55 for each participant, which was 2% of average annual compensation, offset by 0.375% of final average compensation, which was according to the tables, because of the early payment. Thus, the offset portion of the formula was reduced for early retirement in accordance with the regulations. But the formula, as stated prior to the application of the offset, was not reduced for early retirement. Therefore, the early retirement benefit in this example violated Notice 89-70. In addition, the early retirement benefit here was larger than a normal retirement benefit. Thus, there is also a problem under 411(a) accrual rules. Now, assume that you change the facts in the first example and provide that the benefit at age 55, for 35 years of service, is now 1.625% offset by 0.375%; now, this would work, since the benefit before application of the offset, that is 2%, was reduced by .375 to 1.625%, and that was similar to the reduction in the offset from 0.75% to 0.375%. This, then, satisfied the early retirement rules. Also, as I mentioned, reductions also apply if final average compensation exceeds covered compensation in offset plans.

Let's take another example. Assume that an employer's defined benefit plan provides for an offset that appears to meet Section 401(l), except that the plan covers all employees except those who have the title of Assistant Manager and Manager. Now, such employees are not highly compensated, and such employees represent 25% of all nonhighly compensated employees. Do I have a problem with discriminating against this group? Well, I think the answer is you don't really get into 401(l) here because you pass your 410 coverage tests. The percentage of nonhighly compensated employees not participating is 25%, the percentage of nonhighly compensated employees participating is 75%, that passes 410 and therefore you don't even get into these other questions.

Similarly, let's say a plan covers 20 employees, none of whom are owners. The salaries of the 20 employees range from $15,000 to $80,000. The plan provides a benefit of 2% of average compensation up to covered compensation, and an offset of 1% of final average compensation up to covered compensation. Now, clearly this formula violates section 401(l). The only people in the plan are nonhighly compensated employees. There are no highly compensated employees in the plan. Thus, I would submit that this plan should pass. There should not be any problem because you're not violating 401(a)(4), so you don't even have to get into the question of 401(l).

The maximum excess and offset allowance rules apply only to employer-derived benefits. Benefits attributable to employee contributions are not taken into account in determining whether a plan integrates. The rules under the regulations for determining the portion of the benefit which is attributable to employee contributions are based on a uniform factor. This uniform factor is also based on two tests. One is called a minimum percentage test, and the second is called a ratio test. Both these tests are fairly complex tests and I'm not going to go into them now, except to mention that there are these special tests under the regulations to determine what portion of the benefit is attributable to employee contributions.

The next thing I wanted to discuss was using a uniform dollar amount for your integration level. The regulations present several safe harbor rules. These safe harbor rules were supplemented by additional alternatives under Notice 89-70.

Essentially, an integration level for either an excess or offset plan will satisfy the regulations if it does not exceed the greater of $10,000 or 0.5 of the covered compensation of an individual reaching Social Security retirement age in the current plan year. Alternatively, the regulations provide that an excess or offset plan may have a uniform dollar integration level, if it doesn't satisfy that first rule, by satisfying two demographic tests, known respectively as the attained age requirement and the nondiscrimination requirement. The attained age requirement states that the attained age of your nonhighly compensated employees must not be greater than age 50, or the attained age of highly compensated employees plus five years. The nondiscrimination test is essentially three different tests, of which you have to pass one of the three. The first test is known as the minimum percentage test. You pass that where more than 50% of nonhighly compensated participants have compensation that is at least equal to 120% of the uniform dollar amount. A plan satisfies the ratio test if the nonhighly compensated participants, who have compensation that is at least equal to 120% of the uniform dollar amount, expressed as a percentage of all nonhighly compensated participants, is at least 70% of the number of participants who are highly compensated employees. The third nondiscrimination requirement is called the high dollar amount test. That is satisfied if the uniform dollar amount exceeds 150% of covered compensation of an individual who attains Social Security retirement age in that year. Of course, if that happens, the 0.75% factor is significantly reduced.

Two additional alternatives were promulgated in Notice 89-70. First, any uniform dollar amount can be used which is greater than the safe harbor of $10,000 or .50% of covered compensation, as long as it does not exceed the taxable wage base, provided that, again, the maximum 0.75% is reduced to the lesser of the adjusted amount determined in the

regulations or 80% of the standard limit. If you use this alternative, the demographic tests for attained age and nondiscrimination do not have to be satisfied. The second alternative is called the frozen covered compensation table alternative. You can use an amount for a participant equal to the covered compensation for a plan year prior to the current plan year, provided that the plan year which is used is the same for all participants and is not earlier than the later of the plan year five years prior to the current plan year, and the plan year beginning in 1989. This alternative may be used without satisfying the demographic tests. In addition, no adjustments to the 0.75% factor are required, if this alternative is used. It's questionable what benefits you get out of these alternatives, but there they are in Notice 89-70. If you do use a demographic test, you are permitted to rely on the demographic tests, if you had a favorable determination letter for a particular plan year. However, this reliance is limited in that, if there are certain material changes in facts and circumstances, you will probably have to satisfy the demographic tests again.

Now, after going all through this, it seems to me that there are so many different factors involved in reducing the 0.75% as the maximum excess allowance that is permitted to you, that I really wonder whether using covered compensation as your integration level, without anything else, is really that bad. I think we're going to see some very significant increases in Social Security wage base. For instance, I think in one of the budget proposals that was looked at, it was up to 70 some odd thousand. As this rises, I think that's just going to bring up the covered compensation level over the years, and, if you use that, you don't have to reduce the 0.75% maximum.

MR. TANNENBAUM: Thank you, Irwin. If anybody has questions about the legal aspects of defined benefit plan integration, I think this would be an appropriate time to raise such points.

FROM THE FLOOR: The $73,000, I believe, was purely on the Medicare portion of Social Security, not the wage base for other benefits.

MR. RUBIN: I think it's an indication that you can expect change.

FROM THE FLOOR: It will go up, I'm sure. My question has to do with integration and early retirement. You come up with a formula which works at almost every age, but it's off by a little bit at one or maybe two ages. Would that be considered acceptable, or would you have to fix those one or two ages where it doesn't work?

MR. RUBIN: I'm not sure if there's any room in the regulations for de minimus problems, or the de minimus differences. You might go back to 401(a)(4) and try to argue that. Essentially, there's no discrimination in favor of highly compensated employees, which is the basic concept. I'm not sure if there is anything in the regulations that would give you any leeway.

MR. TANNENBAUM: My understanding is that the Service has given us explicit guidelines that say at any age, it cannot be possible for you to exceed the limit. Even if you could show that there's no employee who could possibly be in the situation, that you didn't hire anybody at this age, you would have a problem. The plan provision at every

age must preclude violation of 401(l). 401(l) is an absolute safe harbor. It's not a 95% safe harbor. If you violate it, then you're not safe under 401(l). You have to meet the test under 401(a)(4).

MR. JOSHUA DAVID BANK: This is not really an integration question, but we have covered some other nonintegration topics. I've always wanted to ask this of an attorney. In some of our government filings, such as Schedule B, when there is a plan that specifies the benefit as 50% of pay reduced for less than 25 years of service, we call that a flat benefit. There's another plan that says 2% of pay per year of service, maximum 25 years. We call that a unit benefit. To me, those are identical. It's always bothered me. What is a flat benefit? They sound the same to me.

MR. TANNENBAUM: What happens to somebody who has or would have more than 25 years of service?

How do you define the accrued benefit under the plan? Clearly, you could get the same result in both cases. I know that some plans will accrue 2% for the first 25 years of service and nothing else. It only goes up if your average salary increases. Other plans say you will get 50% at normal retirement age if you have at least 25 years of service. If you would have 30 years at normal retirement age, what is your accrued benefit after 25 years? Is it 50%, or is it 25/30ths of 50%?

MR. BANK: Is that what you would interpret as the difference? It's really not just a Schedule B problem. 401(a)(4) has these strange paragraphs that relate to flat benefit plans having some special outs. We've been calling these plans flat benefit plans; I guess I'd like to keep calling them that.

MR. TANNENBAUM: I think my understanding is a unit benefit is a unit you accrue every year, and if you're not accruing a unit benefit every year, then I guess you have a flat benefit of what you will receive as a retirement benefit. There may be a distinction in the code.

MR. RUBIN: I always thought, and this is from my perspective as a layman actuary, that a flat benefit is something where you say you get $10,000 a year as your benefit, or a monthly benefit of $2,000. That's your retirement benefit. The unit benefit takes into account years of service or some sort of other factor, which is multiplied. Maybe in certain union type plans there may be other factors that they use in computing credits, other than years of service.

MR. BANK: Norman, you mentioned that pre-1989 accrued benefits are not frozen. We all think they were when 415 or top heavy came into effect. Could you expand a little bit on that? I'm not sure how I would determine what additional benefits this guy could get.

MR. MISHER: There's an example in the regulations, which deals with an annual benefit equal to 2% of compensation averaged over a high three-year period. This is example 5 of the 1.401(a)(17)-1 regulations. In example 4, they accrued a benefit in 1989, but they had to limit your high three years of salary to $200,000, including pre-1989

years. The examples stated that the plan formula provided that effective January 1, 1989, an employee's benefit will equal the sum of his accrued benefit through 1988, plus additional accruals based on the $200,000 limit for future years.

MR. BANK: Do you start counting service from zero again?

MR. MISHER: That's correct. It's almost like a new benefit. By doing it like that, you avoid the otherwise applicable rule, which will require you, for computing post-1988 accruals, to limit compensation in pre-1989 years to $200,000. So you can freeze the guy's benefit as of December 31, 1988 in the calendar year/plan year, and then kind of go forward on a new basis.

MR. GERALD E. HOPPER: Do you have any comments on PIA (Primary Insurance Amount) offset plans satisfying the 401(a)(4) general test? Any experience that you've had would be appreciated?

MR. RUBIN: I was not at the ALI-ABA (American Law Institute-American Bar Association) Conference, which was held the first week in October in Washington. People who were there told me that they heard explicitly that the IRS is reconsidering the PIA offset situation, and reconsidering to the extent of making a specific safe harbor for PIA offset plans. And -- in the preamble they said, we've thought about it and we decided against it, but I think they understand that there is such a significant interest in having a PIA offset safe harbor, that what I heard -- again, it's heresay -- that they will try to address the problem in the final process.

MR. HOPPER: Have any of your clients been dealing with trying to have -- a PIA offset plan, their existing PIA offset plan, and -- trying to satisfy the general rule under 401(a)(4)?

MR. RUBIN: At this point, I've taken a wait-and-see approach. I don't think we've heard the final word under 401(a)(4) with respect to PIA offsets. Instead of recommending something specifically to my clients, because of the unique situation, I've said let's wait and see what the very last word is from the Service.

FROM THE FLOOR: Regarding disability, in the initial proposed regulations, they tried to dangle, once again, a requirement that we have a Social Security qualification for disability? Do you see that as an enforceable provision? Should plans have that as a requirement? Number two, since Notice 89-70, 401(a)(4) has had some modifications. Under 401(l), they are allowing, or seem to imply they will allow, project and prorate as a safe harbor for the uniformity of the accrual. Indexing is allowed if you freeze your benefit as of December 31, 1988. The exact wording says use final compensation over 1988 compensation. This is not final average compensation, which is different from other indexing. Maybe it's just a misstatement in the provisions. As far as PIA offset plans, since 401(a)(4), the modifications of 401(l) allow specifically for you to have two integration formulas. You can use covered compensation as one integration level. You use as an alternative integration level, the one that's half of the Social Security retirement age covered compensation, when you use two formulas and match them together. You can come pretty close to a PIA offset. It is almost a laughing matter that they

would have us get rid of PIA offset plans if I can mathematically reproduce them with the two formulas.

MR. TANNENBAUM: I think I am fortunate that I don't have clients, for the most part, who had PIA offset plans. For the ones that did, I have tried to put in the equivalent standard offset plan that 401(l) permits, I've determined which employee the employer really cares to take care of.

In doing this, I found that I was able to either provide the same benefits for the highly compensated employees, knowing that the other employees may have gotten larger benefits, or I was able to keep the same costs at the expense of cutting future benefits. In most cases, I did use the option of freezing the 1988 benefit and then adding additional units of benefit in the future. It's complicated, but for small plans, as long as the owner is taken care of, he tends to accept that this is the cost of doing business. I could not safely tell any client right now, keep going with your PIA offset plan, because we have no assurance that this will be allowed. Maybe the IRS will come out with regulations, but I have confidence in the Service that if they think we have a way to get around their rules under 401(l), they're not going to give you anything on PIA offset other than the simplest. If you had a truly totally offset plan, 83.33% carve out, forget it. I don't think that's going to pop up again under any guidelines. If you had a de minimus, maybe 50% plan, I've seen some actuaries show that you can always compute a formula that's equivalent to this offset. Maybe you could even show in most cases the 50% PIA offset is always qualified, as long as your front end benefit was high enough. Again, no definite answer, but just the thought processes of an actuary who's hoping that it doesn't come up.