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NONTRADITIONAL AND NONQUALIFIED PLANS (ADVANCED)

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Recorder: DONALD S. GRUBBS, JR.

- A presentation for the experienced practitioner covering among other topics:
  - Cash balance plans
  - Floor plans
  - Nonqualified deferred compensation plans
  - Funding vehicles

MR. DONALD S. GRUBBS, JR.: Nonqualified deferred compensation plans have been around a long time. One of the persons who has been working with them, writing about them and speaking about them for many years is our speaker Mark Wintner. Mark is an attorney and a partner with the firm Stroock, Stroock and Lavan in New York and is very well known in the employee benefits area.

MR. MARK WINTNER: I'm going to talk about selected issues under Title I of ERISA with regard to nonqualified deferred compensation arrangements.

I chose to focus this talk on the ERISA aspects rather than the tax aspects, because, over the years, the tax aspects of funding and pension plans and trusts and the like have got the lion's share of attention. It's only recently that people are beginning to focus more and more on the limits under Title I. Also, the increasing limitations on what you can do through qualified plans forces people to focus more and more on whether or not nonqualified plans, which traditionally have been thought of as part of the compensation package, can be tailored to give broader welfare and/or pension plan benefits, either in supplement to or in substitution for the basic plans.

Historically deferred compensation arrangements had two tax issues driving them. The first tax issue, nonqualification, is indicated from the name nonqualified deferred compensation arrangement. They're not qualified plans under the Internal Revenue Code. What that has meant historically is that they are not subject to the various vesting, nondiscrimination and other requirements which are unique to qualified plans. So somebody who wanted to avoid and/or evade or at least not consider the qualified plan requirements -- or if they're impossible to comply with for various reasons -- would look to nonqualified arrangements as a substitute. That continues to be relevant.

The second driving force behind nonqualified arrangements historically has been the notion of tax deferral. For a long time we've all been talking about tax deferral and

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nonqualified plans as being almost synonymous. Quite frankly I think that has to be reexamined from time to time, since the 1986 Tax Reform Act simplified what used to be a marginal bracket system of federal income tax into a two tier system, three tier if you think that there's a bubble in there at the 33% level.

For the type of people who are in the plans that we are talking about, it is close to a flat tax. Then the notion of deferral has to be reexamined. First, deferral used to consist of the notion that when an employee was working, he was in a higher bracket than he would be after retirement. That clearly is rarely the case anymore in terms of executive compensation. Most executives are going to be in the highest bracket or very close to the highest bracket, both while they are in the working phase in their career, as well as after retirement. So the notion that one might be deferring tax from a high income yield, or high federal income tax bracket year to a lower bracket simply doesn't withstand scrutiny anymore. In most cases that's at best a wash. If you think that rates are going to go up in the future, then it may indeed be the reverse of tax planning. You may be pushing money from a low bracket year into a high bracket year.

The second aspect of tax deferral is the notion that the earnings themselves would build up on some kind of tax deferred basis. Since the employee generally will not be taxed in the year in which the amounts are earned, that is, the year to which the services which generated the deferred compensation relate, he will defer the incidence of taxation to his post retirement, or at least his post termination years. During the interval, hopefully, those amounts will accumulate on a tax deferred basis. However, that only happens if the employer is willing to foot the bill for the taxes on the earnings for the interval period. Because the arrangement is nonqualified, the employer simply takes the money and invests it, or plows it back into operations and pays these nonqualified arrangements out of treasury. In either event, the employer will be footing the tax bill for the earnings on the amounts credited to the employees for the intervening years.

If the employer refuses to do so, and in effect tells the employee his arrangement has to bear that charge; that's part of the negotiation. Until a few years ago, the employer could try to avoid the tax by purchasing individual annuity contracts as a means of funding, not tax funding or ERISA funding, but earmarking, and therefore protecting himself against the obligation. That's no longer possible because of changes in the way individual-owned annuities and outside corporate-owned annuities are taxed. Since 1986 if an annuity contract is not owned by an individual, it no longer enjoys the tax deferral peculiar to annuity contracts.

Turning from the tax code to ERISA, most of these nonqualified plans try to bring themselves within one or another of the available exemptions because, they do not want to be subject to Title I of ERISA. If they are subject to Title I of ERISA, it may or may not be the worst thing in the world. One has to look beyond to see what the problems are. But at least most arrangements are designed to avoid ERISA coverage.

What is ERISA coverage for this purpose? Title I overlaps some of the Internal Revenue Code requirements, as well as having requirements of it's own. In particular Title I has rules with regard to vesting, funding, and minimum participation, meaning minimum age and service requirements.

In addition Title I has its own fiduciary rules. The basic rules under ERISA regarding fiduciary responsibility are found in Title I. It has annual reporting requirements which overlap but, in some instances, go beyond those of qualified plans. In addition, and most importantly in some cases, it confers federal court jurisdiction over certain disputes between employees and employers. If you have a dispute, depending on your viewpoint, you may prefer to be in state court or in federal court. Your ability to get into federal court will depend upon it being an ERISA plan.

ERISA applies to employee pension benefit plans, alternately defined as pension plans, which are defined as an arrangement, which by it's terms, or as a result of surrounding circumstances, provides retirement income or results in deferral of income either to retirement or to the point of termination of covered employment or beyond. An arrangement which, either by it's terms or by surrounding circumstances, puts off the payment until after retirement, or at least a posttermination date, can theoretically be a pension plan for ERISA purposes.

Generally you know exactly what a pension plans is. In most cases it self proclaims itself. However, let's distinguish it from a different type of deferral arrangement which says that 20% of the income earned in this year is going to be deferred and paid five years from now, whether or not the employee is terminated, or whether or not he's retired. This is probably not a pension plan for Title I purposes because, while there is systematic deferral, the deferral is not designed to go beyond the working life of the individual.

If this plan, however, covered only people who were 60 years and older, and it deferred income for five years, then the circumstances might argue that indeed, in that case, what might otherwise have been a nonpension plan system of deferral, is a pension arrangement. Certainly any arrangement which did not use the words termination or retirement, but for instance contained a provision which deferred the receipt of income for 40 years, might very well be regarded as a termination or retirement program. You don't have to spell out that most people are going to be gone within the 40-year period.

The second aspect of whether or not you cross over the threshold into the coverage of ERISA, is whether or not you have a plan. Here we've been getting some developing case law in the past few years. Inherent in ERISA is the notion of what is a plan. ERISA only applies to plans. But people have never really thought long and hard about where you draw the line. Most plans are easy to spot. They're arrangements, they are proclaimed by the employer to the employee population, and you know that you have a plan. Where this issue tends to come up is on executive arrangements.

Let's contrast a plan, we'll call it a golden parachute plan, or maybe we should call it a tin parachute plan, which is going to provide benefits to all employees if they are terminated under certain circumstances following a change in control. It covers everybody in the company. That's clearly a plan. In that case it would probably be a severance plan, not a pension plan. But nonetheless it would be a plan for Title I purposes. If instead we had a contract with the chief executive officer which would provide five times his final salary were he to be terminated following a change in control,

then I think most people would say that's not a plan, that's simply the employment contract with the individual.

Everybody, even the courts agree on the two end poles. The problem is where to draw the line in the middle. There are some cases in the last few years, and they tend to be in these executive arrangement situations, where the courts have been faced with whether or not parallel contacts can form a plan if a company has a standard form of executive contract, which it gives to every executive, and it has a certain element of deferred compensation or postretirement benefit payments. If you have three such contacts for your three senior officers, the chances are you don't have a plan. If it's more extensive, and if it's more uniform, then you may indeed have a plan, even though the plan document doesn't exist anywhere. In effect ERISA will impose the existence of a plan on the arrangement, if it has all the earmarks of a plan.

If we have a plan, we then want to find out if we fall within one of the exemptions from Title I. There are a series of exemptions. The broad-based exemptions are found primarily in the statute itself, and to some extent in the regulations. First is government and church plans. Plans maintained by governmental or church employers are generally exempt from Title I of ERISA.

The second is a regulatory exemption for tax sheltered annuities. Those are the 403(b) annuity programs maintained by certain charitable organizations. Note that the prior exemption for governmental employers and churches does not extend generally to charities or to nontaxable employers. It is only on the government side and on the charitable side in which it applies within the narrower framework of churches. However, a broader variety of tax exempt employers may provide these tax sheltered annuities. The general rule is that where the employer simply facilitates the ability of the employee to make executive deferrals out of the employee's own compensation, that is not a Title I plan. It's not subject to the various rules and requirements. However, if the tax exempt employer is doing more than that, and in particular if it's making either matching or nonmatching contributions to the arrangement, then there is a Title I plan. It will be subject to many of the requirements of Title I. In addition, matching or nonmatching employer contributions are subject to certain nondiscrimination requirements under 403(b)(12) of the Internal Revenue Code, which became effective last year in 1989. So if you have anybody who has that arrangement and hasn't already checked it against the newer requirements, he should do so.

We then get to the two exemptions which are somewhat tailored or unique to executive arrangements. They are the excess benefit plan and the top hat plan. First the excess benefit plan is kind of simple to explain. It applies to plans which are designed to provide benefits which would otherwise be provided for by a qualified plan, but which are disallowed or cutoff by section 415. That could be any of the section 415 limitations. Historically, we tend to think of excess plans as applying to a portion of a defined benefit which exceeds the $90,000 as adjusted or 100% of compensation, or a little less frequently that portion of the defined contribution arrangement which has been cut off by the 415 limitations, the $30,000 as adjusted or the 25%.

Increasingly, however, there are other 415 limitations which can be accommodated. There are severe 415 cut backs for early retirement benefits, for benefits for plans which are less than 10 years old, or for benefit plan improvements which are adopted mid-stream and have been in effect for less than 10 years with regard to a particular individual. In any of those cases you can bring yourself into an excess benefit plan and therefore, the excess benefit exclusion from Title I.

The focus on the excess plan exclusion is on the nature of the benefit. Either it is generated by a 415 excess or it is not. It does not matter how many people are covered by it. It does not matter whether or not they are solely highly-compensated employees nor not. It's simply a question of whether or not it's a 415 excess.

On the other hand, there is somewhat of a misconception that other excesses which sound and smell like 415 can be accommodated by an excess benefit plan. I suppose sooner or later Congress might get around to extending the excess benefit plan exemption to these other similar situations. Right now though, the excess benefit plan is specific to 415.

In particular, the $200,000 compensation limit has an effect on senior management which is very similar to the 415 cut-off. If you want to provide the missing benefit, you may be able to do so through a top hat plan; you cannot do so through an excess plan. There's no logical purpose for the distinction. It simply does not fall within the exemption.

If you do have an excess benefit plan and it is unfunded, then it is exempt from all of Title I of ERISA and you need not worry about any portion of Title I. If the plan is funded, then it is still exempt from Part 2, which is the minimum participation and vesting requirements, and from Part 3, which is the funding requirements of Title I. But a funded excess benefit plan will be partially subject to ERISA. In particular, it will be subject to the general reporting and disclosure rules and the fiduciary and jurisdictional requirements of ERISA.

The remaining exemption, which is both the most important and the hardest to deal with these days, is what is referred to as the top hat plan. You won't find top hat plan referred to anywhere in Title I of ERISA or in the regulations, but the Department of Labor and the community had been referring to it as such for quite some time. Indeed, if you want to register your top hat plan with the Department of Labor, the address you send to at the Department of Labor is Top Hat Exemption. So I guess it's taken on an aura of it's own.

The top hat plan is an unfunded plan for top management or for highly-compensated employees. The purposes for which a top hat plan might be used are broader than that of an excess benefit plan.

In the historic top hat plan situations, an employer that does not maintain any qualified plan, or that maintains a defined contribution plan but not a defined benefit plan, seeks to give defined benefit-type of arrangements to his upper echelon of employees. In that case the only way to have delivered that was through a top hat plan, which has to be unfunded. You couldn't do it through a funded plan, because, for tax purposes, the

funding would trigger immediate tax to the individual. You cannot do it through a qualified plan, because we're presuming that you have a discrimination situation.

The same thing would happen with a discriminatory level of benefits for an employer which has a basic or plain vanilla defined benefit plan and wants to give higher levels of benefits to his upper echelon of employees. That could be either across the board, in case of any termination or retirement, or it could be triggered to changing control situations, sometimes referred to as golden parachutes. This would be a subset of golden parachutes. Inside of a golden parachute severance arrangement you can have a gold parachute extra retirement benefit.

The other purposes for which top hat plans can be utilized, and which are drawing people's attention more, are generated by the increasing number of restrictions and limitations on qualified plans. One we just mentioned, which is probably the one I've come across most frequently, is the $200,000 limitation. That has significantly cut back on what some executives get under a lot of plans. In plans which provided 20% or 30% of pay, which is a fairly modest plan, and which never had a 415 problem before, for an executive making $400,000 or more his benefit may have been cut in half, not because of 415 but because of the $200,000 limitation.

There are similar limitations with regard to defined contribution plans, particularly the limitation on 401(k) contributions or 401(m) employer matching or employee contributions. Their top hat plans or make up plans are far less common, because it's harder to fit into a defined contribution framework, but nonetheless we have seen those plans.

The one that people have talked about, that I haven't really seen designed yet, is one which will attempt to wrap around or coordinate with the section 4980A excise tax on what I'll call excess benefits. Section 4980A is the excise tax which was added on excess benefits by the Tax Reform Act of 1986. Those are determined at the individual level, unlike 415, which was always determined at the employer level. There's both a 15% excise tax on excess benefits received during your lifetime on an annual basis and a 15% estate excise tax on excess accumulations remaining at death.

People have pondered how one stops pumping money into a plan when the person who's covered by the plan is facing a likely excise tax. This is sort of reverse tax planning. A person for whom a plan presumably was to be a benefit looks at a situation where, if he were getting the money directly as additional compensation, he'd be paying 28%. Instead it's going into a plan to be deferred to a year in which he's likely to still be in a 28% category, assuming the rates don't go up, and, in addition, he will have a 15% excise tax riding on top of that. If his participation under such plans is to be cut off, then one has to be able to design some kind of nonqualified arrangement to coordinate with it. It's difficult to do, because the tax is based upon facts and suppositions which are difficult to quantify, but I think this will be an area where people will be looking.

What is a top hat plan? A top hat plan covers a select group of management or highly compensated employees. Here the problem has been in defining, or determining what is meant by that definition. The words are not elaborated upon in Title I of ERISA. The Department of Labor, 16 years after ERISA, still has not come up with regulations,

although they have spoken about starting a regulation project. Indeed, they've stated earlier this year, in various speeches, that a regulation project is under way, but with no fixed time period.

The key, it seems to me, regarding what a select group of management or highly-compensated employees is, still has to come back to where do you cut off? The Department of Labor has made some points along the way, mostly in speeches and/or in formal conversations in negotiating with them. There is limited case law, but it's not of very great use.

In discussing what is management, does the management function focus upon the particular employer? If you have a single employer, that's easy, but when you're dealing with a large employer which has subsidiaries and affiliates and divisions, at what level do you test management of highly-compensated employees?

Although Title I generally does not encompass a controlled group concept, the Department of Labor has indicated that it's current thinking, not to be found anywhere, is to focus on the controlled group for this purpose as well. So if you are working for a conglomerate, then the test of whether or not you are a management employee will take into account whether or not you can alter or have some input in the overall management of the entity as a whole, not merely your division or your subsidiary. The same would occur with regard to a highly-compensated employee. Here however, we have even less guidance because the Department of Labor has declined to define what they mean by highly-compensated employee. People have urged them, for instance, to adopt a 414(q) definition of highly-compensated employee, if for nothing else than for simplicity and consistency. That makes far too much sense it seems, because they've declined to do so.

Other people have suggested borrowing the $200,000 compensation level of 401(a)(17), not that that was ever intended to be a dividing line between who's highly compensated and not, but at least, it is established elsewhere in law and people can coordinate their benefit programs. Again, the Department of Labor has declined to do so.

At one point, the Department of Labor did suggest that they would use a test which was three times the Social Security wage base. That too has been withdrawn, and at the moment we have nothing more than a smell test. The one thing the Department of Labor has indicated, again informally, is that if you are among the 2% highest paid people in the controlled group, then you are probably highly compensated, and therefore, would come within the exemption. Anything beyond that is hit and miss.

MR. GRUBBS: To address floor plans, which have also been around for decades, I immediately thought of Clyde Beers, who has written a very fine article on the subject. Clyde is a vice president of TPF&C in New York.

MR. CLYDE D. BEERS: What I'd like to do is to first give a definition of what a floor plan is. (It's not something out of *Architectural Digest*.) Then we will give some examples, legislative background, some possible applications and some pros and cons as to why we would use these types of plans. Finally, we will close with some design and funding issues.

Let me describe what a floor plan is with Chart 1. We have an underlying defined contribution plan, which would be represented by the solid area under the graph. We also have a minimum benefit under a defined benefit plan, the value of which is represented by the line. The floor plan would be the difference, or the amount of benefit that the defined benefit plan would provide in excess of the defined contribution plan.

This is the definition that I wanted to start with. That is, the defined benefit plan provides a minimum or floor of benefits compared to the defined contribution approach.

In looking at why we would have these I've given an example of Profit Sharing Corporation (Table 1). They have a profit sharing plan which averages 7% of pay with an average return on investment of 8% per year. One of the things that we often do is look at examples of what kind of benefits this plan would produce for various employees. Sometimes we use a single salary increase assumption as though everyone in the organization received the same rate of salary increase.

TABLE 1

Example 1 - P.S. Corporation

	Salary Histories		
	Mr. Clerk	Ms. Manager	Mr. Executive
Starting Salary (1955)	$2,500	$3,000	$3,500
Current Salary (1985)	18,000	30,000	120,000
Final Salary (1995)	28,000	64,000	220,000

For purposes of this illustration I'm going to recognize that highly paid people reach that point because they have higher salary increases than lower paid people. So this company has three employees: Mr. Clerk who has 6% per year salary increases over a career, Ms. Manger who has 8%, Mr. Executive who has 11% pay increases each year. As a result, in this particular table, we see their starting salaries clustered closely in 1955 at $2,500-3,500. Their final salary in 1995 is projected to be anywhere from $28,000-220,000 per year.

Based on the plan that this company has, we project their account balances at retirement to be $100,000 for Mr. Clerk, $180,000 for Ms. Manager, and for Mr. Executive, $380,000 (See Table 2). The sum of the annuity value of that account balance and Social Security compared to their pay at retirement produces an annuitized benefit of 86% of pay for Mr. Clerk, 56% of pay for Ms. Manager, and only 26% of pay for Mr. Executive. We're all aware of the problems of defined contribution plans in this regard. These plans induce low benefits with respect to people who have high rates of salary increase.

So example two is the same company except with a floor plan. The profit sharing plan remains the primary retirement vehicle. But the floor plan formula provides a relatively typical 50% of final pay, less 50% of Social Security defined benefit formula.

CHART 1

FLOOR PLAN

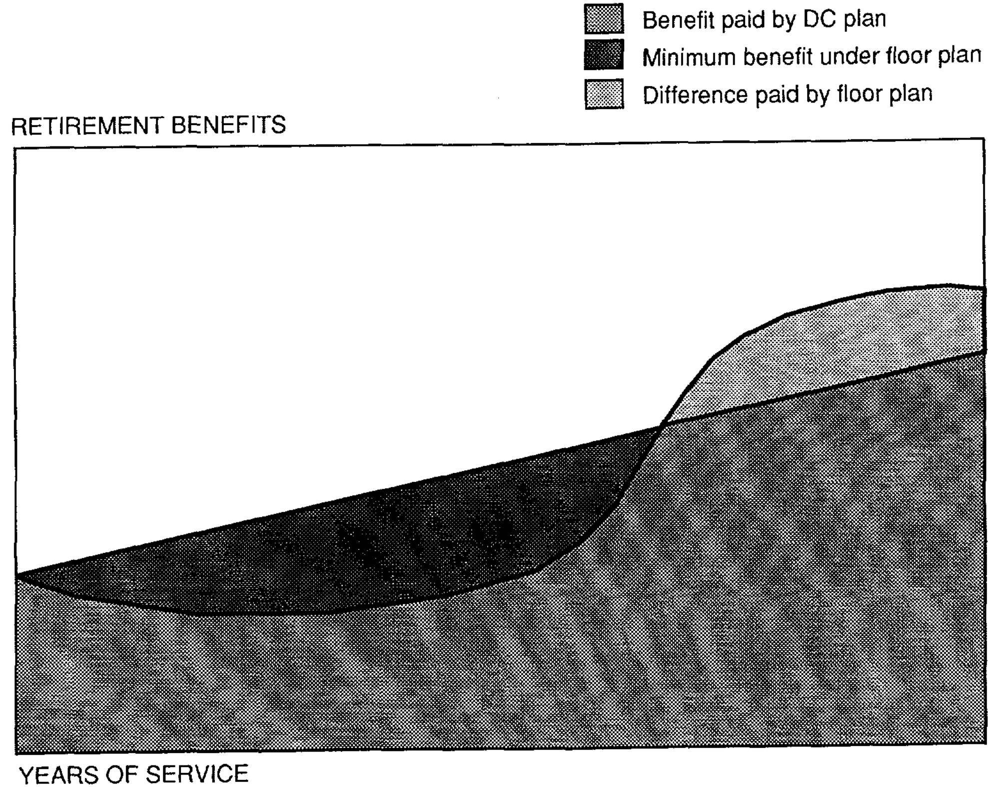

TABLE 2

Example 1 - P.S. Corporation

At Retirement in 1995			
	Mr. Clerk	Ms. Manager	Mr. Executive
Final pay	$ 28,000	$64,000	$220,000
Account balance at retirement	100,000	180,000	380,000
Annuity value	10,000	18,000	38,000
Social security	14,000	18,000	20,000
Total	$ 24,000	$ 36,000	$ 58,000
% of Final Pay	86%	56%	26%

Now the floor plan in Table 3 in effect provides a minimum benefit of $7,000 for Mr. Clerk, $23,000 for Ms. Manager, and $100,000 for Mr. Executive. We subtract out the annuity value of the profit sharing. You can see the floor plan benefit produces nothing for Mr. Clerk, $5,000 for Ms. Manager, and $62,000 for Mr. Executive. That's the reason for the interest in floor plans. The total retirement income as a percentage of pay for these individuals with the combined plan is 86% for Mr. Clerk, 64% for Ms. Manager, and 55% for Mr. Executive. This represents a pretty typical and competitive level of benefit when you compare it to the typical defined benefit plan structure.

TABLE 3

Example 2 -- Floor Plan, Inc.

At Retirement in 1995			
	Mr. Clerk	Ms. Manager	Mr. Executive
Final pay	$ 28,000	$ 64,000	$ 220,000
50% × final pay	14,000	32,000	110,000
50% × Social Security	7,000	9,000	10,000
"Floor"	$ 7,000	$ 23,000	$ 100,000
Annuity value of profit sharing	10,000	18,000	38,000
Floor plan benefit	0	5,000	62,000
Social Security	14,000	18,000	20,000
Total retirement income dollars	$ 24,000	$ 41,000	$ 120,000
%	86%	64%	55%

Let's look at the legislative background on floor plans. Prior to 1969, floor plans were allowed. Revenue Ruling 69-502 basically prohibited feeder plans. A feeder plan is one plan which is integrated with another plan. The IRS's rationale for the ruling was that

the defined benefit was not definitely determinable, that the defined contribution was not for the exclusive benefit of employees. That is, the defined contribution (DC) plan was for purposes of funding the employer's obligation under the defined benefit plan. Therefore, under the terms of the Revenue Ruling, both the defined benefit and the defined contribution plans had to be nonqualified.

ERISA came along and created, in essence, a Catch-22. Revenue Ruling 69-502 said you can't fund these plans. ERISA said you have to fund these plans. Into the breech several years later the IRS came along and issued Revenue Ruling 76-259. Revenue Ruling 76-259 said that you can in fact have qualified floor plans if the actuarial basis for the conversion from defined contribution to defined benefit is specified, if the formula meets the general accrual rules under the code, and if the vested account balance plus prior withdrawals is the item that's being converted into it's defined benefit equivalent.

Now let's discuss some possible applications. One of the earliest applications for floor plans was in the employee stock ownership plan (ESOP) area. When Revenue Ruling 76-259 allowing floor plans was written, one of the things that happened is companies became aware that they could transfer into a defined contribution plan, a substantial percentage of assets in employer stock. This effectively got around the 10% limit of employer stock in defined benefit plans. That loophole, if you will, is no longer in existence, but the ESOP offset was certainly one of the first driving impetuses for the establishment of floor plans.

Another employer reason is to provide downside protection for defined contribution plans. As Mark indicated, this is used very frequently in the executive arena and is providing a defined benefit minimum to what would otherwise be a defined contribution approach. Another application is to bolster profit sharing philosophy. In some cases floor plans can provide a transition from defined benefit to defined contribution. And in some cases, we've seen them used to cut back an overly generous combination of defined benefit and defined contribution plans.

Looking at some of the pros and cons as to why we would have these types of plans, I'll skip over the ESOP offset. Basically, that was a tax ploy to get a lot of employer stock into the plans, which no longer is available. But on the down side protection area, the two basic reasons for establishing floor plans is first, to provide final pay protection for employees who have high salary increase rates over their career, and second, to protect from market declines.

In the supplemental executive retirement plan (SERP) area, some companies want to look at the total retirement income of the executive and perhaps offset, not only the defined contribution plan, but also the qualified defined benefit plan as part of the company's underlying minimum guarantee. Obviously, you can target to very specific objectives, particularly if the floor plan has a nonqualified element to it.

In terms of making up for defined contribution plan shortcomings, a floor plan can help protect employees against lack of profits, poor return on assets, and for the fact that defined contribution plans will be immature for many years. It can help hires at older ages, or in the case of rapid pay increase.

The basic profit sharing philosophy, on the other hand, will help focus benefits on younger short-service employees. Some companies see floor plans as the best of all worlds. Floor plans can be relatively costly because of that characteristic.

In terms of transition from defined benefit to defined contribution, floor plans can be set up in a way that the underlying floor benefit may, in fact, disappear over time. This could occur to the extent that the defined contribution plan starts to provide more and more generous benefits.

Finally, the last area where we've seen this used is in cutting back overly generous defined benefit and defined contribution plans. We've done a fair amount of study on benefit levels at retirement. One of the things that we've found is that major corporate America plans tend to provide adequate income as early as age 60 for many employees who are retiring in the early 1990s. To the extent that employers want to influence their employees to stay longer than that, on average, there may be a need to cut those overall benefits back.

What are some of the cons of the use of floor plans? They're pretty complex. They're costly, because the defined contribution plan is providing a fairly sizeable benefit because of termination and death, and because employees will invest defined contribution assets in low-yield return securities. There are some people who question whether profit sharing is really motivational. To the extent that the floor plan is qualified, you have unfunded liabilities, or potentially unfunded liabilities, and PBGC exposure.

In terms of design, a major issue is whether to look at the plans separately or together. For example, are the eligibility criteria the same in both plans or do they differ? What about the vesting, disability, retirement and death benefits?

Another issue is whether you offset the current account balance or offset a projected account balance based on the time the distribution starts under the defined benefit plan.

Let's look at some of the more nitty gritty questions. In vesting, do you apply the vesting percentages (if you have graded vesting) before or after the offset. You'd get a different answer depending on how you design the plan. In terms of spouses benefits, is the benefit determined as if the employee retired, or based on the spouses defined benefit less the value of the employee's account balance? How do you treat withdrawals, employee contributions, investment options, breaks in service? These are all issues that have to be decided when looking at the design of both the floor plan and the underlying defined contribution plan.

With respect to options, should certain survivor benefits, other forms of payment, and early retirement benefits be separate for each plan? Should both plans pay together? Or is the floor plan secondary? And should reductions for options be before or after the offset? The issue is that the large print can give, but the small print can take away depending on how those benefits are structured.

Because of tax reform another issue has come up, and that is how on earth do we test floor plans for nondiscrimination, if in fact, they're qualified? The general rule is that

the net benefit under the floor plan must be tested. And my guess is that nobody will be able to pass that type of test on an ongoing basis, because of the volatility of the underlying defined contribution asset.

There is, however, a safe harbor in which you can test the gross benefit if certain conditions are met. Those conditions include that the floor plan benefit is reduced by the actuarial equivalent of the account balance in the offset plan. No problem, that's the typical design. Only the vested portion plus prior distribution and earnings are considered. Again, I think that's pretty typical. Only a plan of the current employer can be considered as an offset. I'm not really sure what they're getting at there, and how the control group rules will apply in that situation. I think probably the biggest issue is that the floor and offset plans must cover the same group of employees. The offset must be applied to all employees on the same terms. And all employees must have the same investment options under the offset plan. In my experience these provisions may not, in fact, be typical and could cause some serious testing problems under 401(a)(4) and the regulations. Under the safe harbor, all employees must have the same preretirement distribution options. The floor plan must pass the nondiscrimination rules on a benefits basis without the offset. At the same time, the offset plan must pass nondiscrimination testing on a contribution basis.

And finally, probably most onerous, is that you're not permitted to restructure plans except as necessary to cover the same group of employees or to apply the offset on the same terms, or to include the same investment or preretirement distribution options. At least as I understand it, that would mean you could not band, if you will, the floor plan benefit for purposes of going into the 401(a)(4) testing.

As a suggestion on how to minimize the complexity of these types of plans, I would suggest what I would call a layman's understanding of how the plan would operate. That is, define the floor benefit in each situation, whether it be death, early retirement, normal retirement or whatever. Determine the profit sharing equivalent at the date of payment on the same form of payment; the difference is the floor plan benefit. In other words, offset the current account balance as opposed to some future account balance or some prior account balance based on a different date.

The actuarial basis for conversion can either be fixed or indexed, but it has to be defined. It could be based on valuation-type assumptions, PBGC rates, or a blend of insured rates as the plan may specify.

In terms of funding, not only are the designs of these plans complex, but the funding also can be as complex as you want in terms of nonqualified benefits. Basically the requirements are to treat the plans separately for expense and contribution purposes. Some of the funding issues will be how to treat future profit sharing contributions, and whether to smooth asset values for profit sharing balances.

It's very difficult to differentiate between plan method and assumption changes particularly where you have a change in one plan that's going to affect the liabilities in another plan. For example, let's say you had a money purchase plan that was contributing at a rate of 6% of pay. The defined contribution plan is amended to contribute at 5% of

pay. What does that mean in the floor plan? Is it a gain or loss? Is it a plan change? Those issues are not always clear.

Because of the leverage involved, it may be very difficult in a number of circumstances to avoid over funding a floor plan, particularly where a maturing, defined contribution plan will ultimately eliminate the defined benefit liability.

The IRS attitudes with regard to funding are for cost allocation-type methods, value the net projected benefit. For benefit allocation methods, take the gross floor plan benefit less the defined contribution plan balance plus expected contributions for the year -- in a sense giving a unit credit offset to the defined contribution plan. In that circumstance, the normal cost will have to be artificially fudged as the difference between the end-of-year and beginning-of-year liabilities. Otherwise, you won't have a balance between those liabilities. As usual, there are no IRS regulations to date or expected.

In conclusion, these are relatively complicated structures. But in fact, under certain specific circumstances they provide the ability to target benefit delivery and still use an underlying basic defined contribution plan structure. An ESOP is a special case.

Finally, to the extent that the rules and particularly the testing are made sufficiently onerous, and if the limits on defined benefit plans come down enough, I could easily see a situation where companies would go to a defined contribution plan for rank and file employees and have a floor offset-type arrangement, as Mark indicated, just for the executive highly paid group. Obviously, the problem with that is it leaves upper middle management high and dry. And that's probably why we haven't seen more of these plans to date.

MR. GRUBBS: I am going to discuss cash balance plans. The cash balance plan is really a defined benefit plan that looks a lot like a money purchase pension plan. All employees have individual accounts. Amounts get added to their accounts, usually as a percentage of pay, in amounts that look like employer contributions. Interest gets added to their accounts. When an employee terminates employment or retires, he can usually choose between getting his vested account balance as a lump sum distribution or as an immediate or deferred annuity of equivalent value.

In spite of these similarities to a money purchase plan, a cash balance plan is really quite different, leading some to call it a "funny money purchase plan." The accounts are only bookkeeping devices to keep track of the accrued benefits. They do not represent assets of the plan, and are not even related to the assets of the plan. Because the plan is a defined benefit plan, the employer contributions are based on actuarial valuations. The contributions made may be more or less than the amounts added to the accounts. Interest is credited at a rate specified in the plan, which may be more or less than the fund actually earns. In some cash balance plans, this general description has been modified to provide past service benefits.

Some claim that the cash balance plan has all of the good points of both defined benefit plans and defined contribution plans, and others say it has all the bad points of both.

Both are at least partly true, but regardless, employees do like them. Just as in defined contribution plans, they like those individual accounts.

How do the 415 limits apply to a cash balance plan? Because it's a defined benefit plan, the defined benefit limits apply to the monthly benefit payable at 65 and the monthly early retirement benefits. The present value of those defined benefit limits control lump sum distributions from the plan.

These defined benefit limits apply to the combination of the cash balance plan and any defined benefit plan that the employer has maintained currently or in the past. If the employer also maintains or has maintained a defined contribution plan, then the combination limits of 415(e) apply. The 415(b) limits for defined benefit plans and the 415(e) combination limits may be either more or less restrictive than the limits that would apply to a similar money purchase plan.

What interest rate should be credited under these plans? Because we must have definitely determinable benefits, the interest rate must be specified in the plan. It can either be a fixed rate, 8% for example, or the plan can relate it to some index, such as the consumer price index (CPI) or the T-bill rate. There is no minimum or maximum rate required.

The rate that is set is going to affect the amount of benefits the employee receives. It will also effect the employer's cost. Depending upon the distribution of employees and the rate of turnover, if you raise the interest rate credited by 1%, you may increase the employer's cost anywhere from 10-25%.

Employees may want that rate to be competitive with other rates that are available in the marketplace. They may be unhappy if your plan is crediting a rate that's less than the bank is offering on it's money market fund, or other investments that they think they ought to compare it with. To meet that desire, you may initially adopt a rate that is competitive and amend the plan from time to time. But if you amend the plan to lower the rate, you must notify employees 15 days in advance of a decrease in future benefit accruals.

Alternatively, one might set a rather conservative interest rate such as 6%, and then make ad hoc amendments one year at a time to say, "This year we're going to credit it an extra 3%," for example. If one did that in a pattern, is not clear how the IRS would look at it.

Another alternative to try and keep the rate credited comparable to the earnings of the trust would be to invest in GICs and key the rate credited to GIC earning rates. For those employers who are particularly concerned about keeping the rate credited close to the rate earned by the trust, it might even be possible to design the plan as a variable annuity plan in which the rate credited actually reflects the rate earned by the trust. Now you have something that looks almost like a defined contribution plan, so much so that the IRS might say you have a defined contribution plan though it can be modeled to be a defined benefit plan of the variable annuity type.

How are we going to determine the amount of employer contributions? Because it's a defined benefit plan, it is subject to the minimum funding requirements. There are a number of unanswered questions about how to deal with cash balance plans for the funding requirements. It is possible to use any of the actuarial cost methods. I think the unit credit method has been more commonly used with these plans. But because you can use a variety of methods, there's quite a range of costs that might be developed. Under any method you will ordinarily use a turnover assumption to discount in advance for turnover. Therefore, in a start-up cash balance plan, your contributions in the early years are apt to be less than the amounts credited to the accounts, and the assets may be less than the account balances in all years.

If you're using an actuarial cost method that creates an unfunded liability, that gives you flexibility between a minimum and maximum required contribution. The full funding limit applies to these plans, because they're defined benefit plans. It is possible that the full funding limit might not allow any contributions even though the assets are less than the account balances. That might sound strange indeed.

These defined benefit plans are subject to the FAS 87 and 88 rules. So we have another set of numbers for employer cost which differ both from the contributions and from the amounts added to the accounts, unlike a money purchase plan, in which the accounting cost, the contributions, and the amounts added to the employee accounts (less forfeitures) are all equal.

Can I integrate a cash balance plan? A cash balance plan cannot satisfy 401(l). So if it's going to be integrated, it's going to have to be integrated under the general rules of 401(a)(4). Can a cash balance plan satisfy 401(a)(4)? It will not meet the safe harbors, so you're going to have to go to the general test for defined benefit plans, according to the proposed regulations.

Remember that under the general nondiscrimination test for a defined benefit plan, we're not looking at the alleged contribution to the account. We're looking at the increase in the accrued monthly benefit. The accrued monthly benefit is actuarially equivalent to the account balance. If you can show that the normal accrual rates and the most valuable accrual rates are not discriminatory, through the combination of grouping and restructuring, you may be able to show that a cash balance plan is nondiscriminatory. I have not tried running one of these tests for a cash balance plan. I hope during the discussion period someone who has done so will report the results.

Should benefits under a cash balance plan be paid as a lump sum or as an annuity? All of the plans that I have seen provide for paying lump sums as an option, although it's not required. But the fact that there are account balances just intuitively lends itself to paying lump sums. Because it's a pension plan, it must also provide an annuity option. Immediate or deferred annuities must always be available to that terminating employee, actuarially equivalent to the account balance.

For actuarial equivalence we have to use an interest rate not higher than the PBGC interest rate. Increasing the interest rate will produce larger annuities and thus larger employer costs. This is exactly opposite from our thinking about the interest rate that

we use in a typical defined benefit plan to provide lump sums, where using a higher interest rate will reduce the benefits and reduce the employer cost.

Can I use 120% of PBGC rates if the amount is higher then 25,000? No. That's clearly discriminatory because higher benefits would be paid to the highly paid people. The joint and survivor rules of course, apply to these plans.

What investment choices can a cash balance offer? It can't offer investment choices, because we're not relating the interest credited to the plan's investments. Therefore, it's generally not possible to let employees direct the investment of their accounts.

What about death benefits in a cash balance plan? There's, of course, the requirement for the preretirement survivor annuity benefits. Most cash balance plans provide the account balance just like a defined contribution plan usually does, although that's not required. It can be shown, assuming that you make it available as an annuity, this would ordinarily satisfy the preretirement survivor annuity requirements.

How should we really invest the assets of one of these plans? Employers may have different ideas about that. It is their risk. An employer who wants to minimize his risk, knowing what interest rate is going to be credited to the employees, might invest plan assets in something that earns similar rates. On the other hand, the employer might recognize that it can make a profit by earning more and might invest in equities hoping to outperform the interest rate credited.

Administration of a cash balance plan is ordinarily more complex than that of either a defined benefit plan or a defined contribution plan. It's like a defined benefit plan with all the usual problems for defined benefit plans, and in addition, you have to keep individual accounts and ordinarily produce individual benefit statements on that basis. However, you do save the complexity that comes with having investment choices, which many defined contribution plans have.

MS. ANNA M. RAPPAPORT: Do you have any sense as to whether the Service might be considering a safe harbor under 401(a)(4) for cash balance plans? Do you have any idea about how the Service feels about these plans and whether they are positively or negatively disposed to them?

I personally have not tested any cash balance plan under 401(a)(4), but I am aware of people that have tested some plans under the general test, and they feel they've passed.

MR. GRUBBS: There are some negative feelings among some individuals at the Service about cash balance plans. Even if we get a safe harbor, it might not do most cash balance plans much good because most of the ones I've looked at are not nice, crisp, clean cash balance plans. They have various sorts of grandfather clauses trying to ease transition problems for those who have moved from defined benefit plans. So a nice, clean, safe harbor probably wouldn't help them.

MR. BEERS: We've tested a cash balance plan that is 7% of pay up to the Social Security wage base, 12% of pay in excess of the wage base. This particular group of

employees is relatively young with short service. The group was several thousand employees. Based on our best understanding of the regulations that plan will pass the 401(a)(4) rules.

MR. GRUBBS: And you ran those tests as a defined benefit plan using restructuring and grouping?

MR. BEERS: Yes.

MR. JOSHUA DAVID BANK: I know a consultant who had some excess plans that were handling 415 limitations for a couple of top executives. When the $200,000 pay cap came in, that language was just naturally incorporated into that plan. What it is your opinion about that? Do they have to be separate plan documents?

MR. WINTNER: With regard to the $200,000, the practical answer is it's probably okay in this sense. The excess benefit plan exemption can clearly apply to that portion of a plan which encompasses the excess benefit plan. There's some other portion in the plan, the $200,000 compensation portion of the plan. While the Department of Labor hasn't said that any dollar amount is a clear objective test as to who's highly compensated, informally I have advised people that I think there's a consensus that, by any measure, $200,000 is probably highly compensated. Therefore, that portion of your combined plan would probably meet the top hat exemption. The only concern you might have is that to be a top hat plan, it has to be for the primary purpose of providing benefits to highly-compensated employees. If the excess portion extended to a large number of people who themselves were not highly compensated, I might have some concern about having them combined. In a real world, more often than not, it's not going to be a problem.

The dollar amounts problem is a very rarified problem. It usually comes up with professional concerns or with Wall Street investment type of employers where, with bonuses, even some of the clerical help may be making six figures. You start to worry about at what point you are looking at absolute dollars and what point you are looking at percentages within the employer to determine who's highly compensated. I think most people don't worry at the $200,000 level.

MR. BANK: Concerning the 15-day notice of reduction in accrual rates under a cash balance plan, would that also apply if you did tie your crediting rate to some index and the index went up and down every quarter for instance?

MR. GRUBBS: Not if it's automatic. If you change the interest rate by amendment, the notice is required.

MR. VINCENT F. SPINA: When you convert a traditional defined benefit plan into a cash balance plan, is there a requirement that the initial, theoretical cash balances be equal to the present value of accrued benefits based on PBGC rates or could you theoretically use an 8% rate, as long as the lump sum paid out in the future was actuarially equivalent to the original accrued benefit under the previous plan at PBGC rates?

MR. GRUBBS: The anti-cutback rule would require that the lump sum and the monthly income payable under any circumstance in the future could not be less than the amounts that would have been payable under the old plan, based upon benefits accrued immediately prior to the amendment. That's the only requirement.

MR. BANK: The reason I asked this is if you base all the theoretical account balances based on PBGC rates, you're going to ultimately have a much larger liability in a sense that the sum of the theoretical cash balance is much higher than if you used a lower interest rate. Therefore, for funding purposes you would have a lower liability if you could base it on a higher interest rate, at least in your initial transformation. Do you see any problems with doing it that way as opposed to having all the theoretical cash balances being equal to the present value of accrued benefits on PBGC rates?

MR. GRUBBS: Immediately after you have converted you have account balances. And those account balances have to be immediately reconvertible for the person who quits. That is, he must still have a right to have an annuity. When he elects to convert back to an annuity, that factor which one uses cannot use an interest rate that's higher than the PBGC rate.

MR. BANK: Are you saying that you have to start out with account balances equal to the accrued benefits based on PBGC rates?

MR. GRUBBS: I'm saying that you cannot have a conversion factor to go back from the account balance to the annuities that's based upon an interest rate that's higher than the PBGC rates. I'm also saying that at the point of conversion, and later, any lump sum payable must be equal to any lump sum that might have been payable under the old plan, based upon the benefit accrued as of the change. Also any monthly annuity payable after you have made the conversion must not be less than any annuity that was payable under the old plan based on the benefit accrued as of the change. It's trying to make sure there was not a cutback in any form of benefit distributable, and also, to make sure that after we have made the conversion, we're not using an interest rate to convert from lump sums to the annuity that exceeds the PBGC interest rate. There are a number of ways that one might get to that. Some ways would be more liberal than would be required.

MR. BANK: Not to belabor the point, but could you then start out with theoretical account balances that are lower, but have the minimum benefit in the plan equal to, on an annuity basis, the accrued benefit prior to the conversion, and a lump sum based on the present value of the accrued benefit based on PBGC rates?

MR. GRUBBS: You could have a grandfather clause that would override your other basis for converting.

MR. STANLEY H. TANNENBAUM: Recently there were changes that said you could no longer use the 401(k) employee contributions or deferrals in an offset in a floor offset arrangement, but you could previously. Have you given any thought to the bookkeeping requirements to try to figure out what amount of offset existed as of the date you had to freeze the 401(k) balances?

MR. BEERS: What you're describing I guess would require, in effect, a separate bucket. That is, an identification of those assets accumulated on behalf of the time period prior to that change. I'm not aware of any specific plan that has addressed that. But it would seem to me that what you're describing are the two different assets, one of which could be offset and one of which couldn't. In most cases, in my experience, the offset plan is not a plan that's subject to employee discretion. Typically the offset plan is an employer contribution that's independent of the employee's contribution decision.

MR. TANNENBAUM: I understand the ideal design. I happen to have one plan where they had a profit sharing plan and they put in a 401(k) plan, both of which served as offsets for a defined benefit (DB) floor plan. It created a mess when you had to figure out a minimum accrued benefit at the point of which you can no longer use 401(k) balances? And in what way could you reduce that accrued benefit, recognizing you don't want to? But when you get into it, charge the client a lot of money for it.

MR. BEERS: Yes it sounds like a nightmare, just the whole concept that the employee could reduce his benefit by making a contribution under a qualified plan. I'd hate to try to communicate that.

MR. GRUBBS: For floor plans, does the 415 defined benefit dollar limit apply to the net, the excess of the gross defined benefit minus the defined contribution offset?

MR. BEERS: I'm not sure. My intuition is that it would probably have to apply to the gross plan benefit, but I'm not sure of that answer. I'd really want to defer and find out the answer before I responded.

MR. TANNENBAUM: I have a comment on the idea of that 415 limit on that floor offset. It would seem that if you are treating it as one benefit, you have one 415 limit. If, however, you are going to attempt to use a DC and a DB combined 415 limit, then it probably should be the net DB, because you've already included the DC piece. But if it's one benefit, then it is a gross DB and you don't get anything out of the DC side. You have 1.0 rather than the 1.25 rule.

MR. STEVEN D. BRYSON: In the floor offset arrangement, do you have two separate plans, or do you have one plan?

MR. BEERS: There's two separate plans.

MR. GRUBBS: Let me add that that's not necessarily the case. You can have a combination plan.

MR. BRYSON: How is the full funding limit calculated? Is it on the excess piece as compared with the assets in that excess plan? Or do you look at the gross benefit minus the assets from the two combined plans and calculate in full funding?

MR. BEERS: As I indicated, there's no specific regulation in this area, but our understanding is that you could value either the net benefit (in which case you would value the plan in effect as a separate plan), or you could value the gross benefit less the defined

contribution account balance, plus the expected defined contribution amount for the ensuing year. Let's say your plan was 40% of pay and you had account balances worth $1 million. You'd value that 40% of pay. And if you had a million dollars of account balance, plus $20,000 of contributions coming in for the next year, your full funding limit would equal the value of the gross benefit less the actual asset value in the offset plan, less any assets that are in the floor plan itself.

MR. BRYSON: As far as calculating the current liability for the full funding limit, those two approaches would produce drastically different results, wouldn't they? Because you're taking 150% of current liabilities, taking 150% of the net benefit as opposed to 150% of the gross benefit would produce quite a different number, would it not?

MR. BEERS: Yes. One of the things that we found is when you look at different methods, whether you're using an offset or a net benefit approach, you can dramatically change the incidence of cost recognition under these plans because the leverage of that underlying account is so powerful.