RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 3A

# WHAT HAVE PRACTITIONERS DONE WITH SECTION 401(a)(4)? (ADVANCED)

Moderator: DONALD S. GRUBBS, JR.
Panelists: JUDITH E. LATTA
STEVEN G. VERNON
Recorder: JOSEPH D. MARSDEN

- The panel will discuss the way actuaries have dealt with the application of the regulations under Internal Revenue Code (IRC) 401(a)(4).

MR. DONALD S. GRUBBS, JR.: What have practitioners done with Section 401(a)(4)?

We have a couple of people with a lot of practical experience on this subject: Judy Latta of the New York office of Coopers and Lybrand, and Steve Vernon with the Sherman Oaks, California, office of the Wyatt Company. Steve's going to talk to us about these tests that we have to run to determine whether the benefits or the contributions are discriminatory, then Judy is going to talk about a range of other issues we need to look at in deciding whether we're going to pass 401(a)(4) or not. She's going to talk about ancillary benefits, rights and features, plan amendments, past service credits, and plans benefiting former employees, and then she'll look at some case studies for us.

They are going to be sharing with us what they believe is the way to do things in accordance with the proposed regulations, but we're all very much aware that there may be some changes when we get to the final regulations. Maybe they'll share some thoughts on that with us as well.

MR. STEVEN G. VERNON: The regulations came out in about May 1990, and I don't know if you're like me, but I spent the whole summer dealing with the regulations. Now there are lots of ways to pass 401(a)(4), and I have only used a couple of them, so if you have any of your own stories to tell, stand up and we'd like to hear them along the way. One thing I'd like to comment on is that at the general session, when you saw the back packers with the knapsacks going up the mountain (from a cartoon showing the greater burden of businesses in the U.S. relative to other countries), well, the 401(a)(4) regulations are in that knapsack. That expresses my views on these regulations. I think in a certain sense, they create a lot more work than they're worth, but I happen to have lots of clients that have to deal with them, and never before have I had such happy clients. They were scared about their plans not passing, and for the first time, they would pat me on the back and say, "Great news, we passed." It made me feel good for a while, but basically, all I did was get them to stop banging their heads against the wall, and when they did, they felt good, and I was the one who was there making them feel good. I'm going to talk about some of the processes and some of the case studies that we went through, and along the way, we hope to learn some lessons.

One of the first things you need to do when you're doing 401(a)(4) testing is to gather all the data you can. Now there's what you're supposed to collect, and then there's what you're actually going to collect, and the two can be very different as you'll find out when you do these tests. You're supposed to collect data on every employee for the 401(a)(4) test – every employee that actually accrued a benefit during the year, and that includes people who terminated during the year. Now if your client is typical, they have data on who is there at the end of the year and that's it. They don't have data on who came and left unless that person was a vested termination. So that's the first barrier that you might come to: collecting all the data that you're supposed to collect. In the good faith compliance period, I think getting as much data as you can and making the best of it is probably okay. In the meantime, you tell your clients the kind of data that you will need to collect once the regulations kick in their final form. One thing that I do try to get from our clients is data on all of the highly compensated employees (HCE), because if you are missing some data on nonhighly compensated employees (NHCEs) but you have data on all the HCEs and you still pass, then whatever data that you didn't get for the NHCEs could only help you. So one thing we really try to get from our clients is data on all HCEs. Chances are your HCEs don't turn over very much during the year, so you don't have the problem of keeping track of people that left during the year. The other thing we try to get data on is for a special grandfather formula, and this really causes a lot of trouble with 401(a)(4) testing. If you have a regular formula and then an active or live grandfather, these could cause you trouble. So I try to collect data on all the people that are in that active grandfather.

Just as you're starting off, there's another decision you need to address and that's what pay are you going to use? You have to calculate accrual rates and the denominator of that accrual rate is pay. Getting pay can be hard sometimes. In the regulations, there are some safe harbors as to what kind of pay you can use. If you just have one plan that you're trying to test, maybe it's straightforward, but you get into trouble when you have lots of different plans that you're aggregating, and they have different definitions of plan compensation, so you might end up collecting plan compensation pay that is different from the pay you'll have to use for your tests. Again, in a good faith compliance period, you do the best you can, but beyond that, I think you'll need to use a consistent definition of pay all the way throughout when you're aggregating different plans for coverage testing.

Now another interesting topic comes up. There are safe harbors for the types of plan compensation you can use in the calculation of accrual rates, but then there's also a general test in there. You can use a definition of pay where they look at the ratio, for HCEs and NHCEs, of pay covered by the plan divided by total pay, and if the difference is de minimis, then you're all right and you can have any kind of definition you want in that case. I have one client that wanted to cover bonuses but not overtime, and my first reaction was, no, you can't do that because the NHCEs are the ones that are in overtime, and the HCEs are the ones that get bonuses. But we actually went through and collected data and looked at the ratio of plan compensation over total compensation, and it differed by about 2% or 3%. In other words, for the HCEs, we were covering about 99%, and for the NHCEs, we were covering about 97%. We've had some discussions with the IRS as to what do they really mean by de minimis, and surprisingly, we've heard 5% might be de minimis. Now they hem and haw, and they say, "Don't quote me on that," but I was quite surprised that they might consider 5% as de minimis. So we felt comfortable with 2%, and the client went ahead and covered bonuses but not overtime.

Another issue that could trip you up is when you have to aggregate a defined benefit plan with a defined contribution plan. Defined benefit plans let you use either one year's pay or an average of three or more years' pay when you're dividing through to come up with an accrual rate. If you read the regulations carefully, for defined contribution plans it looks like you can only use one year's pay when dividing through to come up with an accrual rate. So when you're aggregating defined benefit and defined contribution plans, what do you do? We've always used one year's worth of pay just to be safe and we've ended up passing, so it's no big deal, but I'd appreciate any comments anybody has from the crowd on that one.

Finally, if you are collecting data for people who terminate during the year, what kind of pay do you use? Do you annualize their pay? Do you use just the pay that's counted for their benefit? These issues aren't clear, and yet if you have high turnover, that can be a very important issue to cover. The regulations don't say what to do in those circumstances so you're on your own.

One thing we discovered early on is that if you can convert contributions to benefits when doing testing, that gives you a powerful tool to pass plans, and so one of the first things we try to do for defined contribution plans to pass them if they aren't passing a safe harbor is to convert contributions to benefits. This is useful since the NHCEs tend to be younger than the HCEs, and if you convert to a benefit, for a fixed percent of pay contribution you're going to get a higher percent of pay benefit for the NHCEs when they retire. This is useful both for passing 401(a)(4) and for passing the average benefits test under 410(b). In fact, we were having some conversations earlier about this, and we're trying to figure out what's the difference between 401(a)(4) and 410(b), and they're so intertwined, particularly when you get into the average benefits test, that it's really hard to separate them. So we'll be talking at times about 410(b) concepts even though the session is about 401(a)(4).

I'd like to show you an example of how this average benefits test will work with converting contributions to benefits (see Table 1). This is a company that had a plan for hourly and a plan for salaried, and about half the work force was in each plan. The hourly plan had a career average defined benefit plan, and we calculated the accrual rate under this defined benefit plan as about 2.9%. This included imputing disparity. Then we looked at the salaried plan, which is a 10% of pay money purchase plan, and we thought there was no way in the world this would pass. Ten percent of pay is just worth a lot more than this career average plan. But when we converted contributions to benefits, in the salaried plan, the NHCEs had 8.6% of pay, and the HCEs had 5.3%, so when you combine them, we had actually NHCEs having a higher accrual rate than the HCEs. The first thing the client said was, "Well, could we raise that 10% of pay contribution up to 11% or 12%?" So this is a really powerful test if you want to get your plans to pass.

MR. RALPH J. BRASKETT: On the other example, did you test both normal and most valuable or just do the one?

MR. VERNON: In this particular case, we were doing the average benefits test, and under the average benefits test, you do one or the other depending on the early retirement reductions in the defined benefit plan.

TABLE 1
The Power of Converting Contributions to Benefits
XYZ Company Retirement Program

| | | | |
|---|---|---|---|
| Hourly: | Career Average Defined Benefit Plan<br>NonHCE Accrual Rate: | | 2.9% |
| Salaried: | 10% of Pay Money Purchase Plan<br>Equivalent Defined Benefit<br>Accrual Rates | HCE:<br>NonHCE: | 5.3%<br>8.6% |
| Combined Accrual Rates: | | HCE:<br>NonHCE: | 5.3%<br>6.2% |

What's getting a lot of press right now is converting contributions to benefits, and we're seeing a lot of press on age-weighted profit sharing plans. I see some heads nodding. I've got one client with an old plan which is an age-weighted profit sharing plan. If you have a client with large numbers of employees, that might be great as a tax shelter, but the clients hate these kind of plans. You've got a 35-year-old right next to a 45-year-old and they may have the same service, and they can't understand why the 45-year-old gets more money than the 35-year-old. So I think that's a disadvantage with large employers, but with smaller employers where tax sheltering is probably the main thing, that might work.

Let's move on to the average benefits test. We learned early on that the average benefits test was a powerful tool. At first we were really scared to do it because it meant collecting a lot of data and doing a lot of calculations, but what we ended up finding was that this is a powerful tool to pass our client's plans, and now we're almost at the stage where we almost always do the average benefits test up front because it will give us a lot more leverage down the road. The reason it gives us more leverage is that when you break or restructure your plan into accrual rates, the idea is that each accrual rate bracket needs to pass a 410(b) test. Now if you're doing the simple test, that's a 70% participation test, but if you go ahead of time and do the average benefits test, then you're allowed to use a nondiscriminatory classification which is a lot lower than 70%. It's around 20% or 30%. So we've found that we've ended up passing a lot of clients plans that couldn't meet the 70% test in each accrual rate bracket, but they could easily meet a 20% or 30% test. In fact, I had one client that had a Social Security offset plan, it was 50% of pay minus 50% of Social Security. Now that kind of plan normally passes even with the 70% threshold, but it also happens to have a defined contribution offset into that plan, and we couldn't take advantage of the floor offset safe harbors so we had to test the net benefit. We had a 50 less 50 defined benefit plan minus a nonintegrated profit sharing plan, and the net benefit passed using this lower threshold. We had about 24% threshold, and it got to pass. So the lesson we learned is not to be afraid of it.

Table 2 shows some results from this particular case I was talking about. This client had 30 plans, and that was one reason why we were scared of doing the defined benefit test or the average benefits test – we'd have to collect data on all 30 plans. And we were wondering if we really needed to test every single plan, and we decided to do exact calculations for a handful of the biggest plans, and just take guesses at some of the smaller plans. There are really two lessons to learn from this chart. First of all, look at the defined contribution accrual rate versus the defined benefit accrual rate. This company had a defined benefit plan and a 401(k) plan, and so that's what the accrual rates are for defined contribution plans. We found that if a client has a 401(k) plan that is passing the average deferred percentage (ADP) test, then they will almost always pass the average benefits test, and the reason is that the contributions will convert to really high benefits for your younger NHCEs, and the other reason is that the defined contribution benefit accrual rates turn out to be higher than the defined benefit accrual rates, and this is what shows it here. If you look at the defined contribution plans, the first line, you'll see that the defined contribution accrual rates are almost twice as high as the defined benefit accrual rates. So almost any plan that has a 401(k) plan is a great candidate for passing the average benefits test. We've labeled exact versus estimated calculations, and we felt very comfortable with this because, if you look at the estimations, they were so small there's no way in the world even if we were really wrong in our estimates that they would not still pass the average benefits test. So we felt real comfortable cutting down the amount of work that we were doing by just focusing in on the biggest plans, and then taking stabs at the smaller plans.

TABLE 2
Example of Average Benefits Test
Typical Large Client

| | HCE | Non-HCE |
|---|---|---|
| DC Plans (Exact) | 4.5% | 3.7% |
| DB Plans (Exact) | 2.2 | 2.8 |
| DC Plans (Estimate) | 0.3 | 0.3 |
| DB Plans (Estimate) | 0.5 | 0.5 |
| Total | 7.5% | 7.3% |

Now I'll talk about troublesome rights and features. It's a real pain when you're aggregating plans to pass. No when we aggregate plans, before we even go though all the effort of aggregating the plans, we'll sit down with the client and say, "Are you prepared to deal with the consequences of aggregating plans?" Because you can aggregate a defined benefit plan and defined contribution plan and pass the benefits part of 401(a)(4), but then when you get to the rights and features, you might have to offer loans to defined benefit participants, you might have to offer lump sum payments to defined benefit participants, and there may end up being some really onerous requirements. So what we do with our clients now is we sit down at the very beginning before we do all these, and say "Sure, you might pass the benefits part but can you live with the rights and features consequences of this?" Sometimes the answer is no, and we won't even bother doing that.

The other thing to keep in mind is that even with the rights and features, you really only have to worry about discrimination, and so, for example, if you have the NHCEs in the defined contribution plan which has lump sum payments, it doesn't mean you have to offer lump sum payments in the defined benefit plan, because if all the NHCEs are the ones getting that unique right and feature, then you don't have to worry about it. So you have to look at where HCEs are, and where the NHCEs are, and the most troublesome areas are where the NHCEs are in the defined benefit plan and the HCEs are in the defined contribution plan. That's what runs into trouble because the defined contribution plan usually has loans, lump sum payments, and in-service withdrawals. And if you are aggregating a defined contribution plan like that with a defined benefit plan, then you might have to offer all those things in your defined benefit plan, and for all practical purposes, you've wrecked a defined benefit plan.

One of my favorite subjects is, what is good faith compliance? Now it's obvious that good faith compliance is not full compliance with the rules; otherwise it wouldn't be good faith compliance. So what less-than-full compliance with the rules is acceptable? I think certainly collecting the best data you can even though it's not perfect is good faith compliance. Taking a couple short cuts here and there when you calculate accrual rates, might be good faith compliance. The one I really liked, and I asked about this at the IRS session, is where an employer has several plans. This gets back to this client I had with 30 plans where we tested the big plans and they passed, and then we had lots of these smaller plans with identical formulas or even a less integrated formula. Do I have to test all those during the good faith period or can I just say that because the big plan passed, the little plan will pass? I asked that, and the response was, well, they didn't want to be pinned down and they wanted to know the exact circumstances. But the point is that they're really looking for abusive situations, and if you're really being abusive, then that might fail good faith compliance. I think Don might want to comment on that later too, because you've had some thoughts on that. And that says to me if you have a plan where they're really not trying to get away with anything, and the big plan has a formula that passes by a mile, and the small plan has a formula that's the exact same formula and the demographics of the group are similar, then maybe you can waive the expense of doing the test until 1992. But that's just my opinion and I'd welcome any other opinions.

Well, in preparation for this, Don put together some questions that he wanted me to answer. The first one is, "What are the best alternatives for accrual rates?" Don't bother with the total rate method; it just doesn't work. We've always used a rate segment method, and just to give you a simple example, you can have all the HCEs getting 2% of pay and all the NHCEs getting 3% of pay, and that will fail the total rate method. It doesn't make sense, but it can happen. So we always use the rate segment method. Beyond that, though, we really don't try to guess ahead of time which accrual rate method is the best, we just set up our software to do all of them. We've found that the annual accrual rate method produces results that are really volatile, so the accrued to date or the projected methods usually are the ones that pass, but why bother. Just have your software do it all, and then you can figure out which one works. The other thing that has helped us out a lot is there's a special rule for primary insurance amount (PIA) offset plans. It's called the uniform rule, and if you have a uniform formula with a uniform set of retirement ages and retirement factors, then you only have to test on the most valuable accrual rate, and that has really been helpful, particularly when they came out with these bizarre sequential restructuring rules. We didn't even have to get into that, so I was very thankful.

The next question is, how much work is this? We put in a lot of time and a lot of money programming our clients' plans up front and so that was a substantial investment, but once we'd done that, it seems like year after year if you do it as part of the annual valuation, it really isn't a lot of extra work. Most of the plans we've tested have passed by a wide margin, so if we turn the crank on the program next year and it still passes by a wide margin, we'll take a look at a couple sample lives and we'll be done. That's the way I look at it. So I think once you've set up your client's plans year after year, it's really not that bad.

Another question is, can you develop standardized software? Yes, we've done that. It really has helped and it gets us to the stage where we can turn the crank every year. We really have a three-step process where first we calculate the projected and accrued benefits -- and if you're doing benefit statements for your clients, that's not a lot of extra work. Once we've calculated the accrued and projected benefits, we crank that into another program which calculates the accrual rates, and then we take that and go into a third step which calculates the restructuring and the 410(b) testing for accrual rate. So we've developed standardized software that has worked pretty good.

How many pass? Most of the clients we've tested have passed. We have a rule of thumb that with an offset plan, if it has no more than a 50% offset, chances are it will pass, particularly if you can do the average benefits test like I was talking about earlier. So our clients can keep their plans. We get into issues, such as, is it worth the extra expense each year of having your offset plan? and for some of our clients, changing to a safe harbor formula meant choosing between cutting -- let me back up a second. If you go to a safe harbor formula, I don't know how many clients say this to me, "Don't cut back benefits for anybody, and I don't want cost to go up." I see heads nodding. That seems to be the standard set of objectives. Well, you just can't do that when you go from an offset plan to a covered compensation plan. You're going to be shifting benefits from one group to another if you keep costs the same. Usually if you're keeping costs the same, you're shifting from younger people to older people, and it's really the relationship of the Social Security offset versus the covered compensation level. Once we explained that to our clients, and later said that their offset plan passed and they can keep it; those are the ones that were slapping me on the back and saying, "I love to see you, Steve." So most of our clients have ended up keeping their Social Security offset plans because they just didn't want to face cutting back benefits for a particular group of people.

What if you fail? That's a good question. The IRS really hasn't given us, I think, good guidance as to how to correct a situation that fails. We've heard that retroactive benefit increases or expanded coverage will do you just fine. We hope to see some liveable guidance in the future. One idea we've tried, and it has some disadvantages too, is just to make the testing date the first day of the year, and then at least within a couple of months into the plan year, you might know whether you flunk or pass. Clients is that the clients that are passing by a wide margin are those that are keeping their plans. If they're close even though they pass, I think a lot of our clients are going to the safe harbors anyway because they just don't want to live with the uncertainty from year to year.

And finally, do we have approximation versus precise calculations? In the good faith compliance period, approximations are probably okay as long as you're not trying to do something abusive. If the reason you're using approximations is to get your plan to pass, and it didn't pass with precise measurements, then that might be an abusive situation that the IRS doesn't like. But if you're just taking a couple of short cuts or approximations that aren't intended to be abusive, the sense I've gotten from the IRS is that if you're passing, then that's probably okay in a good faith period, but my sense is that once the regulations kick in and are finalized and are applying, I'd prefer to do precise calculations. The biggest issue here is on the data, when you're talking about approximations versus precise. If you're using the accrued date method, do you have an actual salary history to calculate an exact accrued benefit, or are you taking one year's pay and projecting backwards? Again, I would prefer using the exact calculation with the pay history just to comply with the IRS rules.

MR. GRUBBS: Steve, what if you have an offset plan? How are you going to calculate those Social Security offsets? Are you going to do that precisely?

MR. VERNON: That's a good question. We do the precise calculations conditioned on the data. Once the data's in there, the numbers really are Social Security benefits. Our position has been do the best you can with as much data as you have. Again, I don't say that to try and get away with anything, but I'm not going to get too worked up about getting a 35-year pay history for an exact calculation. Relating to Social Security calculations is does Revenue Ruling 84-45 apply still? As I understand it, that was a qualification issue, so do you now need to comply with Revenue Ruling 84-45? An aggressive position is that you don't need to any more, and so you can just go ahead and calculate benefits based on some method that complies with 401(a)(4) and produces a plan's benefits that meet 401(a)(4). I think it's a little aggressive.

MS. JUDITH E. LATTA: Steve, I would submit that it's not aggressive. In fact, at the idea of the offset, the fact that you used the Social Security offset just happens to be the way you came up with the benefit. You could have used another country's government sponsored plan, and as long as you pass your 401(a)(4) regulations and the testing, you would be fine. I know some companies who were using maximum Social Security offsets, and I would submit that those as well may be fine now under the new rules. The only time I think you need to worry about 84-45 is if you use the maximum – final pay minus 100% of the Social Security maximum. Clearly, they've left out all the issues as to how you calculate Social Security benefits in those sections of the regulations, but I don't think it's aggressive at all. I just think it's clear and simplifies the administration of your plans.

MR. VINCENT AMOROSO: I don't disagree with any of this conversation. You all might want to be aware that there is a circuit level case, *Dameron* vs. *Sinai Hospital,* that dealt with this issue on vesting grounds. An offset which is more than the actual Social Security amount was deemed to be a forfeiture under the 411 and the 203 rules under Title I.

MR. VERNON: Good. On that note, this is the end of my presentation.

MS. LATTA: I guess I'm still not at the stage of making fun of these regulations. They still give me a major headache, and maybe that's because all of my clients haven't passed, and these regulations are great once you figure out how to pass under them. If you're close, there are about a thousand trips up that mountain, and there are about a thousand sheer scalings in front of you to say, "No, not this road," and then you can go back and start all over again. I think the issue comes in when you've got any sort of group of employees that for whatever reason doesn't have any benefits, or potentially has a defined contribution plan to provide benefits because they're high turnover, and therefore, from a human resources compensation perspective, the idea in a defined benefit plan of someone actually retiring from these positions is remote, and therefore, you want some sort of capital accumulation plan and a savings plan. In those cases, when you try to go through the average benefits test, you often find yourself in trouble.

The same is true for the one year wait in service eligibility, and I find that it more often is in place with your defined contribution plans than with your defined benefit plans. If that's the case, unless you put the one year wait in service into your defined benefit plan, which personally sounds like a no brainer to me, then you will find yourself not getting that total leverage that Steve was referring to because a large group of your NHCEs is not satisfying the one year wait. Because your defined benefit plan has no eligibility period in it, you end up not getting the amount of help that you expected from your defined contribution plans. So there seems to be a lot of room right now with the good faith compliance for good faith efforts, but there's also a lot of quicksand involved in the testing, and you can easily get mired down if you're in the situations I'm referring to. Furthermore, career average plans seem to work better under these tests than final pay plans when you start to try to combine defined contribution plans with defined benefit plans.

When you're testing final pay defined benefit plans, your annual accrual rates recognize and factor out the increase in the final pay's effect on your benefit accruals, and they do that just by taking rates and dividing them by your final pay at the end of the year versus the beginning of the year, and your annual accrual rate is with regards to the service accrual as opposed to the final pay escalation. When you go to combining defined contribution plans with defined benefit plans, the first thing that they seem to do if you're using the annual method is put you on what they call a benefits basis, where you take the benefit at the end of the year minus the benefit at the beginning of the year, and divide that by compensation. Clearly, the accrual is made up of two pieces: the additional service and the escalation of your final pay. So you initially take several steps backwards before you're able to hopefully add your defined contribution plans, and first you have to make up those steps you took backwards and hope that there's enough room that's left in those defined contribution plans that they're going to push you over the edge. A lot of plans do pass, but when you have plans that on the surface don't seem discriminatory but for valid business reasons there are some disparities in the benefits that you provide to your employees, it seems that there are a lot of issues and that the regulations do not indicate which way to go next.

I want to talk about the ancillary benefits, rights and features, past service credits, and former employees, because we don't talk about them a lot. There's not a lot written, which maybe is the good news but sometimes is the bad news, and I think we've been so focused on the main benefit formulas that there hasn't been a lot of attention paid to these other issues. I think optional forms of benefits certainly are the second most focused on issue at this point in time, and that's because since early retirement subsidies play into that feature, the effect could be significant. But ancillary benefits rights and features are subject to the nondiscriminatory classification test. This is based on the entire controlled group, which I think is what the IRS said in the session, but at least I thought it was clear reading the regulations that when we go to the nondiscriminatory classification test, that we are in fact dealing on the entire controlled group basis even if we've used qualified separate line of businesses. The nondiscriminatory classification test is helpful, but it depends on the mix of your employee population as to your concentration of NHCEs. Rather than most often being closer to a 20% threshold on the nondiscriminatory classification test, I tend to be more around 40%, and that's probably the mix of the employers that I'm looking at. As I think about that and about getting into former employees, I'm starting to think, "Is that going to be enough room?" Clearly with the former employees, we're going to find that we've got a higher mix of HCEs than we have in the active population, and that's just because these are people who were retiring at the end of their careers or they were vested, and therefore, we've lost that entire group that was lower paid in the early years. So I'm not sure when I get to the nondiscriminatory classification test and actually try it for the former employees whether I'm going to get as much room as we feel we do on the active side. Personally, I think that the whole section on definition of the highly compensated former employees should be revised to parallel what we do on the active side. One method might be to look at the former employees and their salaries in the year they become former employees, and pick out the top 20%, like what we do on the active side, or create some thresholds that we believe in as far as what the pay levels for HCEs really are upon termination and upon retirement so that we would get a distribution of former HCEs parallel to what we have in the active group.

With the optional forms, ancillary benefits, and rights and features, they're really going to have a facts and circumstances element as well on the effective availability. We have to live with these regulations for a while and get out of good faith compliance to find out what is going to pass and what isn't. We have had some relief in the fact that age and service can be disregarded, and therefore it is the effective availability. But they say that if your HCEs end up enjoying this benefit more than your NHCEs, we might pull the rug out, and it's not clear where that line is drawn. It's not clear even in some of the examples that are given in the regulations.

Moving on to plan amendments and past service credit, again we're dealing with all the relevant facts and circumstances. There is a disturbing example given in the regulations where a plan sponsor implementing a plan and wanting to give past service benefit accruals may not be able to credit all past service, and that's just because of the fact that they'll find that their HCEs also have a correlation with higher average past service than the NHCEs. For small employers, I think this is a problem where they have a high turnover rate but where a family owns the business and they've been there forever, which may be a valid working relationship. The problem is that on facts and circumstances, this could put you in a situation where you cannot put in a straightforward plan covering all service, and that you may have to limit the past service to five years, the safe harbor. So I find that disturbing. As a result, where the employer is putting in a plan or amending their plan, I encourage them sometimes to do it prospectively.

Some of the advice I have given on plan amendments and past service credits -- it's not clear to me whether that's good advice any more, but the advice in the past certainly hasn't been designed to create discriminatory situations. So I think that some of us are going to have to sit back and think about the advice we've been giving clients over the years, and basically test it again under these rules and make sure that we're aware of the pitfalls. On that score, they do put a confusing example in the regulations where they say if you had a plan that complies and then you added permitted disparity to that plan and used up the permitted disparity latitude for discrimination, so that clearly your plan amendment discriminates in the favor of HCEs, that would be okay if the benefits otherwise satisfy 401(a)(4), in their words. That runs afoul of some of the other examples that they use. It seems logical that if your plan after amendment satisfies 401(a)(4), that your plan should be in compliance, but because your amendment favored HCEs, you may not be in compliance. I have a situation where a plan has a salary cap of $75,000, and it's typical in the securities industry to see these types of plans. Well, can they raise that salary cap? Ralph Braskett says no.

MR. BRASKETT: On the face of the regulations it would be no, because who do you favor? You favor the HCEs.

MS. LATTA: On the face of the regulations, but if you then go back to "if the benefits otherwise satisfy 401(a)(4)," then maybe it does. So it's time to be rethinking those things, and it makes you rethink when you implement a plan or change a plan. It's almost as if you have to be your most aggressive at that point, and then scale back if you want to, as opposed to taking a conservative approach initially, and then as you find the salary cap may be leaving your higher paid employees short, you possibly can't do anything.

So I've just alerted you to some of the pitfalls. I don't think the answers are coming out in these regulations even if they do come out this summer. It appears they won't expand these particular sections in any significant way.

We had another situation where we were amending a plan that had been a contributory plan, and the evolution had been that eventually, the employee contributions were refunded to the employees but benefits were not taken away. Then after a lot of soul searching, it was decided that they should also reinstate benefits for the employees who had decided not to contribute when they could, and they should be treated as equal to the employees who contributed, got the benefit accruals, and then got back their employee contributions. Again, it was an issue of does this favor HCEs? Because the employee contributions had stopped over 10 years ago, you had high average past service for this group, and therefore, you had a correlation with HCEs, and yet the rationale when we went forward -- and I feel very comfortable right now again in the good faith era, which gives a lot of extra comfort -- we went forward saying that that's just right, it's just treating people equally. But they clearly talk about turnover, and if you had excessive turnover where employees have left in this intervening 10-year period, and therefore, didn't enjoy this additional benefit and now you've got religion and put the benefit in, have you in fact, discriminated? With some things that we might have thought were logical, some things that our plan sponsors may want to do from a plan design perspective, we're not going to be the good guy, we're going to be the guy saying, "I don't know," and I'm not sure whether we'll have to go for private letter rulings every time we want to make one of these changes, if we want to have any assurance that they are in fact correct. I don't know how they're going to fix these things retroactively if you go ahead thinking you did it right, and then later they decide that it's disqualification.

The kinds of things that I'm suggesting are only giving proportionately more benefits to highly compensated employees but with good benefit planning rationale. So those are the kinds of problems that I see and I think we've just begun. I think that the in next three to five years we're going to find a lot of things that make a lot of sense to do to our plans that we're not going to be able to implement, or that we're going to feel uncomfortable and have to go through a lot of gyrations in order to gain comfort in order to implement. Certainly if we get to a point of actuarial certification that these benefits do in fact comply, there's one more box on the Schedule B -- "To the best of your knowledge, do these plans comply with nondiscrimination coverage of participation rules?" -- the trouble is we know too much. Also, I have a lot of clients who really don't want to take any chances. These are big programs, and these are plans that have been around. They're doing a good job, and they don't want to take that risk, and they shouldn't have to. Things should be a little bit more even handed.

Getting to former employees, this is another quagmire. What do we do with them? When I was reviewing the regulations to speak at this meeting, I said, "Wow, why didn't I notice in 401(a)(26) that they figured out that preretirement terminations should be excludable employees?" meaning that you should be able to look at retirees separately from vested terminations. The trouble is when you go try to find it anywhere else, it doesn't exist, and it might not exist in upcoming regulations. You look at just ad hoc retiree increases, which I would think are pretty simple and should blow right by. There are some safe harbors in 401(a)(4), but I have quite a few clients who really are only interested in giving ad hoc retiree increases to employees who retire from active service, and are not increasing benefits for terminated vested employees who have gone into benefit payment status. I don't think it's clear the way the regulations are written right now that 401(a)(4) and 410(b) allow you free sailing in that situation -- that you really aren't in a situation where you can avoid looking at your terminated vested employees, and therefore, you fall into the rules for former employees, and generally end up looking to see whether 60% of former employees benefiting were not highly compensated. Well, if you look at 60% of your nonhighly compensated former employees, and you're only looking at your retirees -- and as we already said, a retiree's average salary is much higher than your active work force's average salary -- then it's going to be easy to not be able to say that 60% of the former employees benefiting were not highly compensated. Yes, because we didn't have highly compensated definitions prior to 1987, we've got some room because my understanding is that pre-1987, we get to use the dollar limitations that came in 1987 to try to figure out whether people are in fact highly compensated or not. Therefore, for the historical retirees, we're going to have a very favorable percentage of HCEs versus NHCEs. But with the retirees that are coming out now and with all the work force reductions that are going on, I think again we're going to find ourselves in a situation where we're not finding that 60% of former employees benefiting are not highly compensated.

I've recently looked at putting a retiree increase in for a company that has several different plans, and some plans are large and they're in their mature businesses, but other plans are small because they are in new businesses that they have acquired, and these didn't bring the retirees over, and therefore, we have only one or two retirees in those populations. I find myself in a situation where because I don't have five retirees that would get the ad hoc retiree increase, then I may not be able to give them updates even though from an employer perspective, they want to treat those people equally, and in fact probably have an added desire to not look like they're favoring the old line corps of businesses. Yet they may be in a situation where in order to meet the five former employee rule, they may have to merge some plans, which would be promoting form over substance, and it doesn't seem that should be necessary. So I'd certainly be interested in any of your experiences with putting in ad hoc retiree increases, and the issues that you came across and how you feel that you resolved them at this point, and as well whether you think that you're going to be as comfortable resolving them that way five years from now when you go to do your next one.

The first thing that I've said -- generally I'm thinking that we're dealing with plans that aren't meeting safe harbors and therefore you're into average benefits tests -- is that you really are at a disadvantage if you don't have eligibility conditions in all your plans at this point. Of course, the strange thing is that if you have a collectively bargained group, you don't have to fix those plans, but that means that the nonunion group working side by side may have a one year eligibility period before they can get into the plan. With the collectively bargained ones, it's not worth fighting with them about it and having to give up some wage concessions, and therefore you're going to leave them with immediate eligibility. I would suggest that, again, this is form over substance if you're going to give credit for all service, and that the regulator should recognize this and allow us to do our tests excluding people who do not meet the minimum eligibility conditions. That would be reasonable, and otherwise, we're just going to go through many amendments and some negative employee morale even though we know they're not getting anything different since ultimately they'll get the same benefits under the program, they're just going to come in a year later. As well in this particular matter, I'd suggest that you make changes now because in 1992, if you go to do the test and you don't have the one-year wait in your plans right now, those people in the beginning of 1992 are going to be eligible for plan coverage and they're going to hurt your test. So because a one-year wait has obviously one year before it kicks out all the short service people, the test only gets the advantage after it's been in effect for at least a year. Again, with an employee population where any change, particularly if we say we have to do this in order to comply with nondiscrimination rules, is viewed as tainted, even if in fact it is pretty much an academic change from a benefits point of view.

Moving on from that topic, for a long time I've been an advocate of Social Security supplements. I certainly was under the prior integration rules -- that if you had a Social Security supplement, you really weren't integrated until the age at which your Social Security commences. While your Social Security supplement was being paid, you had a nonintegrated benefit. Social Security benefit plus your integrated benefit level was a nonintegrated benefit level. When 401(l) came along, I continued to use what I thought was a very logical practice, and I'm pleased to say that it sounds like the IRS is looking at it in order to figure out how you would be able to treat your Social Security supplements not only as ancillary benefits but perhaps restructure them such that they're part of your definitely determinable benefit, and therefore, protected and usable for nondiscrimination purposes. I don't think that a lot of plan sponsors are going to have a hard time with that particular concept. They really look at the Social Security supplement as another form of an early retirement subsidy. It's something else that eases people into early retirement and is a logical extension of retirement income needs. Now what would be really nice is if we could have that passed and in place so that plans that pass 401(l), given recognition of the Social Security supplement, will be eligible to satisfy safe harbors, and will be able to have determination letters, at least applications for determination letters, filed this summer. I don't think that's going to happen; I think that if you've been relying on that Social Security supplement as part of your integration demonstration that you will be in a situation where you will not come under the safe harbors.

Another situation we found was in a company where we had diverse work forces, and we had a high turnover work force where a capital accumulation plan made a lot more sense than a defined benefit plan, and the company had gone forward with that type of implementation. They found that they were having trouble passing or even testing on a combined average benefits test where the defined benefit and the defined contribution plans were all taken into account, and miraculously – you can convert a defined contribution plan into a cash balance plan – all of a sudden it was a defined benefit plan. It was actually a cheaper defined benefit plan than it was a defined contribution plan because you could anticipate forfeitures which were huge because of the high turnover. You really hadn't changed the substance of the benefit package that had been provided to the employees, and you got all the great benefits of combining defined contribution and defined benefit plans.

If you do have these diverse work forces, one approach to dealing with that might be to have a cash balance plan which has all the visibility, and can operate pretty nearly like a defined contribution plan. Very often that high turnover work force is probably not a terribly sophisticated work force, and you may want as well to have the investment return in your hands as the plan sponsor with fixed rates of return as opposed to in the employees hands, which we certainly have been hearing a lot about with the 404(c) regulations on the defined contribution side. So from a benefit design point of view as well, it may make a lot of sense, and for the few of those employees who do make it through the management tiers within those particular work forces, you're going to have a nice retirement benefit provided for them as well.

The other way that can enhance your testing is that you can add pretty heavy early retirement subsidies to that particular cash balance plan, and given the high turnover of the work force and the fact that it's somewhat of a transient work force and not many people actually retire, you're able to give a double kicker to your test from a most valuable benefit perspective. So that can be more valuable as a cash balance plan than it is a defined contribution plan, where your most valuable benefit rates and your normal benefit rates are the same. You can in fact have much healthier most valuable benefit rate plans by putting in the early retirement subsidies, and if it's a lower paid population at the same time, that may be best. If they do make it through, they deserve to retire early with a subsidized income so it may not be adverse to management's philosophy as well. We've had situations where there were ancillary benefits, optional forms of benefits, rights and features, which really grew up because of historical reasons – very often driven by a parallel collectively bargained group getting something that you didn't want to give to your whole group. You couldn't, for that particular company, ask nonunion people to have to work to 55 when the collectively bargained employees had bargained to retire at 50. So you've got some exceptions under the old rules because you had some administrative staff and you had some body of NHCEs that were also enjoying those benefits, and you don't have any discrimination issues. But under the new rules, which are very much more red-lined, you can find that you can no longer extend those benefits to that very targeted group of employees, but you can't take it away from the collectively bargained employees. You've got to grandfather if you do anything.

So one other alternative is to find another group in your population that it might make sense to extend, for example, retirement to 50. You don't want to give it away to the entire population, but there may be another population that has a higher proportionate number of NHCEs that it might make sense for. And so rather than getting yourself into situations with grandfathering, again with negative employee reaction to taking something away, you sometimes can find it beneficial to look hard and long for a group to which you might also be able to extend benefit, probably not a main line group from the company's point of view, but a group for which there is a reason to allow them to be different, and to cater to their particular needs. So we found that is certainly one way toward meeting all of the objectives.

I've already gone over the issue on retirees and ad hoc retiree increases -- that you might actually merge or create separate plans for only the retirees. If that client is going with separate line of business in their compliance, that may not help either. It may be that you've got one immature line of business and one mature line of business, and the immature one just doesn't have five retirees, and I think under the current rules, it doesn't matter what you do. I don't think you can extend that retiree increase. So the fact that the separate line of business rules seems to say right now that if you use the rules at all, you have to use them for everything, that may bring about disadvantages in some particular focus situations.

I've also thought about some of the cost of living increases that we put in the past that have been motivated by -- I guess retiree increases really took off in the 1970s when we had high inflation, and we started putting ad hoc retiree increases in, and then as inflations cooled, we probably didn't have as much pressure to put ad hoc retiree increases in. But I've had some clients look into their consciences and say, "Gee, those people who retired in the 1960s, they really lost a lot of purchasing power between the 1960s and the 1970s," and so design retiree increases that were really targeted to try to go back and "fix" the benefits for the entire retiree group, and to recognize that it's similar to the active situation in that the retiree increases were done on a prospective basis initially. And now you may be in a situation where you want to go back and try to beef up the benefits of the old retirees -- I don't mean old, but retired for a long time. I've had several clients actually do this, and sometimes they go through great contortions in order to do this. But I am convinced that their motivations are not for some chairman who retired 20 years ago; I'm convinced it's for the rank and file employee that they feel just aren't getting adequate retirement income, and I think that under the new rules, again we're going to have some trouble being able to design these types of programs and satisfy the nondiscrimination rules.

Joint ventures can create really complex situations, particularly if the joint venture is made up from two companies that are both mature where one company is providing the expertise and the other company is providing the production part of the joint venture. What the latter company can do because they have a wide cross section of employees might not parallel what the company providing the expertise -- which by definition ends up being HCEs -- can do. You really can find yourself in a situation where, because there's certain things that one employer can do for their employees and another group can't do for their employees, I think the only solution is non-qualified benefits to make up benefits for those HCEs bringing the expertise, which is actually what you don't want to be doing when you're setting up a joint venture. A joint venture typically will be successful based on that expertise moving to that joint venture and not worrying about some loss in compensation, but being able to focus in fact on making a go of the joint venture. So I've certainly gone through a lot of gyrations, none of which seemed terribly satisfying as far as how to deal with those situations. I'd be interested again in any cases that you've dealt with.

The only other thing I was going to mention is the coordination of different pension plans within an employee population if you have people moving from one pension plan to another pension plan. I think now that they got away from the benefit structure issue under 401(a)(26). If you let benefits either wrap around benefits in other programs or escalate based on final pay within the controlled group, I think you're okay now. The trouble would be if you go to separate lines of business. I'm not sure that if you end up having different lines of business and having people transferring between lines of business that you won't find yourself in very similar situations to what we found before we got the relief on the benefit structures under 401(a)(26). I think you may find the same types of problems in your existing active work force if they go with separate lines of business.

MR. BRIAN S. SANN: I'd like to address a question to you, Don. I think at a different meeting, you advocated doing away with the PIA offset type plans -- that it's not worth the testing and the trouble and expense, contrary to what Steve has indicated -- and I wonder is that still your feeling, and what comments back and forth between you and Steve can you give us?

MR. GRUBBS: At this point, I think I would vary between the larger and smaller employers. The smaller employers are all running for the safe harbors to avoid all of this testing and complexity and uncertainty. I think it's now been demonstrated that based upon what we think the rules are, you can say PIA offset plans can pass. I never thought that PIA offset plans were any good and any excuse I could use to get rid of them I think would be a good thing.

MR. SANN: I wonder if both you and Steve can give an indication of what's big and what's small. Would you try to do it with a 100-life plan?

MR. GRUBBS: I wouldn't advise anyone with a 100 lives to go for anything but a safe harbor.

MR. VERNON: Let me rephrase that. The issue is that I think the testing of offset plan might result in anywhere from $500-1,500 of extra fees each year, and whoever can bear that, then that's a big plan. If a plan doesn't want to pay that extra money each year to qualify their plan, then they're small. Practically it's $500-1,000 and up. I think we're saying let's look at the offset formulas, and if it's under 500, we just say let's look at a safe harbor.

MR. GRUBBS: One of the things this brings up though is the absurd provisions regarding the past service. The safe harbor plans are free from the general test, but they don't escape all these other tests about ancillary benefits, and amendments, and past service. And suppose they had a PIA offset plan, and I found a formula that was going to satisfy the new integration rules, and I'm going to use that for past and future service. I have effectively made an amendment updating past service which is apparently subject to these rules and the regulations upon past service, and I'm giving it for more than five years of course. Do I pass? I don't think I have problems, but nobody knows.

MS. LATTA: I guess on that score, I find it frustrating that there are situations where we know we're going to pass, particularly in the situation that Don's talking about, or where prospectively you have a nonintegrated formula, and historically, you had a formula that at least used to pass. And certainly over time, ten years from now when that nonintegrated formula is going to be powerful, then we know that when we go to an average benefits test, we would by definition pass, and I would hope that we get to a situation where the IRS gets away from dotting i's and crossing t's, and recognizes that by logic, you can demonstrate that your plan passes. Certainly the idea of collecting data to prove something that's trivial should not be required, particularly where there's lots of room when you're passing. It's a different issue if it's a close call, but where there's lots of room passing, annual testing in an exact way makes no sense at all from a value added perspective.

MR. HOWARD J. SMALL: Actually my question's a follow-up on that very point, and I'm just curious to get some of your reactions or anyone else in the audience here. I mean there is a practical side to all of this 401(a)(4) testing. Judy and Steve referred to it in their presentations. Right now, we've been operating under good faith compliance. At some point, we're all going to have to answer the question, "How precise do you want to be?" The practical side of me says I would like to perhaps not be as exact as strict interpretation of the regulations would call for, but make sure that I'm passing with enough of a margin so that if I were called upon, I could probably demonstrate an exact compliance test. The other side of that of course, is there's a certain professional responsibility and if we're ever asked to certify, is what I'm suggesting adequate or not? I'm wondering if anybody wants to comment.

MS. LATTA: I certainly think that from a certification point of view, if it's clear in your own mind, that when you do those tests, you're going to pass by a wide margin, I have no problem certifying to that fact. You're going to need to make the decision how close is close, and where do you end up needing to actually go through the test in order to be able to say that in fact this plan is in compliance? But I've got some situations such as with my $75,000 cap plan. I've got a 1% differential on a Social Security wage base, but by definition, it passes because I discriminate against my highly compensated employees. Now should I actually have to go through and collect compensation for all employees? It doesn't make any sense.

MR. SMALL: How were you advising your client?

MS. LATTA: Well, right now I'm doing a test and saying, "Look, here's some sample benefit accrual rates, here's your age, service, salary distribution. Anyone can look at that and figure out that you pass." We haven't seen the form that the IRS is going to give us when we file for determination as to how much detail they're going to want on it, but I'm hard pressed to tell that client that I have to do annual testing.

MR. GRUBBS: We're currently in the period of good faith compliance, and I think it's clear that anything that isn't abusive is going to fly, and we don't have a problem. Our problem is what's going to fly when we get out in the period where we are not subject to the good faith compliance rule, and indeed, we have uncertainties in which some quirk in the data can throw you out. It may look like your plan passes by a mile, but some quirk in the data may throw you out because of this one person test. For example, you have an offset plan. You run your test and it looks clear that your offset plan passes easily if your plan offsets by the actual Social Security benefit. If you happen to have an employee who had a long period of governmental service when he wasn't covered by Social Security, then that person's ratio might pop up, and you might have one individual, one HCE, stuck up there above the other people, and it's going to flunk your test. That sort of thing just worries me.

MR. VERNON: I just want to add on the worth each year of testing. We've discussed that a lot, and certainly one interpretation we've received is that one test during the 1989-91 period is probably sufficient, particularly if you have a wide margin of passing. We don't see annual testing in the good faith period. But once we're out of the good faith period, our thoughts are to see what the IRS says about enforcement. If we have to check off the box every year on Form 5500, saying that this plan passes each year, that might say annual testing. It might be that they just want a test when the plan is filed for an approval letter. If that's what they want, then maybe we don't need to do annual testing so we'll just have to wait and see how the IRS is going to enforce this.

MS. LATTA: But that's kind of like letting the IRS tell us we need annual valuations which I don't think any of us need, and if we need them, then we were doing them. But now our plan sponsors with fully funded plans all have to do annual valuations.

MR. SMALL: Let me distinguish between annual testing and this collection of data to get the exact answer. That's where I'm coming from, and there's a decision that you have to make. You've got a client that's paying for the service and doing all the exact calculation, the data collection, and together with deadlines that you have to deal with, and the practical situation of will it work anyway even when you're all done. I don't know the answer to that.

MR. VERNON: We've wrapped that up with other issues about collecting data because simultaneous with all these rules, you've got five year vesting now. Our point is that, you're going to be doing calculations on lots of your people anyway, and you've got to collect the data sooner or later so why not do it on an annual basis so that we can not only do your vested termination calculations, the termination after five years, but also do your annual testing? That's theoretically nice, but the clients often say "Well, forget it, I can't do it anyway."

MS. LATTA: I think the problems arise as well when your plan is not your total employee population. I think from a point of view of running tests in conjunction with your annual valuation that once you've gone through the test, you know the system will kick it out and that's not going to be a big deal. But the problem is when you're dealing with a total employee population as opposed to one plan, then how are you going to require data on the group that maybe doesn't have any plan or is covered by other plans? There's just a whole host of issues there. I'm convinced that we should be able to do point in time tests, gross them up in a way that's reasonable to reflect counts that are maybe for every day in the year. But the idea that you actually have to do your tests on the entire population who ever earned a dollar of benefit during the plan year – that's a lot larger data burden that a lot of our clients are not going to be able to comply with, and we're going to say we'd like you to work towards complying with it so we can feel better certifying the test.

MR. GRUBBS: Judy, you said if a plan has trouble passing, I might be better off with a stricter eligibility requirement, and you suggested using the one year eligibility. Wouldn't I even be better off if I have six months eligibility with annual entry dates on the plan anniversary dates so I don't have anyone entering during the year?

MS. LATTA: I think that's one alternative to the issue of employees coming and going during the year.

MR. GRUBBS: Steve, you mentioned that in order to aggregate defined benefit and defined contribution plans, I could only do that if they had the same rights and features. If I have a profit sharing plan that has a loan secured only by the account balance. How can I put that feature into a defined benefit plan?

MR. VERNON: You're right, that's a problem. First of all, let me say that it's not that you can't do it, it's just that you have to show that within the aggregated group, the NHCEs are offered that feature in enough proportion compared to the HCEs.

MR. GRUBBS: But that would seem to be one feature that I just cannot get into a defined benefit plan, and similarly, we talked about in-service withdrawals. I'll disqualify my defined benefit plan by allowing in-service withdrawals.

MR. VERNON: You're right. That's why that's a problem. Right now they have certain benefits called core benefits that have to be offered across the whole aggregated group, and then they have noncore benefits which only have to be offered in a nondiscriminatory way within the type of plan that it makes sense to offer those. I would submit that loans and in service withdrawals should be considered noncore benefits. They only need to be offered within the group that it makes sense or the plan it makes sense, but right now they're called core so we're stuck with having to offer those on a nondiscriminatory basis. I think that's a problem, you're right.

MR. GRUBBS: And Steve you also said that with these accrual rates, the annual accrual rate method was the toughest because they bounce around. If the accrued benefit has gone down during the year, do I have a negative annual accrual rate?

MR. VERNON: That would only happen if you had it under that annual method, and the regulations really don't tell you what to do there. We've just put those people in at zero rather than having them negative, but I really don't know if that's right or wrong.