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Nontraditional Plans after General Agreement on Tariffs & Trade (GATT)

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Summary: A number of nontraditional plans have surfaced in the past few years. These plans don't always "fit the mold" whenever regulations are written. This session examines various types of nontraditional plans—including cash balance, target benefit, and life-cycle plans—focusing on compliance issues as they relate to the design, funding, and administration of these plans.

Mr. Norman W. Clausen: We're going to discuss two types of defined-benefit plans and three types of defined-contribution plans. On the defined-benefit side, we'll cover cash-balance plans, where benefits are defined in terms of an account that is credited with benefit credits and interest credits, and life-cycle (or pension equity) plans, where benefits are defined in terms of a lump-sum benefit that's a multiple of the employee's final, average pay. One type of defined-contribution plan doesn't have a particular monthly pension in mind, but rather we just have a set of contributions that is higher for the older or longer service employees than it is for the younger, shorter service people. You might pay 2% of pay for the first ten years, and then 8% of pay after ten years. Extreme cases of these are prevalent in smaller plans.

Really the employer's only interest is to provide the highly compensated employees (HCEs) with a certain level of benefits, and basically the plan administrator or the actuary or some other party figures out how little you can pay the nonHCEs and still allow the plan to pass. Someone would call this a "new comparability" plan.

From the Floor: Many cash-balance plan sponsors expect their trust funds to be able to earn 2% more than the rate that is being credited to employee accounts. As a result, some actuaries define the assumed rate for future interest credits as 2% less than the discount employed in the valuation. When these actuaries compute the plan's current liability—let's say the current liability interest rate is lower than the regular funding interest rate—they project the plan using a lower assumed rate of future interest credits. Do you feel that it's OK to go ahead and do that? You may be defining a function as the rate for your crediting on the account to be 2% less than what the interest rate can do, something like that.

Mr. Clausen: Let me make sure everybody understands what we're talking about here. Let's use a very simple example. We have a cash-balance plan, someone just has one year of credit and all we've done is set up an account with 5% of pay. Say this person is age 30, they've just been hired with one year of service, and the only thing that they've earned so far is an account that's been credited with 5% of pay. We promise the person that we're going to credit one year of Treasury bill rates on this account. The question is, what's the liability? Let's say that the person's pay is $30,000 and 5% of pay is $1,500. We've given him a statement that he has $1,500 in his account. Let's not talk about the current liability; let's talk about regular funding liability. What's the liability? Typically you'll take that and you project that out to the expected payment date based on assumptions of what you think one-year Treasury bill rates will be, and that might be 7% interest. Then you'll discount that at the rate you expect to earn on your investment, say 9%. So what you might be holding as a liability by projecting it out at 7% and discounting at 9% is $1,000. You're holding a liability instead of $1,500.

The point gets a little bit more complicated than that because that's what happens if you assume people take lump sums. If you want to assume people take annuities, you also have to say, we're going to project this account to the expected payment date, and then we have to make an assumption as to how to convert that projected account into an annuity. I think most plans are moving to a GATT basis—with the 30-year Treasury bond rates. So let's say you have to make an assumption as to what that will be, and if you're assuming 7% for one-year Treasury bill rates, you might want to assume 8% for what the long-term bond will be. So you convert that projected account to an annuity, and then you turn around and project. So you project the current amount out at 7% to expected retirement age, then use 8% for an annuity, and then discount that at 9% to come up with your actual value.

That's fine for your regular actual liabilities. Now the question is, what about current liabilities? If you're using 7% for your current liabilities, if you have taken an account, projected it at 7%, converted it to an annuity at 8%, and then converted back to 7%, you can have a current liability that exceeds the account balance. It's my understanding that the only thing you can change for the current liability is the discounting rate, and that all the assumptions that you use in the regular valuation in terms of projecting the account out to retirement and converting it into an annuity, you have to stick with those same assumptions. Obviously you have to reflect that; however, it's also my understanding that the current liability rate is probably somewhere close to a 30-year Treasury bond rate, and most cash balance plans don't credit more than a 30-year Treasury bond rate. So I would be surprised in practice to see any circumstance where that projection rate realistically cannot be lower than the current liability rate.

From the Floor: But isn't is reasonable to make the assumption that the fund will earn 2% more than the rate of interest credited?

Mr. Clausen: That's frequently the way you present your funding assumptions to the client and the way you design the plan. The client wants to know how much is this going to cost and you'll say, well, we're going to credit one-year Treasury bill rates. Then if you think you can earn more than that, there will be an agreement that we think we can earn 2% or 3% more than what's going to be credited on the accounts, and that differential is frequently factored into the Financial Accounting Standard (FAS) expense, for example. The point is when we're setting up a plan using an ongoing assumption, we have our explicit assumptions of a 7% interest credit and a 9% discount, but implicitly we're assuming a 2% differential. I think that the current liability idea is based less on what the company could earn, but more like an annuity. One of the several definitions of current liability is what you can buy annuities for, and so I view that lower discount rate liability as not necessarily what you could earn.

Ms. Carolyn Evanna Zimmerman: If I could add something to that. I agree with Norm. I've never seen anybody do that, but I would think that the IRS would invoke the individually reasonable assumption test, and say that if there's a particular interest rate that you are looking at for crediting the interest on the cash balance accounts, it might look at that as something that has to stand on its own rather than being dependent on another interest assumption. Of course, we're not the final authority, the IRS is, but—

From the Floor: You think that the current liability rate changes from one year to the next and lowers every year like the bond rates, so I don't know that you couldn't have some assumption for future interest credits that also change along with bond rates. Maybe all preserve the same spread. I was just wondering, how often do you change your assumptions?

Mr. Clausen: I think all those assumptions for funding are supposed to be long-term assumptions, including what you assume will be on one-year Treasury bill rates (or whatever the index is), what the fund uses, what you assume you're going to be earning. I think you have to be reluctant to change those assumptions and change them only infrequently because they are supposed to be long-term assumptions. That's been my experience.

From the Floor: How can you keep from not changing your analysis? I'm aware of a situation where this discount rate will change year to year. Now maybe I'll go back and assume a two-point spread.

Mr. Clausen: Correct me if I'm wrong, but don't the FASB discount rate and the current liability rate have much in common?

From the Floor: Do you think they'll announce a change?

From the Floor: I think it makes more sense to have return float on long-term assets on your returns. The discount rate is defined as something different. I think using an interest credit assumption that's tied to the current liability interest rate is really wrong, so I don't think it would work, and I do wonder if the IRS, for the current liability and doing what she is suggesting, I think that sounds so intelligent. It can make so much sense that I think there's a lot of hope that the IRS would accept that.

Mr. Clausen: That's certainly possible.

From the Floor: The approach of linking the discount rate and the assumed rate for interest credits makes much sense. I think you might not be better off right now on the FASB side because the FASB is the snapshot approach. It was not designed to use a long-term assumption method of looking at things. That doesn't say it's logical. To make it logical, you'd have to put in the logic that contributed to it. I think you'd have an argument just like when people first started doing *FAS 87* valuations. If they linked any movement in the discount rate to the movement in the salary increase assumptions, you'd have a much lower effective duration, so that could help that here. The IRS is not sure. Carol, talking about being linked to something individually reasonable, you could almost say that maybe you could link when you take two basis points off the current 30-year Treasury that goes into the current liability rate instead of the four-year blended average.

Mr. Clausen: I think the salary increase assumption is a good analogy. If you read *FAS 87*, that's supposed to be a long-term assumption. It shouldn't change every year.

From the Floor: I disagree. Read *FAS 87.* It says that the assumption is supposed to be consistent with the economic climate, and you can decide the consistent economic climate is the inherent inflation that is attached to the discount rate.

Mr. Clausen: Yes. What I was going to say is, in my experience, the majority of companies change the salary increase assumption when they change the discount rate. Then they'll change the salary scale, so I think to that extent you're crediting something that has a Treasury return. At least if you believe in that practice and if you subscribe to the practice of changing the salary scale whenever the discount rate changes, you ought to similarly subscribe to the practice of changing the assumed interest credit. I agree with the gentleman that there's more of a precedent for doing that on FASB than there is on the IRS side. Let me just add one other comment tangentially. We're working with the PBGC in terms of settling some of its concerns about how to determine the current liability for purposes of variable premiums. And I think what we're going to try to urge the PBGC and the IRS is to define, in plans of this type where you pay lump sums, the current liability as the lump sums that will be payable were the plan to terminate today. So, for example, in the case of the cash-balance plan, it would simply be the lump sum of the accounts. This is just something that we're just starting to think of and to talk about, so that's something we may see in a couple of years.

From the Floor: There have been attempts to have self-directed cash-balance plans using some equity indexes as the index. We've had some discussion on that.

Mr. Clausen: Yes, I believe that several plans of this type have received favorable letters.

From the Floor: You said that when you calculate term liability, all the account assumptions are the same, paid as a regular valuation except for discount rate. What if you were evaluating a plan with a lump-sum option, and you had an assumption as to how you were going to pay that lump sum in the future. Would they stay the same when you're determining current liability, or do they have to change?

Mr. Clausen: It's my understanding that does change. You're supposed to assume that nobody takes a lump sum, which is particularly ridiculous in many of these plans where 99% of the people do take lump sums, but that's the way the rules are.

From the Floor: I'd like to address the question at pension-equity plans. Most are designed as final-average pay plans. Because of that we're looking at backloading problems. Rather than looking at a more career average pension equity plan, some of the issues we pulled up that are under consideration, especially when the plan has 4% early in your career, accumulating up to 18 or 20% later. It clearly should be done on a final-average pay basis.

Mr. Clausen: I think we can answer both of those, but let me put them off a second. I do want to go through a variety of issues, and I think we can touch on some of the points that we've talked about here. These are just four or five different sections of the Internal Revenue Code and different provisions. We're going to go through each one of these in turn.

The first issue is the question of what benefits are definitely determinable. About 20% of cash-balance plans have what I call ad hoc amendments. They will guarantee a low rate of interest, like 4% or the consumer price index, and then the plan will be amended every year to credit an actual return interest credit that the plan sponsor wants. From a funding point of view, well, we're not getting into that. We've discussed this with the IRS, and some people at the IRS have raised the issue of whether or not this is definitely determinable, whether or not this type of provision violates the definitely determinable doctrine. We've asked them whether they're going to come out and say that, and basically the answer is no, that they wanted us to get the word out that you can't do it, but they're not going to do anything or publish it. How do you draw the line between a flat-dollar plan that's amended every two years to raise the flat dollar amount, or a company that increases benefits to retirees for cost of living every two years? How do you distinguish between that and a company that increases its interest rate every two years? So the IRS doesn't know how to draw the line, and as a practical matter, we're not telling clients they shouldn't do it, but I wanted you all to be aware that there is a concern.

The other definitely determinable issue that some people worry about is that you can't determine the person's annuity until he or she retires because you don't know what his or her account is going to be because the interest rate is variable and the annuity conversion is variable. Some people ask, doesn't this violate the definitely determinable rule? The answer is no, it doesn't. The IRS has clearly said that's not a problem. Consider the plan that the gentleman talked about before where you give employees a choice between two rates of credit. You can either get the rate equal to the current yield on the five-year Treasury bonds, or you can get the return from the Standard & Poor's (S&P) during the year whether that return is 30% or minus 10%, and you give people the choice up front. We shied away from talking to the national office about this type of plan because it's barely on a learning curve, but I suspect when it does get around to looking at that type of plan, it will raise a definitely determinable issue. I don't think that's a problem. I think those plans are OK, but I think they're going to raise the issue.

From the Floor: I think Margorie Hoffman would not be enamored about that type of plan.

Mr. Clausen: Yes, I agree. She's not even carried away with the concept of an S&P return let alone employee choice.

From the Floor: Isn't a plan with an S&P return comparable to a variable annuity plan, and aren't those permitted?

Mr. Clausen: I think I may be the last person in the country to have a variable annuity plan as a client, but I still do, and they're still allowed even though the IRS has frowned on them and hasn't issued a ruling on them in 20 years. There's no question that the person's benefit can go down from year to year under those types of plans. So I don't think that benefits decreasing from year to year because of investment returns is a valid concern to the IRS.

From the Floor: What's the IRS position on not being able to determine the amount of the accrued benefit?

Mr. Clausen: We have been trying to get the IRS to acknowledge that you can define the accrued benefit as a lump sum, that it doesn't have to be an annual benefit payable at normal retirement age. We're working on that very hard, but we don't know whether we're going to succeed or not. I would think we're probably going to wind up being able to either define it as saying that it's either a lump sum at normal retirement age or as an annuity starting at normal retirement age, but in either case that it's going to be variable; it's not currently a determinable amount. So I think that's the way you're going to have to judge the accrued benefit, that it's an unknown amount or unknown annuity payable at 65.

From the Floor: Will the definition of accrued benefit include the right to receive future interest credits?

Mr. Clausen: If I'm 45 and I could terminate today and get a lump sum of $30,000, my accrued benefit, as defined in the plan, is that amount plus a specified interest credit until age 65, which could be zero, if that's in the plan. We're talking pension equity now. I should say here for pension-equity plans if we had a flat rate plan where we credited a constant percentage of pay for all years of service where you wouldn't need credit interest after retirement. But many pension-equity plans have age- or service-graded credits where, if you're older or have longer service, you get substantially higher credit. That's to minimize the costs for terminating employees. If you have that type of plan, you have to credit interest. In other words, if you want to pay somebody 2% of final average pay in their 30s, and 10% of final average pay in their 50s, the only way you can justify and comply with the back loading rules is if you credit the right rate of interest from 30–50, so that 2% of pay equates to 10%, or at least 75% of 10% (because you're permitted 33.33% back loading). So most of the pension equity plans that are like that credit guaranteed interest after termination.

The way they define the accrued benefit is it's your percentage of final average pay plus 4% interest out to retirement. So I think if you had a flat 15%, you wouldn't have to do that. You could credit 0% interest at determination, but you would have to have an annuity conversion rate to convert it into an annuity.

Let's talk about the issue of fixed rate versus variable rate. The dilemma we all have with the fixed rate versus variable rate is that most employers want people to take their lump sums and go away. But many enlightened employers recognize that's not in the employee's interest and they want to have reasonable and, in some cases, even generous annuity conversion factors so people who want to take annuities will take them. If you do that, you can't promise 8% or 9% interest, because if you promise $30,000 plus an account you convert to an annuity rate at 8% or 9% interest, you're going to get whipsawed with Code Section 417(e) when the 30-year Treasury bond rate is 6%, because then you're going to wind up having to pay a lump sum of much more than $30,000.

So if you want to have a generous rate, you have to have a rate that's variable. But once you get into the rate that's variable, then you get into the issue of not being able to put a dollar value on the pension benefit. It's the same thing with the interest credit. If you want to have a generous interest credit, it has to be a variable rate. You can't guarantee 10% because you get whipsawed on Section 417(e). So most plans have a variable interest rate. Most cash-balance plans have a variable interest rate. I don't know about pension equity. Pension-equity plans typically have a low fixed rate after termination, and I believe most plans use a variable annuity conversion basis. Did I answer all your questions?

From the Floor: I think so. The question was, what do you do about the interest rate when you convert the account into a lump-sum annuity? You said, well, you can use whatever the conversion rate is at that time.

Mr. Clausen: I think most people are going to be heading towards using the GATT rate to convert accounts into annuities at retirement. Whenever a person's entitled to a lump sum, you know you're required to have an annuity, so generally what everybody does is take that lump sum and convert it into an immediate annuity based on GATT interest and GATT mortality. I think that's what most people are going to do. You don't have to do that. The whole GATT 417(e) issue sets that as a maximum rate to convert annuities into lump sums. This is so you don't necessarily have to do that, but I think companies are going to be inclined to do that or maybe something shorter. Instead of using a 30-year Treasury bond rate, they might use a ten-year Treasury bond rate or something like that, which ought to give a lower rate.

From the Floor: Tell us about the work you've been doing with the IRS about defining the accrued benefit as an account balance.

Mr. Clausen: There's a group of practitioners from about ten different consulting firms who just spent about six months grappling with the 417(e) issue. We just submitted a ten-page paper to the service on Notice 96-8, and this is what half of the issue is. How do you define the accrued benefit? How does 417(e) apply? So we have a whole set of beliefs, and we're trying to persuade the IRS that the accrued benefit can be defined as the account balance. We've been working on it for the last four years. It's a very slow process, and, hopefully, four years from now we'll be able to say that the IRS has come around to our way of thinking.

From the Floor: Can we get a copy of that paper?

Mr. Clausen: Yes, it certainly will be available. Anybody who wants a copy of that paper can call me, Norm Clausen, at Kwasha Lipton and I'll get a copy to you.

It would be great if we had nondiscrimination and safe harbors, but none of them work so everyone opted to do general testing.

Back-loading is one of the problems with going to a cash-balance plan from a traditional plan. You all know that when a traditional plan pays a minuscule benefit to somebody who leaves at age 30 with five years of service, you don't pay that person hardly a thing, whereas under a cash-balance plan, they get a benefit that's three to four times that amount of money. If you have many people with a lot of turnover at those earlier ages, you can substantially increase the cost of the plan. If you seek to deliver the same level of benefits to people retiring with a full career, you find that the cost of the plan could be much higher than with a traditional plan. So the typical response is, let's have an age- or service-weighted plan, where an employee only earns 2% or 3% of pay for the first couple of years, and then we'll pay 8% to 10% of pay after that. You have to demonstrate to the service that complies with the back-loading rules that it doesn't violate the 133.33% rule. As a practical matter, you're going to wind up with a 3% to 4% increase rate that you're going to have to guarantee. Most plans don't have that written into the plan document, but we think it will come eventually.

There's a handful of plans that credit one interest rate during employment and then a lower interest rate thereafter. For example, you might credit one-year Treasury bills plus 1% while you're employed and just one-year Treasury bills after employment. Notice 96-8 seems to say you can't do that, but they're really saying you can't credit one-year Treasury bills while you're employed and 0% after termination. Nevertheless, how we would prove that a plan like that complies with the back-loading rules is a difficult question.

One other point, there's at least one person in the national office of the IRS who thinks that you can't have an integrated cash balance plan because it violates the back-loading rule. If you had to credit 4% of pay up to $50,000 and 8% of pay over that and if you have somebody that's earning $50,000 one year and the next year they're earning $200,000, then suddenly their average rate almost doubles or grows 50% and that violates the 133.33% (one-and-a-third) rule. Now there are exemptions that allow for this circumstance under traditional integrated career-average pay plans. But there's one person at the IRS who that says that you can't do that, that the exemption doesn't apply to cash-balance plans. I think that's kind of a ludicrous notion, particularly because the 401(a)(4) safe harbors allow for an integrated plan. So it would be silly to say the IRS gave you a 401(a)(4) safe harbor for a plan that violated the back-loading rules, but I did want you all to be aware about it. Does anybody else besides me come up with this?

From the Floor: I have a plan in for a determination letter request, and I submitted a back-loading demonstration based on projecting future benefit accruals assuming level salary. The agent isn't willing to accept the level-salary assumption. If I do a projection with salary increase, the plan fails.

Mr. Clausen: The proof that I always thought you had to submit to the IRS was to say, let's look at the benefit accrual in any future year. What's the maximum benefit accrual in any future year as a percentage of pay in that year? And what's the benefit accrual in the first year? Then demonstrate that the one can never be more than 133.33% (one and a third) of the latter. If I'm accumulating 2% of pay now and it's going to go to 8% in 20 years, I have to say, this 2% has to earn a certain rate of interest to get there. That's the proof I've done. What I've seen many people do is the other demonstration that relies on projecting out total accrued benefits, doing other projections with salary scales, and, frankly, I've never understood how that demonstrates anything.

From the Floor: I always thought that the Section 411 regulations allowed you to assume constant future pay.

Mr. Clausen: Right. Under the fractional rule, you have to do a projection because you have to pay a percentage, a fraction of the benefit the person would have earned by normal retirement age. And so for purposes of that projection, I think it's actually that the current ten-year average base stays the same or something like that. It's kind of complicated, but it's only for that limited purpose of having a benefit to take a fraction of. The concept of doing a projection to demonstrate compliance with the 133.33% rule I just don't understand. I know people do it, but I don't understand it.

From the Floor: So it seems that the agent's position on analyzing it, assuming a 5% pay increase every year, is valid?

Mr. Clausen: No, because what employees accrue is a function of what they're going to earn, not what somebody assumes. This is a cash-balance plan?

It seems to me you have to look at the annuity the person earns each year. You have to prove that what they're worried about is someone who's 30, that when this person reaches 50, the benefit that he or she will earn in that year at age 50 is not more than 133.33% of the benefit that the person will earn this year. So you have to look at both of those as a percentage of pay in the applicable year expressed as an annuity commencing at normal retirement age. Whatever the pay is, it doesn't matter whether it's higher or lower. That's going to come out in the division—it's going to be a percentage of the pay divided by pay, so pay is irrelevant. If this is not an integrated plan, the only distinction is the two different benefit rates and the period of time, and the period of time is relevant only as a function of the interest credit between the two accrual years. I haven't stated that very well. So that's all that's relevant. Whether the person's pay is 10,000 times the current one, it doesn't matter.

Ms. Zimmerman: It seems to me that you could have the same issue with the traditional 1% of final-average pay plan. If you looked at what the person was earning when they're 25 and what they're earning at 50, clearly that plan would pass the muster of the IRS.

Mr. Clausen: A 1% career-average pay plan.

From the Floor: So how do I convince the agent that my plan is not back-loaded?

Ms. Zimmerman: I wonder whether that analogy would help.

Mr. Clausen: There are two scenarios here. When you calculate the Section 415 limit, if you have someone retired before age 62, the question is, what's the maximum pension you could pay them? On the 415, the answer is, you take the dollar limit and reduce it to 62 based on Social Security factors, and then you reduce it below that based on an interest rate, which is either 5% or the rate specified in the plan for early retirement discount purposes.

What's different about pension equity and cash balance is there's no such concept as an early retirement discount. They're not framed in terms of a benefit payable at 65 that's reduced, so we don't have anything to latch onto there. Likewise, if you look at the revenue ruling, I think it is about 10–15 years ago, that talked about this, when you determine the maximum lump sum, you have to look into the form of benefit that is discounted to produce that lump sums under the plan. In other words, if your lump sum is your early retirement benefit versus a normal retirement benefit, you can get different Section 415 amounts.

Once again, a cash-balance plan doesn't define a lump sum in terms of an annuity so we don't know how to apply the applicable ruling we have with these issues. Basically what we don't know is whether or not we can reduce the age-62 amount based on a 5% factor or if we have to use GATT factors, and we don't know if we have to determine the value of the dollar limit at 65 or if we could reduce it down to say, age 35, and then determine the present value of that. And to be honest, I don't think we'll know in another ten years.

As to Section 417(e), I touched on this before. The essence of Notice 96-8 is that you have to make a reasonable assumption. The general rule in a cash-balance plan is you have to take the promised lump sum, project it out to normal retirement age based on a reasonable actuarial assumption, convert it into an annuity based on a reasonable actuarial assumption, and then take that projected amount and discount it to today based on GATT interest and mortality. That's the minimum lump sum, unless the interest credits and annuity conversion basis you use fall within certain parameters, and then they're going to say you don't have to make those calculations to do that. We've basically been arguing that not to be the case. That's an artificial measure, and really all we're talking about here is nonforfeiture, and that there ought to be other ways to determine noncompliance.

Consider, for example, the S&P 500 plan that we discussed before. If you read Notice 96-8 from the IRS, what the people in the service are thinking is, well, everybody knows stocks outperform long-term bonds so, therefore, if 30-year bonds are yielding 7% and you have an S&P fund, you have to project this out at 9% and then discount it at 7% and pay much more than 100 cents on a dollar. We're saying from a nonforfeiture point of view that is somewhat silly. If the plan credits a fund that's earning S&P returns, the person can take their account, go out and put it into an S&P fund, and earn the same return, so there's no forfeiture there because they can get the same return outside the plan as they can inside the plan. So we're saying, essentially, it's a nonforfeiture issue, and for them to force us to go through this projection is somewhat silly.

From the Floor: What do you think most plans are doing to calculate the Section 415 limits?

Mr. Clausen: Certainly the safest thing to do is to specify that the lump sum is simply the age-65 amount discounted with GATT interest and mortality. That's the safe approach. I think most of the other alternatives would give you a little bit higher lump sum, but I wouldn't have any trouble arguing that the reduction for early retirement can be based on a 5% interest rate. And if a client wanted it to do that, I would certainly say that a reasonable approach is to determine what annuity was payable at the termination date using a 5%-interest-rate discount and then take the present value of that.

From the Floor: Under a fairly generous cash balance plan, doesn't 415(b) frequently cause problems for people at relatively young ages?

Mr. Clausen: Yes, and if you run through some examples, you could find that, in theory, people can terminate at age 30. Don't forget it's a generous plan. Say we're paying 10% of pay. That benefit could exceed the dollar amount because the dollar amount gets reduced substantially. In practice, though, I've never seen that to be a problem except very rarely.

From the Floor: We were working as consultants and someone else suggested a very generous cash-balance plan. It had very dramatic problems with Section 415 at early ages.

Mr. Clausen: I would also say this about 415. I think it's virtually impossible to tell an employee, particularly a participant in a typical circumstance, we have a fairly generous savings plan that's been around for a long period of time. It's virtually impossible to tell an employee whether or not all of his or her cash balance benefits are going to be paid from the qualified plan, so I think it's vital to maintain an excess plan. In a traditional plan, there are arguments that can be made that you need not have an excess plan. I think with a cash-balance plan it's hard to make those arguments because people that are affected are all over the pay scale; it's not just a bunch of high-paid executives. So I would agree with the gentleman that it is possible, particularly with a heavy savings plan, and that the consequence is that you really need 415 excess plans.

From the Floor: Does determining the lump sum based on an immediate annuity equal to the Section 415 limit reduced, based on a 5% interest rate, provide a higher lump sum while you're discounting the fee?

Mr. Clausen: I may be wrong on this, but I think you can use a 5% interest assumption to determine the annuity is payable. But then I think when you take the value of that annuity, you have to use the GATT interest rate, don't you? That's my understanding, and I thought that process helped you. Somebody's going to come up with a different answer, I don't know what.

From the Floor: It seems to me that you can use a 5% rate when you used that under the converted plan.

Mr. Clausen: Right, and without getting into the technical details, you can argue that it really is 0% interest, it's really the rate that's built into the early retirement discount. Some of the earlier plans had escalating annuities built into them, and the interest rate that was inherent in the early retirement discount was something close to 0%. So there are academic arguments you can put together.

So as to Section 417(e), we're just going to have to wait and see what happens there. I think we've covered that, but basically Notice 96-8 just talks about plans, tells you that you can credit any Treasury security plus a margin. It didn't seem fair that a plan that credits one-year Treasury bills couldn't have an add-on excess when a plan that credits 30-year Treasury bonds would be crediting a higher rate of interest. So to put these plans on a level playing field, we persuaded the IRS to allow an add-on for indices to the plans that credit less than the 30-year Treasury bond yields. They didn't add as much as we thought was appropriate. In this paper I mentioned before, we put together a history of what the actual differentials were, and we think we can justify another 50 or maybe 100 basis points beyond what Notice 96-8 permits out of the yield. Once again, we're approaching the subject with the service about these plans. Notice 96-8 just talks about plans that credit a spot yield. In other words, the interest credit for the coming year will be whatever the spot yield was on a particular security as of a date in the past.

We've asked the service to expand Notice 96-8 to cover plans that credit an actual return. Some of the plans credit the return on a trust fund. One company had a money-purchase plan and a cash-balance plan, and whatever the money-purchase plan happened to return, they're crediting that same return to the cash-balance account. So you have some plans crediting trust fund returns, and other plans crediting bank deposits.

For example, we're going to credit whatever the First National Bank of Cincinnati credits on its 30-day Treasury bond or certificate of deposit accounts or the S&P indices. So this is a subject we're discussing with the IRS. Our position basically is that if all you do is credit the return, there ought not to be any forfeiture on these types of plans because people can take their account out and invest it, if not in that particular guaranteed security, something very comparable. Skip the fixed minimum interest rates; they're going up from there.

The other issue we're trying to push relates to converting the accounts into annuities, where you say we can't credit more than 30-year Treasury bond rates or else we're going to be whipsawed. Essentially what the IRS is doing is putting a ceiling on the annuities that cash-balance plans, pension-equity plans, and life-cycle plans can pay. We're saying, Section 417(e) was intended to put a floor on lump sums, not a ceiling on annuities. So we're trying to get them to back away so that if you want to, you can credit more than that and provide higher annuity rates of return.

Next we're going to talk about defined-contribution plans.

Ms. Zimmerman: The issues surrounding the defined-contribution plans are nowhere near as complex as what Norm just described on the defined-benefit side. The main focus in compliance on these plans is showing that the contributions are nondiscriminatory. We also have to look at 415 limits and how that might affect the benefit objectives, and also the effect of top-heaviness on these plans.

The reason I say that nondiscrimination is a main focus is that these plans generally give a higher contribution to older people because they're trying to make a defined-benefit cost pattern. Because you often have your HCEs concentrated among the older people, you have a plan that, on its face, can look discriminatory. So you have to demonstrate that it's not—and then even more so with the new comparability plans, where you're directly targeting a higher contribution for the HCEs. Again, you need to be sure that you can show the IRS that it's not discriminatory. There are some safe harbors, but in our practice we found them somewhat limited.

From the Floor: What exactly is a new comparability plan?

Ms. Zimmerman: The way I understand them is that you start with an objective of how much you want to provide for the HCE, and then you use the 401(a)(4) general testing to show how much of the contribution or how little of the contribution you have to give the non-HCEs to support that. It's probably more of a small-plan issue. I don't think the larger plans deal with it that much.

From the Floor: The American Society of Pension Actuaries did a teleconference on this about two years ago and then produced a videotape on it. It does a great job of describing that particular type of plan.

From the Floor: There's also a study note that Eric Lofgren wrote ("Pension Plan for Today" 362-48-94).

Ms. Zimmerman: On nondiscrimination, on hyper-defined-contribution plans, again, we found the safe harbors to be very limited, and in our practice we almost always resort to the general test. There is a limited safe harbor on each age-weighted profit-sharing plan, and we haven't found a practical use for them yet for two reasons. One is that the structure of the plan that's offered in the safe harbor is very limiting. You can't distinguish much between your upper and your lower ranges of the contributions. The other thing is it still requires demographic testing, and we found that by the time you gather the data and you do the calculations, you've done almost as much work as you would with the general test, but you've given up a lot of flexibility in going the safe-harbor route.

Has anyone had better luck with those than we have? And there is some advantage in that you get to compare average allocation rates rather than looking at individual ones, but, again, because of the limited range of contributions, and the fact that you have to give up permitted disparity, both of those things make it seem that the general test worked just as well with very little additional effort.

There's a design-based safe harbor for target-benefit plans. Again, that carries many restrictions with it. I think the most significant of those is that you cannot reflect any past service prior to the date that participant joins the plan. So if you're designing a new plan and you have people near retirement, you can't make much of a provision for them. I should add that we have had no trouble getting our target-benefit plans to pass the general test when we designed the defined-benefit formula around the safe-harbor rules. Again, we usually use the general test for these plans, usually with cross-testing so we can look at them on a defined-benefit basis and kind of level the playing field. It can be particularly critical for new comparability plans, because if your HCE is older, then you get more leverage by looking at it on a cross-testing basis. I haven't heard any discussion recently, but at one point the IRS had proposed eliminating the cross-testing option. Of course, that would affect the design and the availability of all of these plans.

Let's look at 415 limits, and the basic point is that these defined-contribution plans generally give you a higher contribution level as you get older. So the caveat is that if you get somebody who has finally worked his or her way up to the point where he or she is entitled to the higher contributions, particularly if there's another defined-contribution plan, you may find that the person bumps up against the 415 limits and can't really get the contribution you had in mind. We find that particularly true in the target-benefit plans, because they are using a true actuarial equivalence. You have a much wider range of contributions than you do on a typical age-weighted profit-sharing plan, and so you can find somebody nearing retirement that just can't get to that targeted benefit because that person runs up against the 415 limits.

From the Floor: What would be the solution for that?

Ms. Zimmerman: Well, the obvious solution is a nonqualified plan, and that's really what we've done. The other thing might be to design your formula or integrate the plan better with other defined-contribution plans. You have to try to avoid the issue. When you're funding a target-benefit plan, you can't anticipate future pay increases. So along with that, you're often playing catch-up at the end of someone's career. The best solution that we have found is really to set up a nonqualified kind of shadow plan that will pick up the additional amounts, but then you can't fund that very well either.

If you are working within the target-benefit framework, there's not an easy solution, but you're right. If you wanted to get back into the defined-benefit liabilities and other things that go along with that, you certainly could.

Just a note on top-heavy rules—again, if you're designing one of these plans, you want to be aware that your top-heavy requirements may force you to take a little different look at the plan than you would have originally. An example of this would be a new comparability plan, where, let's say, you wanted to target a 6% contribution for the owner and you find that the office staff could support that if they're only getting 1% of pay. With that range of contributions, you may very well have created a top-heavy plan, in which case you can't give the office staff 1% anymore. You have to bring them up to 3%, and now you haven't accomplished the same objectives that you thought you would when you started out. Just something to be aware of when you're designing the plans.

From the Floor: You frequently have to build that into your test facility.

Ms. Zimmerman: Frequently, right. You start at 3% if you think you're going to be doing that, but you then would need to take that into account when doing the cost projections, and so on.

With that, let me turn this back over to Norm. We can talk a bit about the design.

Mr. Clausen: The traditional plans have really been designed over the last 20–30 years to meet the needs of employers over that period of time. Why are these new plans coming up? I would say that the principal reason is the movement from what I call career employment to performance-based employment and total compensation, with the life span of products and jobs getting shorter and shorter. It's just no longer possible for employers to say, come with us at 25 and we'll give you a job for the next 40 years. Employees are more worried as employers are more worried, and I'd say that's the motivating factor. The second most important factor is to get more bang for the buck out of the plans. And then there's a whole host of reasons that have been important for different employers, such as greater cost control and reduced funding requirements. Many times with the final-average pay plan, the company may have been overfunded and then have to start making contributions again, whereas it would not if it switched to one of these plans. All of a sudden, the company's projected benefit obligation will drop down to your accumulated benefit obligation and the company won't have to make contributions for four or five years.

These plans help facilitate benefit changes. If you decide your plan's too rich and you want to cut back, and you only want to do that for new hires, changing to a totally different type of plan will let you do that without being obvious about it.

From the Floor: Can you give us some examples as to why these plans help deal with a new type of worker?

Mr. Clausen: Two examples. A large number of employers are concerned about people who have been working for them for 10–15 years and then just can't do the job anymore. They say, look, we've got to fire these people. But on the other hand, they're two years away from being eligible to retire. They feel bad. What do they wind up doing? They provide early retirement windows or special severance programs just to moderate the impact of the pension plan. Ten years ago, this never would have happened. Management said, "The issue is, Charlie's been a loyal worker; we'll keep him on, and we'll find something for him to do." Now employers are not saying that. Employers are saying, "Every employee has to pull his or her weight." Because of that new attitude they're saying, "We want to be able to get rid of people when they cease to work whether that's at 30, at 50, or at 70." With that type of an attitude, the traditional plan just doesn't work.

From the Floor: Many people like the fact that you don't have discontinuities, like at early retirement.

Mr. Clausen: You don't have that cliff. The concept basically is that you're saving for retirement over your whole career. If you worked for five employers and each of them gave you a traditional, final-average pay plan, and I worked for five employers all of whom had a capital-accumulation plan (whether it's pension equity or cash balance or whatever) during that period of time, I'd get double the benefit you would because of the front-loading that's inherent in these plans.

From the Floor: What you're saying is, if the plan was designed in a certain way, the way that the original cash-balance plans were, there's more front-loading. So the short-service person leaving after a certain number of years gets a notably bigger benefit than he or she would on a traditional, defined-benefit plan.

Mr. Clausen: Precisely, under a traditional defined-benefit plan.

From the Floor: If you're hiring more employees on a short-term-project basis, you need a carrot to get them to come with you, and the traditional plans don't do that.

Mr. Clausen: Yes, that's the other issue. The issue I first described is a long-service person who just can't do the job anymore because the job has changed and he or she doesn't have the skills or the inclination, whatever the reason. But the other aspect is that more and more, there are jobs that have a limited duration. We want somebody to come in and work for five years and do this job. How are we going to get them? The traditional pension plan isn't going to attract them.

From the Floor: I still see that factor being a major motivation of the cash- balance plans. Is that the major motivation, or are cost-control issues and regulations also of greater importance?

Mr. Clausen: Increasingly, most of the companies that went to cash balance when it was new—five, ten years ago—went to it for specific reasons. Many of them had to do with finances, either lowering their cash contributions or lowering their expense or some other financial reasons. I think more and more of the companies we're talking with are going to cash balance because they realize that their traditional plan just doesn't fit with the rest of the work force.

From the Floor: Something I saw quite a bit was that the initial question of the employer is, should we terminate this plan because employees don't appreciate all that we're spending. So there was an initial question and they were very flexible at looking at recent flaws.

Mr. Clausen: And I think usually that question comes up with employers that have greater mobility. And they say, this is just not doing anything for us. And the real reason is what we talked about before: that it just doesn't fit anymore. The companies that like a traditional plan are companies that say, "We have a power plant. We want to train somebody and keep that person for a specific job. We want this person to run that power plant for the next 20 years." They don't want this person to leave. They want to handcuff him or her to the desk. The way you do that is you put in a generous plan that doesn't pay anything unless you put in 30 years. But as soon as you stay 30 years, then you get your golden reward. Those are the companies that love traditional plans. But the companies that aren't like that question their plan and they say, "It's not doing anything, let's get rid of it." So I think it's the same thing.

From the Floor: When do you think we'll see real performance-based, cash-balance plans?

Mr. Clausen: I'm talking about performance-based employment, not performance-based benefits. Many companies believe in performance-based compensation where you have bonuses and other things, but then the issue is, we know retirement benefits are part of compensation, but should we have performance-based retirement benefits, or a traditional profit-sharing plan where you credit 15% in good years and nothing in bad years? That's the ultimate in performance-based compensation, but I haven't seen much of that. Most people who say they we want a performance-based compensation intend it would be solely in the form of cash bonuses or stock bonuses, something like that. I've seen a couple of companies provide performance-based cash-balance plans; Bell South is an example, but there are not many.

From the Floor: Isn't there an issue of not knowing what your profits are until February, and having to determine benefits at the start of the year in order for the *FAS 87* impact to fall in the previous year when the profit occurred?

Mr. Clausen: There's an analogy that a fair number of savings plans have with a variable match, where they'll credit 50% and up to 100% if we have a good year. There and then you're always crediting based on last year's results.

From the Floor: But you might do a different accounting treatment there. I think it's clear with a variable savings plan match that the additional amount has to be charged in the year for which the performance generated the additional match.

Mr. Clausen: Suppose we'd always thought we paid the match. Does anybody know that? We have a savings plan and I'm going to pay a 50% match, but I'll make it a 100% match in 1997 depending on my 1996 performance.

From the Floor: My experience with matches is you go back and look at what people contributed in 1996 and adjust the 1996 match based on 1996 performance. That's what I was talking about.

Mr. Clausen: But if you do that, many companies don't like to go back and restate the account. They like to do it for a future year because then people get more appreciation out of it, but then you run into those mismatched problems. So that's one of those class dilemmas.

From the Floor: If you make a fixed commitment in December to increase the following year's match, you can recognize the cost of that increase in the preceding year, for accounting purposes. Sometimes companies are sure that there will be some increase, and they'll commit to the part of the match that they're sure about, and recognize that in the previous year's cost.

Mr. Clausen: Well, we're talking about savings plans. We have the same type of issues with defined-benefit plans.

From the Floor: Something on a defined-benefit plan is when it is recognized, not when you actually pay the check, except to do a rebate buy; and not when it's considered effective for the IRS, but when the decision is made—not when the IRS recognizes it. Because the decision to recognize is totally different for IRS purposes and for FASB purposes. But Ken said you can do that by making an approximate decision that way. Most auditors will buy it.

Mr. Clausen: But the gentleman's point is that the full extra match would have to be deducted in the year in which it's paid, just as you were saying, even though you might charge it against expense in the preceding year.

From the Floor: There's a statement in *FAS 87* that expense and deductibility, etc., has a bearing, a linking. But there's no way it's one to one.

Mr. Clausen: An interesting, related issue is if you had a cash-balance plan. We have one plan that credits 4% of pay; and when it has a good year, it'll credit 6% of pay under the cash-balance plan. From an *FAS 87* point of view, is it reasonable to simply inflate your current service cost by 50% for that year? In my judgment, I think it is, but that's certainly an open question.

There's an issue of which is better—this is basically the issue of cash balance versus life cycle or pension equity. Cash balance is a better fit with a 401(k) savings plan, that you can give out accounts, and people understand them better. The big advantage of the pension equity or life cycle is that it rewards fast trackers because they're the people with leverage. Final average pay goes up fast.

We talked before about a target-benefit plan. Would it be better to just do it in a defined-benefit plan? When you're designing these plans, there's a critical question of defined-benefit versus defined-contribution that the employer has to grapple with. The key issue there is who gets the investment risk and who bears the investment rewards? Most larger employers feel that they're here for the long term. They could do a better job investing, and they would rather control the money. Most small employers are saying, I may not be here in five to ten years, why should I make these long-term investment decisions? I'm in the business of making widgets. I don't want these investment decisions. Let's push that off to employees. So that's a key decision in terms of whether or not you ought to have a target-benefit plan versus a cash-balance plan that might do the same thing. And, of course, there are short-term issues in terms of terminating a defined-benefit plan.

Are there any funding issues that we want to talk about? Most of us believe you can just do traditional unit credit with a cash-balance plan. You don't have to do any projecting and rating. Just because you're fully funded doesn't mean you have enough money to pay off the account balances. Obviously, of all these plans, traditional plans pay money in monthly benefits. If you're going to start paying lump sums, that has a significant effect on the investment decisions of the plans. It may have an effect on the investment return you're going to assume because you're going to have a shorter duration.

Ms. Zimmerman: If I can interject something there. On the liquidity shortfall, there's a GATT requirement that you have to maintain at least three years worth of benefits and expenses. Of course, that's not generally a problem in traditional plans, but you need to look out for that when you're paying out lump sums.

From the Floor: If you have a plan that's less than 100% funded you have to be careful if you convert into a plan that has a lump-sum option, because you can't make a payment without going through many hassles.

Ms. Zimmerman: That's a very good point. The other thing on floor-offset plans is depending on how you have your defined-benefit formula and your defined-contribution offset, you can end up with negative normal costs. What we've done there is used entry-age normal funding methods. The other thing that happens is with RPA 94, you have the override on the full-funding limit. The particular plan that we work with, the floor-offset plan, is really meant to be a minimum safety net. And so right now benefits are being paid out of there, but we don't expect that in the future as the defined-contribution plan catches up. So right now we have a very high current liability, and we're looking at a situation where we could very well have to fund more than the total present value of that plan, and we haven't found any good way around that one.

Let me just wrap up quickly. We touched on funding. Expensing is really no different than what you're talking about with traditional plans. There's some question as how you value an age-weighted cash-balance plan. We've generally just used the projected and prorate method where we make sure that each person's liability is at least as large as his or her cash-balance account adjusted for the interest leveraging.