

Pension Penchant

DEFINED BENEFIT PLANS HAVE LOST SOME OF THEIR LUSTER. Poor investment policies, disastrous business cycles, and economic downturns have caused the demise of many a plan. Other contributing factors, however, have also taken a toll. Creative number crunching alone won't fix the private pension system; common sense must also play a part.

Since the enactment of ERISA, most of the emphasis on improving defined benefit plans has been on liberalizing the positions and rights of the plan participants. Not much attention has been paid to employers who establish and maintain these plans, despite snowballing liabilities.

Age 65 used to be synonymous with retirement. But more and more individuals are living longer and continuing to work past age 65. Age 68 should replace age 65 in

sponsor can establish a plan formula equal to 50 percent of a participant's final average compensation. The safe-harbor approach generally requires that the full benefit be reduced if an individual hasn't completed 25 years of service at NRA. Service could be defined as either years of service with the employer or years of service while a plan participant. The benefits under the plan would have to accrue using the same definition of service mandated by the benefit formula.

A 55-year-old business owner considering the establishment of a plan, who started his company at age 40, would find the safe-harbor approach to be expensive and all too restrictive. If the owner elected to use years of plan participation as a basis for determining benefits at NRA, his benefit would end up being only 20 percent of his compensation ($10/25 \times 50$ percent = 20 percent). The benefit formula for all employees would have to be increased to 125 percent of compensation to allow the owner to retire with the full 50 percent benefit.

If service rather than participation were used to meet the 25-year requirement, he would be entitled to the full 50 percent of pay at NRA. Benefit accruals, however, would have to be based on service, creating huge liabilities because, depending on the size of the workforce, the contributions in the early plan years would not cover the benefits that had accrued initially. PBGC premiums would also increase significantly as a result of the shortages.

Requiring benefits to accrue over the same period as dictated by the benefit formula isn't a concept that appeals to many employers. The safe-harbor rules should be changed by reducing the 25-year requirement to either 10 years or 15 years. (The 10-year approach might be best as the dollar limit under IRC Section 415 is prorated over 10 years of participation.) Additional safe harbors should also be considered, such as one that allows for a benefit equal to X percent of compensation but requiring 15 years of employment, and another that allows accruals to be based on either total service or total plan participation.

Safe-harbor unit benefit structures don't have much appeal either. Backloading enables participants to accrue higher benefits after completing certain periods of service or participation. Current law generally restricts the backloading of accruals by using the 133 percent method of

the Internal Revenue Code. This is a concept borrowed from the Social Security System but it eliminates the Social Security Normal Retirement Age (SSNRA) approach where SSNRA is based on an individual's date of birth. Plan sponsors should be able to reduce pension expenses, and eventually SSNRA will be equal to a plan's normal retirement age (NRA) of 68. Age 68 is simple, and simplicity is a factor that should be considered whenever changes to the rules covering defined benefit plans are contemplated.

Safe Harbor

Current law allows a plan sponsor to determine a plan's benefit structure based on certain safe-harbor formulas. A

PAUL S. POLAPINK is vice president and chief actuary Price Raffel & Browne Administrators Inc. in Los Angeles.



accrual. Under this approach, accruals in any future plan years cannot exceed accruals in an earlier year by a factor of 133 percent. Plan sponsors should be allowed to reward those employees with longer periods of service while reducing plan expenditures for short-service employees.

Under current law, a safe-harbor formula might provide for a benefit equal to 1 percent for each year of an employee's plan participation, times the employee's compensation for the first five years of participation, 1.25 percent for the next five years, and 1.33 percent for each year thereafter.

New safe-harbor structures could be added to allow for something similar: .75 percent for the first five years of participation, 1 percent for the next five years of participation, and 1.5 percent for each year of participation thereafter.

An employee who terminates after five, 10, 15, or 20 years of participation under the first approach will accrue a benefit of 5 percent, 11.25 percent, 19.5 percent, or 23.3 percent of pay. Under the second approach, the accruals would be 3.75 percent, 8.5 percent, 16 percent, or 23.5 percent of pay.

The use of permitted disparity in an "excess benefit" formula is intended to provide higher benefits, expressed as a percentage of compensation, for those individuals whose compensation amounts exceed their covered compensation amounts. Unfortunately, the maximum applicable to the excess compensation is limited to 26.25 percent, and the maximum is prorated for years of service or participation of fewer than 35 years.

The disparity under these excess-benefit plans should be widened. The permissible levels of disparity should be increased by allowing for additional safe harbors. One approach would be to reduce the years-of-service requirement for the full benefit to 15 years of employment and increase the excess to 37.5 percent. Benefit accruals could be based on either total years of plan participation or

total years of employment.

Adding additional safe harbors would make defined benefit plans more attractive. It would also help to reduce the number of general-tested, cross-tested, and carve-out scenarios provided for in IRC Section 401(a)(4). These techniques, referred to as "(a)(4) testing," require complex and extensive testing, restructuring of plans, and in many instances the establishment of multiple plans. These approaches are used initially to accomplish what could be done by revamping the rules covering permitted disparity and by adding some liberal safe harbor benefit structures.

Cross-tested scenarios involving small groups can be extremely sensitive to changes in demographics, resulting in a sponsor's eventual dissatisfaction with a program. Of utmost concern is the fact that some creative scenarios have been developed that appear to fall within the allowable testing guidelines. Recent comments from Treasury show that this creativity has not gone unnoticed.

Finally, enhancements to permitted disparity and the use of additional safe harbors would also level the playing field for those employers who can't use general-testing or cross-testing techniques because of issues with their own demographics. Addressing the problems through the use of safe-harbor formulas would also make it much easier to include the changes in the IRC and the regulations.

Vesting Schedules

Some might argue that our lawmakers wouldn't approach the fix to defined benefit plans by sweetening the pot for more highly paid individuals. But this has already taken place in the defined contribution arena. One of the most popular arrangements for smaller employers today is a safe harbor 401(k) plan. Under one approach for this type of plan, an employee can make a deferral equal to the lesser of 100 percent of pay or \$14,000. No discrimination testing is required if the sponsoring employer makes a 3 percent fully vested contribu-

tion for each employee covered by the plan. This contribution is required even if the employee fails to make an elective deferral. In addition, the 3 percent employer contribution covers the top-heavy requirement, if applicable, and it can be used in the general test if a profit-sharing contribution is made.

A highly compensated individual earning \$150,000 could make an elective deferral of \$14,000 and receive an employer allocation of \$4,500 (3 percent x \$150,000) for a total of \$18,500, which represents 12.33 percent of pay. An employee who elects not to make a deferral receives an allocation of 3 percent of pay. This results in a disparity of 9.33 percent.

Furthermore, using cross-testing techniques, and assuming the right demographics, might allow an additional employer allocation of \$23,500 to be made for the HCE, which would cost the employee an additional 2 percent of pay. A total of 28 percent of pay for the HCE compared with 5 percent for the other employee, or a disparity of 23 percent of pay.

One might also want to consider some change in the rules on the vesting of benefits. The statutory schedules should include a vesting schedule that requires at least 10 years of service with an employer. Such a schedule could provide for 20 percent after two years of service and 10 percent per year thereafter. All service, including service before the adoption of the plan, should be counted if this schedule is adopted.

This schedule should also apply to top-heavy plans. Again, many employers can't comprehend the notion of rewarding short-term employees and would prefer to concentrate on providing adequate benefits to the stable part of their workforce.

Providing additional incentives to employers and trimming expenses for short-service employees could help the ailing defined benefit system. This notion, coupled with more flexible funding rules and additional safeguards to prevent plans from failing, should top priority lists change in the defined benefit arena. ●