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COVERAGE AND PARTICIPATION REQUIREMENTS

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Recorder: WILLIAM A. FARQUHAR

- o Highly compensated employees within controlled group
- o Percentage, ratio and average benefits tests
- o Aggregation and comparability of plans
- o Separate lines of business exceptions
- o Minimum participation requirements by plan

MR. WILLIAM A. FARQUHAR: I am a Consulting Actuary with CIGNA in Hartford and my co-panelist, Brad Fowler, is a Consulting Actuary with Milliman and Robertson in Seattle. We are going to discuss the topics that are outlined in the program as well as share some of the preliminary analysis that we have done on coverage testing. I should clarify that this is specifically directed toward pension plans.

Before we get started though, I would like to put the session somewhat in perspective in that the only thing we have today in terms of regulations is with respect to the highly compensated employees and the definition of compensation. So aside from that, all we can go on at this point is the law, the Committee Reports, the Blue Book and the commentary and exchange of information in sessions like this -- including the session that was held at the Enrolled Actuaries Meeting in Washington.

It is important to try to guess or anticipate, or wonder what's going to come out in regulations, but it would probably be more productive and useful to discuss what an appropriate strategy is. In an environment where we don't have regulations, and we don't even know when we'll have proposed regulations, we are going to have to deal with the situation without all the information we would like to have. There will always be many questions we still won't have answers for. There are contradictions between the law and the Committee Reports and prior Revenue Rulings. To what extent do you anticipate there will be technical corrections to reconcile some of these differences?

Our strategy in dealing with our clients can go all the way from one extreme of doing absolutely nothing and just waiting until we know most or all of the answers; if so, we may be waiting a long, long time! At the other extreme is doing something, anticipating what the rules may be, with the possible problem of prematurely doing something in terms of the design, or combining or changing plans, that we may not, in retrospect, have wanted to do if we had waited for more direction. So I feel that is the real challenge that we face; perhaps not just in coverage and participation but in the whole area of implementing the Tax Reform Act. Whether it be integration, or any of a host of other questions, the real challenge is developing a strategy to deal with the unknowns in situations where we don't have all the answers.

So with those comments, I am going to turn it over to Brad. He's going to be making some remarks on the definition of highly compensated employees and the controlled group.

MR. BRADLEY C. FOWLER: I should add by way of introduction, that my own background and practice has been primarily in dealing with larger plans so I come to this topic from that point of view. And under the old environment, if you were a large plan guy, there wasn't a whole lot of need to be an expert in things like comparability, Revenue Ruling 81-202, and a lot of things that are suddenly going to become much more relevant to the large plan environment as well as the smaller plan environment.

In order to talk about coverage under the new Act, we have to first talk about the concept of the highly compensated employee. I think many of you are familiar with this, because we had to deal with this already in 1987 in order to do the Average Deferral Percentage (ADP) testing under 401(k) plans. The definition of a highly compensated employee is an employee who during the current or prior year met one of the following conditions: was a 5% owner, earned more than $75,000, earned more than $50,000 and was in the top paid 20% of employees ranked by compensation, or was an officer at any time and earned over 150% of the defined contribution plan dollar limitation.

In making the determination of who is a highly compensated employee, there are a number of other special rules. Probably one of the most significant of these is the concept of the look-back year as contrasted with the determination year. The recent temporary and proposed regulations define the determination year as, in effect, the plan year for which you are trying to prove that you meet the coverage test. The look-back year then, is the 12-month period immediately prior to the start of the determination year, in most cases. The Internal Revenue Code (IRC) says is that for most of the categories that I just described, if an employee was not highly compensated in the look-back year, then he will not be treated as highly compensated in the determination year, with a couple of exceptions.

The exceptions are, first, if the employee was a 5% owner at any time during the determination year, then he must be counted as a highly compensated employee. Second, if he was among the top 100 employees ranked by compensation during the determination year, and satisfied one of the other three conditions (being over $75,000, or top 20% and over $50,000, or the officer condition) then he also must have to be treated as a highly compensated employee. But he has to meet both the top 100 test and one of those other three conditions.

As far as officers are concerned, if there are no officers who are paid over $45,000, then the top-paid officer is deemed to be highly compensated. No more than 50 employees have to be treated as officers if there happen to be more than 50; or if less, the greater of three employees or 10% of the total employees. So there's a lid on the number that come in through the officer category.

Compensation, for the purpose of defining a highly compensated employee, is based on compensation as defined in Section 415(c)(3). It is basically all compensation received by the employee from the employer during the year including 401(k) deferrals, cafeteria plan deferrals, contributions to a tax-sheltered annuity, or a Simplified Employee Pension (SEP) program. So all of that pretax salary deferral type of income that would be nontaxable is brought in for the purpose of determining whether someone is a highly compensated employee. Also the cut-off points are indexed and for 1988 the $75,000 goes up to $78,353, and the $50,000 limit goes up to $52,235.

There are a number of rules that have to be applied in trying to determine what the composition or size is of the top-paid group; that is, in the top 20%, which is the test being over $50,000, and in the top-paid group. Now fortunately for most large, diversified employers, the $50,000 level is a higher level than the top 20%, and if that's demonstratively true, then you don't have to worry a whole lot about determining with precision the top 20%. But if that's not true, some additional rules apply.

First, there are a number of employees that can be excluded in trying to determine what the base is to which 20% is applied, to find out how many people are in the top 20%. These include employees with less than six months of service, employees who ordinarily work less than 17-1/2 hours per week, or less than six months per year, employees who have not had their 21st birthday, nonresident aliens with no U.S. source of income, and collectively bargained employees to the extent provided in the regulations. And one of the surprises, I think, that came out in the temporary regulations in February, was in Question & Answer 9, which said the size of the top-paid group would be determined including collectively bargained employees, unless over 90% of all employees working for the employer (and the employer is on a control group basis), are collectively bargained and the plan being tested covered only noncollectively bargained employees. So for a number of organizations then, that provision will probably require that the top 20% would include more individuals than maybe we thought.

There were several other provisions in the temporary and proposed regulations, having to do with measuring the top 20%. In particular, they were simplifying rules for determining who worked 17-1/2 hours per week. Basically, they said you don't look at all at weeks when the individual did not work, so you only look at weeks where there was work. If on average someone works over 17-1/2 hours more than 50% of their weeks, then they are above the limit. If more than half of the weeks they work below 17-1/2 hours, then they can be excluded. Also, the tests can be applied on a job category basis, or on an individual employee basis. So if you want to take certain job categories or positions and exclude or include them on that basis, that's permissible.

Similarly, they were simplifying rules for determining employees that work ordinarily over six months per year. This is a facts and circumstances test and the experience of the employer over recent prior years is to be taken into account. So if it's a seasonal industry, and the season was unusually short and employees that work normally six months in a particular year don't get six months, that would not be sufficient reason for excluding them.

Also, in the proposed regulations there was a considerable discussion about allowing the look-back year to be a calendar year. And I think this was aimed primarily at plans which had a noncalendar year plan year, where the employer wanted the flexibility to determine who is highly compensated based on a calendar year because it fit better with the payroll records. This is permissible and in fact you can use any calendar year that ends within the plan year as the look-back year in place of the 12-month period ending at the start of the plan year. If that's done, there are some complicated rules then for how you determine the top 100 paid employees in the determination year, and they involve annualization of amounts actually paid for the portion of the determination year that extends beyond the look-back year.

I think I mentioned it, but I should just reiterate that the determination of who is highly compensated is done on a control group basis and not necessarily on the basis of the entity that maybe is the sponsor of the plan. The IRC for a number of purposes defines controlled groups. There are several kinds of control groups discussed including parent-subsidiary type relationships where there are a group of organizations that are tightly controlled, affiliated service groups, and in certain cases, leased employees that are brought into employees of the employer. These types of aggregations have got to be applied for the purpose of satisfying minimum coverage. I should also emphasize that if you apply the rules for trying to determine who is highly compensated and you do it at a control group level, you are going to get, in general, a slightly different set of employees even within a subsidiary than the group that you might have if you apply the rules only within the subsidiary. In particular, rules having to do with the top 100 paid individuals for the determination year are going to give a different 100 individuals at a control group level than if you were mistakenly trying to apply that to a subsidiary.

There are special rules for aggregation of family members in determining highly compensated employees and the extent of their benefits. The family members that have to be aggregated include the spouse and any lineal ascendants or descendants (that would be parents, grandparents, children, grandchildren) and spouses of lineal ascendants or descendants. Notably absent are relations such as brothers, sisters, aunts, and uncles. Aggregation of family members only applies to individuals who are 5% owners or who are among the top 10 employees ranked in terms of compensation. So it is a fairly limited universe for which you have to go out and find any family members and carry out an aggregation process.

When there are family members involved, the compensation taken into account then becomes the combined compensation of the highly compensated individual and the family members that are aggregated up to the $200,000 cap. Similarly, the contributions or benefits that are used in testing coverage would be the combined contributions or benefits for the employee and the aggregated family members. Technical corrections clarify that the aggregation of family members is not intended to apply for Section 415 testing, nor for the $7,000 cap under a 401(k) plan. This aggregation is intended to be limited to the area of coverage and determination of highly compensated employees.

There are also a number of rules applying to determination of highly compensated former employees. A former employee is considered a highly compensated former employee if he was highly compensated when he separated from service, or if at any time after attainment of age 55 he was a highly compensated employee. Former employees are not counted when we go looking for the top paid group, the top 100 paid employees or for current officers. Highly compensated former employees are relevant to some of the tests under coverage and participation, I think primarily in the welfare plan area, where plans cover former employees. They're ignored for many other purposes. Under the proposed and temporary regulations there is considerable discussion of the concept of a deemed separation year, and the idea here is that if an employee's compensation falls from one year to the next below 50% of the high three-year average compensation prior to that point in time, then the employee is said to have a deemed separation from service in that year. A case in point would be an employee that went to half-time status, for example.

When an employee has a deemed separation, and if at some later point he should terminate, he will be classified as a highly compensated former employee. Even though he might not have been highly compensated in the actual year of separation, he was highly compensated at this deemed separation year. There is also a concept of deemed resumption and this is a facts and circumstances test, but it is in effect the reverse of a deemed separation. It occurs when, as a minimum condition the employee has to have compensation go back up to a sufficient level. Then it would reverse the deemed separation.

There are several other interesting provisions within the temporary and proposed regulations on highly compensated employees. In several areas there are optional provisions which a sponsor can elect to use. One of these is for the purpose of determining highly compensated former employees who left service prior to January 1, 1987. These are in effect those highly compensated former employees that left practically before we knew about the concept of a highly compensated employee. One of the optional rules for determining these individuals is anyone who is a 5% owner or had compensation in excess of $50,000 at separation or anytime after age 55. So this would be a simpler test than applying the full-blown test back historically. This alternate definition may be used if it is specified in the plan so there has to actually be a plan provision that says we are going to do it this way. It has to be used uniformly and provided for in all plans of the employer, which again would be in a control group level and encompass both health & welfare plans and the pension plan.

I think that wraps up what I want to say on highly compensated employees. Bill is going to talk about the tests that are actually applied to determine satisfaction of the coverage rules.

MR. FARQUHAR: Once you've gone through and determined who the highly compensated employees are, and of course you then know who the nonhighly compensated employees are, and you have identified the controlled group, the first two of the three coverage tests are relatively simple. The first test is the percentage test; the second test is the ratio test; and the third test is an average benefits test. You only need to pass one of the tests and you need to pass the test once in each quarter.

The first test I'll very briefly explain is the percentage test. You are testing plan by plan. And as you look at each plan, you determine if 70% of the nonhighly compensated employees of the total employer group are benefiting from this particular plan that you are testing. One of the questions that is still not completely resolved is, "who benefits from the plan?" It seems to be clear that if you are eligible to participate in a 401(k) plan, even though you don't actually contribute and participate in the plan, you are considered benefiting from the plan; hence, you would be included in this percentage to reach the 70%. There seems to be some disagreement on whether in a contributory defined benefit plan you're benefiting from the plan by being eligible to participate or if you have to actually participate. It's my opinion from what I have read that you have to actually participate in the defined benefit plan in order to be considered benefiting from the plan. This of course could cause some serious problems for the few contributory defined benefit plans where there isn't a very high participation rate.

In doing the percentage test, you can exclude certain employees -- those employees who don't meet the age and service requirement for the particular plan that you're testing. And you can also disregard union employees who are subject to a collective bargaining agreement. So what usually happens is that you will probably only have one or at most two plans that could pass the 70% test. If you have, for example, the same general group of employees that are covered by a defined benefit pension plan and also a 401(k) plan, both of those plans might have at least 70% of the nonhighly compensated people in them. But that's about as far as you can go in meeting the coverage requirements with the percentage test.

So you then have to go to the second test, which is the ratio test; it takes this 70% criteria and ratios it by the number of highly compensated employees in the particular plan you are testing to the number of highly compensated employees in the entire controlled group. If all the highly compensated employees are in the plan you are testing, then this test really degenerates into the percentage test -- 100% of 70%. On the other hand, if there are no highly compensated employees in the plan, then the plan is deemed to pass, irrespective of how many nonhighly compensated people are in the plan. If for example, the ratio is that half of your highly compensated people are in the particular plan that you're testing, then you would have to have 35% of the nonhighly compensated people in that particular plan. So if the highly compensated employees are reasonably distributed in somewhat the same proportion as the nonhighly compensated people, then you could have several, or perhaps even all of your plans pass the coverage test by means of passing this ratio test. The law is saying that if you have all of the highly compensated people in one rich plan and all of your nonhighly compensated or most of them in another plan, then the plan that has all of the highly compensated people is not going to pass the ratio test.

Brad has some examples of a case where he has worked through the percentage test and ratio test. I think it will be illustrative to have him go through the work he has done in this case.

MR. FOWLER: I should add by way of background, this is an actual case and it was picked because I think it illustrates a lot of the problems or consulting challenges in the new coverage and participation Rules.

This is a large diversified manufacturing organization, nationwide, employing close to 40,000 employees. They sponsor a companywide salaried defined benefit pension plan and a companywide salaried 401(k) plan with an employer match. The employer match is variable, depending upon the level of profits obtained by the company in the prior year, so the match can actually get to be quite rich following a year of very good returns, both in terms of the proportion of each employee dollar that is matched, and the maximum percent of an employee's compensation that is eligible for matching. The company is heavily unionized, but not sufficiently heavily unionized. So schematically, when we look at the employees that are subject to this testing provision, we've got the block of excludible employees, about 19,000 union employees subject to collective bargaining. For the pension plan, there is no minimum age and service requirement so there are no excludible employees for that purpose in the pension plan. But there is a one-year service requirement in the 401(k) and there are about 2,700 excludible employees for the 401(k). Then there are the nonhighly compensated employees that we have to deal with for coverage in the salaried programs. The salaried plan participants are about 11,600 in the pension plan, and a little over 9,000 in the 401(k). Then there is a block of nonunion hourly employees of about 5,000 who are not covered in the salaried programs, and finally, about 1,700 that are under no plan at all.

Now I should add that the benefits strategy of this firm, which is fairly typical, is to provide nonunion employees with benefit programs that are similar to and in some cases better than those available to collectively bargained employees in the same vicinity, doing the same kind of work. And the strategy here is to keep your nonunion employees nonorganized. So it's not necessarily a strategy of trying to provide the minimum possible benefits to the nonunion employees. Then there are the highly compensated employees; virtually all of these are included in the salaried benefit program, or in some cases there are some highly compensated employees over in the excluded group of union employees.

In looking to see if 70% of the nonhighly compensated employees are covered, it would require about 12,900 employees to be covered. The actual coverage is about 11,600, so the plan fails the 70% test. On the 401(k), the result is similar. The 70% level would be a little over 11,000 employees and just over 9,000 are covered. So the salaried 401(k) program also fails the 70% test.

The ratio test says that that percentage of nonhighly compensated employees covered should be at least 70% of the percentage of highly compensated employees covered. In this case, 63% of the nonhighly compensated employees are covered, whereas 97% of the highly compensated employees are covered, and 63% only represents 65% of 97%. In other words, it doesn't meet 70%. So we fail the ratio test as well.

The result for the 401(k) plan is a little worse. The 401(k) plan covers 57% of the nonhighly compensated employees. Again, about 97% of the highly compensated are covered so this plan does not meet a 70% ratio test.

The number of employees is approximate. Just a few comments on that. We were dealing with the headquarters of a large organization. You would think if you had any chance at all in dealing with a controlled group concept it would be best in dealing with corporate headquarters. Even at that level there are significant problems in obtaining data -- even data as basic as employee counts and compensation levels for the entire control group. In this particular situation the employer had decentralized payrolls and had never had any need to collect compensation data at headquarters on nonunion hourly employees. This was handled locally. They did collect data, such as hours, and sufficient data to do eligibility calculations, and valuations on their hourly pension plans, but the compensation data was not there. They also noted that in a few minor instances they had subsidiaries where the entire benefit program was run by the subsidiary, and this was a fairly centralized organization. But even in that structure there were a few subsidiaries that were totally independent of headquarters and for which little or nothing was known -- even to the extent of how many highly compensated employees there might be out there at that subsidiary and what kind of benefit program was being provided.

At this point, Bill is going to talk now about some of the other tests, such as the average benefits test.

MR. FARQUHAR: The third coverage test is the average benefits test, and there are two parts to this test. The first part is the old classification test or the fair cross section under the old law, which means the plan does not discriminate in favor of the highly compensated employees. I am going to get back to that and make some comments after I go through the second part of the average benefits test, which is the average benefits percentage.

Now the first two coverage tests were done plan by plan, as Brad has outlined. The average benefits percentage is done in the totality of all of the plans for all of the employees in the controlled group. You sort them out into just two categories -- highly compensated and nonhighly compensated. The test is very simple after you have sorted the employees into these two groups. You determine what the average benefits percentage is from all plans, or if an employee is not in any plan, his percentage is zero. Then you add up the average benefit percentage for the highly compensated employees and the average benefit percentage for the nonhighly compensated. The average benefit percentage for the nonhighly compensated employees has to be at least 70% of the average benefit percentage for the highly compensated employees. So the key here is that you are doing it for the entire group. You are not comparing plan to plan; that is not the test. The test is highly compensated to nonhighly compensated.

You can either include all of the employees of the controlled group, or you can exclude those employees that do not meet the lowest eligibility of any plan. This may be a situation where the law may cause plan sponsors to do something that is contrary to the intention of the law. The intention of the coverage was to bring in as many of the rank-and-file and cover as many employees as you could. If you have one plan that provides immediate participation, then in order to do the average benefits test you have to include every employee whether or not he is excluded from participating in another plan. So you could have a situation where sponsors may decide not to provide immediate participation if it would make it more difficult to pass the average benefits percentage test.

Now for determining the average benefits percentages, we must go back and dust off the old Revenue Ruling 81-202 to determine what the average benefit percentage is. There are three ways that you can compare average benefit percentages. You can do it on a benefits basis with the defined benefits projected to 65 or you can do it on a unit basis, with the benefit earned per year of service. If the plan is a defined contribution plan, then there are certain conversions using reasonable actuarial assumptions that you would have to make to convert contributions to benefits. The third way of testing is on a contribution basis and again if you a have a defined benefit plan you would have to use certain reasonable actuarial assumptions to convert it to a contribution.

Revenue Ruling 81-202 also provides rules for imputing benefits from Social Security. So you could either do these three tests imputing Social Security or without imputing Social Security. There seems to be some question and some contradiction as to whether for purposes of doing the average benefits percentage tests you are going to be able to impute Social Security. Although it seems to be clear, and I will get to this later on in determining comparability of plans, you would definitely be able to impute Social Security benefits as part of determining whether two plans are comparable.

In addition to following Revenue Ruling 81-202, there are some modifications that have to be made; some prior to the Tax Reform Act. Revenue Ruling 83-110 updates the procedures for computing Social Security. The highly compensated employees may have earlier vesting, for example if they are in a different plan which provides immediate vesting, than under the Tax Reform Act where you have five-year cliff-vesting for the nonhighly compensated employees. Revenue Ruling 74-166 goes through and determines what the average percentage vesting is over time. So for example, if you took a 25-year time horizon, 100% vesting, the average would be 100%. Yet in five-year cliff-vesting, the average would be 80%, 0% for five years and 100% for 20 years. Then I believe you take half of that spread so you would have to normalize or increase the benefits for the plan that provided the earlier vesting by 10%.

There are also modifications as to how Revenue Ruling 81-202 would be applied with respect to the Tax Reform Act. One main area is with respect to the new integration rules for imputing Social Security, which is the basis on which you determine how much Social Security is provided. If you are comparing benefits, you would basically use the integration level which would be 3/4% up to covered compensation times credited years of service. But that .75% needs to be graded back for people who are born after 1937 to basically .65% for people born after 1957. And if you are comparing contributions, you can impute that the contribution to Social Security is 5.7% up to the taxable wage base.

There are also adjustments in Revenue Ruling 81-202 for ancillary benefits such as death benefits or disability benefits that you can normalize and take into account. It has to be the greatest benefit so if there is subsidized early retirement you would need to take that into account in determining what the projected benefits are.

The Committee Reports make reference to the possibility of projecting salaries. In the past when you used this Revenue Ruling to compare plans it was based on current compensation. So this presents some interesting situations as to the possibility of projecting salary. If you don't project salary, there is no difference between a career average and a final average plan. So using current salary you could have a final average pay plan for the highly compensated and a career average plan for the nonhighly compensated. And you could demonstrate that they are both getting the same benefits, whereas a salary scale would show up the difference. Also, when comparing a defined benefit with a defined contribution plan the salary scale or projecting of salaries would probably do a more accurate job of providing a fair comparison.

But then the flip side of it is if you project salaries, you could probably come up with a situation where all plans are comparable because you have a cap on the salary of $200,000. With some salary scales you could probably run everybody's salary up to $200,000 so everyone gets the same benefit. We'll just have to wait and see what the rules are.

I would like to comment on what I have done for several university plans. Perhaps this might present a simple case study that could be applicable in a number of other situations -- hospitals that may have laboratories or clinics or physical fitness centers. (We don't know whether they are separate lines of business or not and Brad is going to get into that issue.) But a typical university situation is that you have two plans. You usually have one plan for the faculty and one plan for the support people. I have gone through and done some testing of several of these for the average benefits percentage test and have found that they have been well above the 70%, notwithstanding that typically the faculty plan is maybe contributing 10% of pay and maybe the support plan on a contribution basis is probably 5% or 6% of pay. Remember you are not comparing plan to plan or you would not meet the 70%. You are comparing highly compensated to nonhighly compensated and there are enough nonhighly compensated people in the faculty plan to bring that average up. So when you combine the two of them you meet or exceed the 70%.

Then what it comes back to is, does it really meet the average benefits test? Remember I glossed over the issue of the classification test. I don't know the answer to it. I've got my own thoughts as to how rigorous the IRS will be or should be in defining how that classification test will work. For the salaried and hourly situation, since the salaried plan is presumably already qualified as covering a fair cross section, you may be alright in that situation. It just doesn't seem to be reasonable to have such a rigid definition in the classification test that in essence forces you into having one plan for both groups. It almost invalidates the whole purpose of going through the average benefits percentage test. Even if you've passed the numbers, you can be denied meeting the coverage tests because you have two separate plans and it's presumed that you're not covering a fair cross section or you're discriminating in favor of the highly compensated because they all happen to be in the salaried plan.

The university situation is a little tougher because in the past the university faculty plans didn't qualify under the IRC 401(a). They qualified under the 403(b) and those rules have changed, so that may have made that situation a little more difficult. But I would like to hope the classification in these particular situations is not intentionally trying to discriminate and sort of pick and choose, that it is the way these plans have been structured and the benefits have been provided. Hopefully more liberal regulations on determination of classifications tests will allow them to proceed with the average benefits test and demonstrate that they are providing nonhighly compensated people with 70% of the average benefits that they are providing for the highly compensated.

There are a number of other issues that I want to comment on with respect to all three coverage tests, including the percentage test and the ratio test. One of the major problems obviously is going to be data collection problems of identifying who the highly compensated employees are, identifying which employees can be excluded and in some cases even identifying the controlled groups. I was at a workshop where someone was pointing out that they have a situation with a client that is owned by a foreign company and it has other subsidiaries of which they are not even aware. So this whole data collection problem of identifying the groups and identifying the highly compensated employees is going to be a very, very complex area, especially if you get to the average benefits test where you are talking about the totality of all the plans. If we have difficulty in getting the data to do an annual actuarial valuation for a fairly well-defined group of employees on one specific defined benefit plan, this multiplies and expands those problems.

As I mentioned earlier, you must pass the coverage test on at least one day of each quarter. Again, we must have some strategy. I don't believe we will collect this data and do these calculations and make these tests four times a year. Probably you'll make the test once and even then the question will be how exact you will do the test. Will you make an approximate test. If you're 80% or 85%, you don't worry about a lot of the details and the fine points. In doing the top-heavy tests, I don't know whether or not you had bad luck but I've always had a few cases that come out to be 59.9% or 60.02% and then I have to go through and fine-tune the calculations. Maybe we'll have better luck in terms of the 70%.

Of course, the effective dates for meeting the coverage requirements are plan years beginning after December 31, 1988, so effectively you have to be in operation for clients starting in 1989. There are some exceptions for collective-bargaining situations. We were commenting earlier that even if we're optimistic that some sort of proposed or temporary regulations can come out by late summer or Labor Day, that still doesn't give any of us much time to go through what the alternatives and what the redesign issues are. The implications of this whole coverage issue are just enormous!

What are the "sanctions" -- the term the law uses? I always thought they were penalties. This is probably one area where the law is a little more realistic in regard to disqualifying the plan. In the past if a plan was disqualified, the employer not only lost his tax deductions but theoretically all of the vested benefits in the plan for everyone became taxable income. So I believe the IRS was rather loathe to disqualify plans; maybe they would do some arm twisting and jaw boning. Now I think there is a distinct possibility that plans may be disqualified if they don't meet the coverage requirements. The sanctions or penalties are still that the employer is not able to take a tax deduction, but the taxable income only relates to the value of vested benefits for the highly compensated employees; and then in the future, any increases in that. So basically, the rank-and-file or the nonhighly compensated employees have no penalty.

This then gets to another situation where the law is intended to bring in more of the rank-and-file employees or assure that they get a certain share of benefits. You could have a situation in a nonprofit organization which doesn't take tax deductions, so that's not really an issue. They may decide not to bring the benefit levels together to meet the 70% or to bring more nonhighly compensated in. Where you're contributing 10% to the plan that the highly compensated are in, then give these people another 5% of pay and let them pay the taxes on it because it's not a qualified plan. That may be less expensive to do than some of the other design alternatives. So you could be in a situation where when not meeting the coverage requirements, the sanctions could result in doing something outside the plan, or provide some additional funds to pay the taxes for the highly compensated employees.

There are also some rules for acquisitions and dispositions of plans that provide a transition period. I am not going to get into the details of that, but if you acquire or dispose of a company, the plan doesn't immediately fall out of the coverage requirement. There are some transition periods where you have time to look at the situation and make some adjustments.

I would then just like to comment briefly on aggregation and comparability of plans. For purposes of meeting one of the first two tests, either the percentage test or the ratio test, you are permitted to aggregate plans if the plans are comparable. And you basically go through the same procedures that you would for determining the average benefits test -- Revenue Ruling 81-202 to determine whether the plans are comparable. And if they are comparable, then you would be able to aggregate them to see if the combined plans would meet the 70% rule under the percentage test or similarly under the ratio test.

Brad has some further comments on his case study, and then we'll be getting into the separate line of business exception.

MR. FOWLER: You will recall that in our case study we didn't pass either of the first two tests, and I just reiterate what Bill said about data collection. He did not have totally accurate data, even on counts, so we had to take a modeling approach to even begin to get a handle on the average benefits test. There was no detailed compensation data around for the nonunion hourly people but we did have some broad averages, although they didn't include things like overtime and certain other pieces of compensation that would need to be included.

As far as the fair cross section test was concerned, the first step of the average benefits test, the salaried programs of this employer had been qualified under that test before and did include a large number of clerical employees that were at the same salary level or even ranged a little below the salary levels of the nonunion hourly people. So we felt fairly comfortable that the fair cross section test would still be satisfied. In modeling then the average benefits test, we had a couple of interesting results. First we ran smack into the point that Bill mentioned which is since the pension plan had no minimum age or service requirement, we had to bring everybody in. And that's a real disadvantage. It greatly expands the number of people for whom you've got to collect information.

The other big question that we had was whether or not Social Security could be counted for the purpose of the average benefits test. At least philosophically in my mind, there shouldn't be any question. It should be counted. (The IRS has not confirmed this opinion, however.) Otherwise if you have an integrated defined benefit plan that even isn't maximally integrated, you start out behind the eightball on the average benefits test because of the integration. In this particular case there was an integrated defined benefit plan and so we ran the test assuming that Social Security would count and then qualify the result.

On the modeling basis we found that if this employer could introduce an hourly 401(k) plan covering the nonunion hourly employees and obtain from either employee deferrals or employer contributions a 1% level of participation, in other words, 1% of compensation for all nonunion hourly employees and not just those that elected to participate, that so long as the matching in the salaried 401(k) plan didn't hit the maximum level, they might be in the ballpark on the average benefits test. In effect, this was taking advantage of what Bill mentioned. The salaried programs cover so many nonhighly compensated as well as highly compensated people at a high benefit level, you could average in a few people with worse benefits under lesser plans and still hit 70% on an average benefits basis.

However, the variable match in the salaried 401(k) plan was really troublesome and we estimated that if the match hit the maximum levels, the contributions required in an hourly 401(k) plan would have to average upwards of 3% of pay before the test would be satisfied. There is a provision in the average benefits test that in projecting defined contribution type plans you can either use the most recent year's contribution level to project the future or you can use a three-year average. And so, using an average would be somewhat helpful but in either case, anytime that salary program hit the maximum matching level, it was going to create problems in an hourly 401(k) plan.

We also then looked at aggregation approaches and these were probably some of the most fruitful possibilities that were considered. On the pension side, it looked like using comparability. If we pick a couple of nonunion hourly plans and apply comparability then we might get by and qualify the pension plan on the basis of 70% following aggregation. And I guess I would urge you to look at this kind of approach in a lot of situations. Again, it takes advantage of that fact that you are providing high benefits to a lot of nonhighly compensated people in the salaried program and that helps when you aggregate. However, comparability testing is almost as much work as the average benefits test.

In the 401(k) plan, comparability was also a possibility if the sponsor were to put in a 401(k) plan for nonunion hourly people and bring a sizeable share of those employees into the program. Under the IRC, though, if you're going to combine 401(k) plans for the purpose of coverage then you have to apply the

ADP and the average contribution percentage (ACP) tests to the combined plans. So the potential exists that if the hourly program has got a less generous match or no match then it will have lower participation and this will drag down the maximum allowable participation level for individuals in the salaried program. So you're going to have a ripple effect over in your salaried program although you might get through the coverage requirement.

At this point, I would like to talk a little bit about the line of business exception which is another possibility in situations like this. The line of business exception provides that if an employer is treated as a separate operating unit or a separate line of business, then the coverage test can be applied individually to that employer rather than to the control group as a whole. And there are several requirements in order to have this kind of treatment. First, the plan has to satisfy the reasonable classification or fair cross section test. So you have to be able to show that this entity is a separate line of business and is in fact a fair cross section relative to the control group.

Second, the entity has to be a self-sustaining line of business or operating unit -- in effect something that can almost be set apart and operate independently. It has to be maintained as a separate line of business for bona fide business purposes. So in order to determine whether this is in fact the case, it is a facts and circumstances test. The IRS will be looking at differences between the products and services that are offered among alleged separate lines of businesses and whether they are geographically disbursed or have other characteristics that set them apart. They will also look at the way the employer is organized as a whole and see whether the organizational structure in fact supports the contention that these are separate lines of business. They are not going to be approving separate lines of business if in fact they look like they are simply created for the purpose of meeting the coverage tests or to undermine the requirements.

In particular, you can't set up your headquarters as a separate line of business, nor can you set up your salaried employees as a separate line of business and your hourly employees as a different line of business. A separate line of business has to have at least 50 nonexcludible employees, where the excludible employees are those that you remove when you apply the coverage test. And the employer has to notify the Secretary of the Treasury that the entity is being treated as a separate line of business, so it's a formal declaration. There are special rules that will be promulgated in regulations as to how you allocate headquarters type personnel and people serving more than one line of business among the lines. Basically every employee has to be assigned to a line of business and there are probably going to be several approaches allowed, including allocating people to the line for which they primarily work or some kind of a pro-rata allocation.

There are a couple of safe harbors in the law. These are not safe harbors with respect to the bona fide business purpose requirement or the stand-alone requirement. But they are safe harbors with respect to any other scrutiny. These say if the number of highly compensated employees in the line of business is not less than half nor more than twice the percentage of highly compensated in the control group as a whole, then it will be deemed to be not disproportionate. In addition, there is a further safe harbor which says if at least 10% of the highly compensated employees of the entire control group are in the separate line, then the separate line will be deemed to be acceptable.

Again, looking at the case study, you might ask what about separate line of business approaches? There is certainly enough diversity in this organization that there are bona fide separate lines of business but there are a number of elements that weigh against that approach.

First, when you have a common salaried benefit program that cuts across the entire organization, the separate line of business treatment is not as advantageous as where you have lines that are entirely distinct, and you really intend to provide different levels of benefits among these different businesses. In the situation that we looked at earlier, because of the common salaried benefit program strategy, you could divide all those people up into separate lines and some of the lines could probably pass, but it's likely that the problem would be exacerbated in the lines that receive the bulk of the nonunion hourly employees.

Because of the mathematics of the rules, I suspect that it's still possible if you are creative enough in setting up the lines of business that you might be able to manufacture some advantage by doing it, but it would be a considerable amount of analysis if you weren't in a position to abandon the overall idea that you wanted salaried benefits to be fairly uniform. Also that uniform treatment of salaried employees is one of the elements that would argue against separate line treatment in the eyes of the IRS when they are looking at how you are organized by business unit.

At this point, Bill is going to talk a little bit about the minimum participation requirement that was also added by tax reform.

MR. FARQUHAR: Up to this point, we have been talking about the coverage tests -- who you have to cover by the plan. The Tax Reform Act also has new minimum participation requirements that apply for each plan. Simply stated, every plan must benefit the lesser of 50 employees or 40% of all employees in the employer group, so if you have more than 200 employees in the group, then each and every plan that you set up needs to have at least 50 employees that are participating. And you have to meet these requirements on every day of the plan year as opposed to once a quarter.

One of the first questions is what is the definition of a plan? A plan has different benefit formulas, or there might be some grandfathering; there is a whole host of issues as to what defines a plan. And this could have quite an impact on whether or not you have 50 employees who are in a particular plan. If the plan has multiple formulas or grandfathered somebody, once you got below 50 employees does that mean you no longer meet the minimum participation requirement?

And unlike the ability to aggregate comparable plans for purposes of meeting the percentage test and the ratio test, no aggregation is permitted. Each plan has to stand on its own. Even if there are two comparable plans with 25 people, you are not able to combine them. So what happens if you fail to meet these minimum participation rules? You either have to merge with another plan or you'd have to terminate the plan. And here is where the law is generous. If you have to terminate the plan because you don't meet the minimum participation requirements they will waive the 10% excise tax on the reversion.

There are some exceptions to meeting the minimum participation requirements. One is multiemployer plans, or plans with no highly compensated employees or certain underfunded plans. It was brought up in a workshop that there are some government contracts that require separate plans to be set up or maybe it's just separate cost, but there may be other exceptions that are approved that would waive the requirements of meeting the minimum participation requirements.

MR. FOWLER: You might think that a very large employer like the one we were looking at earlier at least wouldn't have any trouble with the 50-employee participation requirement, but that's also not the case. Most large employers that I deal with have got some problems in this area as well. It's very common, for example, for some of these companies to sponsor what I would call umbrella plans covering a large number of hourly employees. But each separate location or separate unit, some of which are bargained and some of which are nonunion hourly, might be covered under different benefit levels and possibly different early retirement provisions. So there is considerable uncertainty whether each of those units might not be considered a separate plan under the definition of this minimum participation requirement. We might not have to go back and try to assure that each of those benefit levels within that one large plan (that might have 5,000 or 10,000 employees in it), covers at least 50 active employees. So, that's an issue.

I think by way of wrap-up, there are a lot of consulting difficulties, even in the larger plan arena surrounding coverage and participation, and quite a diversity of strategies that a sponsor might have to pursue in order to satisfy the new coverage requirements. In the study that we have been looking at, basically the strategies boil down to increasing the benefits for some proportion of the non-union hourly employees so we can get the benefits up, or decreasing benefits for the salaried employees sufficiently to get the benefits into a comparable situation by that means. There are also some strategies that might be only marginally benefit-related, but if you are on the borderline, an employer might decide that they could alter the numbers in some of those tests by acquisition or by disposition of a business unit that might carry away a disproportionate number of nonunion hourly employees. There are some diabolical strategies that might be applicable in unusual cases where it might pay to unionize some people and push them into the collectively bargained group if there was any opportunity to let that happen. It might also be possible to increase the number of highly compensated employees through selected increases in pay which would change the arithmetic in some of the tests by pushing people out of one category and into another category.

Employers right now, I think, are struggling with which of these strategies are going to be applicable and even which tests they should attempt to pass. But I guess I personally would question the practicality at this point for large plans to even pursue the average benefits test as a strategy, just because of the data collection problems and the effort required to perform that test for a very large workforce every year. I know some clients I've talked to are very uncomfortable with the idea of relying on that test rather than a test that is a lot more clean, like either the percentage test or the ratio test, where they can quickly estimate whether they've got a problem each time the company acquires or disposes of a piece of their business.

MR. DALE LAMPS: I think you probably referred to this question implicitly in passing, but I would like to hear you address it explicitly, and that is that Revenue Ruling 81-202 still exists and will be usable in the future, basically in its present form. If you can demonstrate that two plans are comparable, then they would be able to be aggregated for purposes of the percentage test and the ratio test. Is that correct?

MR. FARQUHAR: That's correct.

MR. FOWLER: Just a further comment on that. That's one of the reasons why I think Revenue Ruling 81-202 is of considerable interest to actuaries who work with large plans. We are going to be a lot more concerned about aggregation to meet some of these tests than we were in the past when we could fall back on fair cross section. I should comment though that Revenue Ruling 81-202 is subject to a number of changes as indicated in the Tax Reform Act and it would be applicable with those changes.

MR. FARQUHAR: One other comment is just from an administrative point of view. The calculations will be similar but the amount of work in doing comparability between two plans would limit the scope of the work because you would just be doing it for those two plans. Whereas for the average benefits test you would be doing it for the entire group and for every single plan that the participant participates in, so the scope of the work is much more limited.

MR. BRIAN B. MURPHY: My first question relates to the small plans regarding the participation rules. With a really small employer, 35 or 40 employees, would that mean you cannot have a separate salaried and hourly plan?

The second question is, were there circumstances mentioned under which unionized employees with a collectively bargained plan cannot be excluded from this test?

And finally, with regard to data collection, I would submit that I can easily understand the problems of a very large company in dealing with the data, but I think with small employers there can also be serious problems wherein you are remote from the employer and don't know what the entire corporate structure is. It sort of makes me wonder whose responsibility it is to make all of these tests. In other words, if an insurance broker sends me data on 25 people and says, "Here's the plan document. Tell me what the contributions should be," is it my responsibility to go back and say, "Now, wait a minute. I have to know everything there is to know about this employer and all of the other interlocking networks there might be of other corporations that own it."

MR. FARQUHAR: With respect to the small employer meeting the participation requirements, let's say there is just one highly compensated person. (There has to be one highly compensated person in the salaried plan.) I believe you'd have a problem meeting the participation. The hourly plan could pass because there would be no highly compensated people. So I think you would have a problem there; I don't know what the answer is.

If I understand the second question right with respect to union employees, my understanding is if you have an hourly plan, a plan for employees that includes both union and nonunion employees, then you have the option of either excluding the union employees to meet the tests or you have the option of including them in. So you could have a situation where if all of the union employees are participating in the plan and maybe only 50% of the nonhighly compensated nonunion employees are participating in the plan, excluding the union you would not meet the 70%. But if you want to include the bargained employees to meet the coverage, and again, it would have to be the same plan or they'd have to be comparable plans, you do have the option of including them.

The last question was on data collection. Could you repeat that?

MR. MURPHY: There can be problems collecting data with smaller employers, too; specifically whose responsibility is it? For example, suppose an insurance broker or some agent sends me a list of people and says that these are the people, this is the pension plan, tell me what the contributions should be. Do I then have to say, "Now wait a minute. Pursuant to these rules, I need everything there is to know about this corporation and all the other corporations that own it." Or can I just take the sheet that's given to me and say "this is the contribution rate." Where does my responsibility begin and end?

MR. FARQUHAR: How do we define responsibility? If we are defining responsibility in a legal sense, such as the government requiring us now to certify a Schedule B, I would anticipate certification from an actuary who has done the average benefits test. I believe that the ratio test and the percentage test are just numerical calculations and the critical part of it is collecting the data. The actuary would have to make the same disclosure that you do in a valuation which is based on data that has been submitted to you. So I'm not sure that there is any real value in having an actuary certify that you can divide two numbers and come up with a percentage greater than 70%. The only thing the actuary could possibly be certifying to on a valid basis would be that he has used assumptions and Revenue Ruling 81-202 to do calculations that determine the average benefits percentage.

MR. FOWLER: I think your questions get into almost a business or professional issue as much as a technical issue. I think there are a number of areas, and this is one under the new law, where as a consultant or service provider it is important to be fairly explicit in dealing with your clients as to what your responsibilities are. I know a number of our clients are, for example, internally taking care of filling out the Form 5500, including the questions that have to do with whether they meet the coverage test or not. They understand that's their responsibility and they're undertaking it. I think the fact that it's become a lot more complicated and so on, means we need to communicate with them and be sure they understand what's required if the plan is going to remain in compliance with these tests and that we either explicitly assume or not assume responsibility for going ahead and collecting all the data and doing the work. On the question about the small plan, I think that the rule for participation is 50 employees or 40% if that's less, so a 35-employee firm could have two plans, each of which covered more than 40%, and meet the minimum participation requirement. They would still have to somehow meet the coverage requirement.

MR. PATRICK WELSH: Brad, I wanted to get back to a curve you threw me right at the end of your comments. You went through your case study and showed that you had problems with all three tests and came up with what I had found was a good solution in a similar case in installation of an hourly 401(k) plan to help meet the average benefits tests. Then right at the end you seemed to say that for large employers, if they have any kind of problem at all, they shouldn't even fool with that test because of the data collection practicalities. I guess I maybe would like you to expand on that a little bit. But also, if you were going to use the ratio test to pass coverage in your example, how would you do that?

MR. FOWLER: If I understand the question, I think you said putting in an hourly 401(k) plan was part of your strategy, is that right? I agree that that's a helpful strategy. I think what I intended to say with respect to that, is that when that's done and they are aggregated to satisfy coverage with the salaried 401(k), it is necessary to do the ADP and ACP tests on a combined basis. And if the hourly program doesn't have the same incentives to induce deferrals, and the deferral rate is lower, then you will impact the salary program through that test. You would do that in my mind, with the goal of meeting the 70% test or the ratio test with respect to the combined 401(k) programs. I intended to say then, sort of changing subjects entirely, I questioned the practicality of using the average benefits test sort of as a general statement for a large, complicated employer situation. Does that respond?

MR. WELSH: Partially, but I think in your example, didn't you still have a problem with your defined benefit plan?

MR. FOWLER: No. The defined benefit plan was more or equally amenable to solution through an aggregation approach by picking a couple of the rich or nonhourly union plans and selectively covering enough employees that the total, when aggregated, would satisfy the ratio test. It was possible, first to show comparability, because Social Security does count under Revenue Ruling 81-202 and then second, to meet the ratio test. So the worst problem was on the 401(k) side because at the current time, there was no hourly 401(k) program whatsoever to combine with the salaried 401(k) program.

MR. JOSHUA DAVID BANK: Bill, with regard to the percentage test earlier, you were distinguishing between employees who were eligible for a 401(k) and those who elected not to join a contributory defined benefit plan. What is your basis for distinguishing those cases, especially since contributions to either one, if they are matched in the 401(k), are both considered mandatory contributions? What is your basis for saying that the defined benefit participants are not benefiting from the plan if they choose not to contribute?

MR. FARQUHAR: I believe there is nothing explicit on that. There is a section in either the law or the Committee Report which specifically comments on 401(k) plans and that's why I say it's an open issue on the defined benefit. It's just not clear as to whether employees are or are not benefiting from the defined benefit plan. Where I think it is clear, as I read it, is on the 401(k) plan -- the ability to participate is considered to be benefiting.

FROM THE FLOOR: Not much was mentioned about proving that you're complying with these rules. But is there any form or filing where the employer or the actuary must prove that the employer is complying with these rules?

MR. FARQUHAR: I have not heard of anything. The only thing that I know about is there is supposed to be something on complying and getting approval with respect to the separate line of business. But as far as the general coverage tests, I am not aware of anything.