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ELIGIBILITY, COVERAGE AND PARTICIPATION

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- o An overview of what practitioners have been doing with the new Internal Revenue Code Section 410(b) and Section 401(a)(26)
- o How have they been doing?
- o Comparability calculations for the above

MR. DONALD J. SEGAL: We will begin with the discussion of the minimum participation requirements, the proposed regulation under Section 401(a)(26), just doing an overview. We will follow with Liz King going over the eligibility and coverage requirements as stated in Section 410(b) of the Internal Revenue Code. Lall Bachan will then be speaking about how all these apply to multiemployer plans because multiemployer plans are treated somewhat differently than single-employer plans. Then we will address the issue of comparability. A great deal was said about it about a year ago and we've gotten absolutely no guidance since then.

Section 401(a)(26) was added to the Internal Revenue Code by the Tax Reform Act of 1986 (TRA-86). The genesis of this issue was that there were many plans out there which covered a very small number of people, usually the principals of the group, partners in law firms or investment banking houses where there were individual defined benefit plans for the partners and there was set up next to it a plan for the remainder of the staff. By use of comparability, it was shown that these individual defined benefit plans were deemed to be comparable to the staff plans and therefore non-discriminatory. And in many cases extremely large contributions and deductions were taken and this disturbed the IRS. That basically was the origin of Section 401(a)(26). Comparability was done with the staff plans using Revenue Ruling 81-202.

There was perceived discrimination with this situation because the amount of benefits being paid to these highly compensated individuals seemed to be excessive. Very often the rate of accrual in the individual defined benefit plans or the plans that covered the partners, the principals, the owners were at a faster rate than in the staff plan. The form of the benefit offered was more favorable to the highly compensated employee. Very often, the rate of funding was greater and inasmuch as individual defined benefit plans were set up, very often the participants in these one-man plans had more control of the investment of plan assets than a participant in a staff plan. All of these were deemed and perceived to be discriminatory even though these plans were demonstrated to be comparable under Revenue Ruling 81-202. Thus, we have TRA-86 creating 401(a)(26). I would like to quote from a couple of the paragraphs of 401(a)(26) entitled, "Additional Participation Requirements." "In general, a trust shall not constitute a qualified trust under

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this subsection unless such trust is part of a plan which on each day of the plan year (very important words) benefits the lesser of 50 employees of the employer or 40% or more of all employees of the employer." The reason I'm quoting from the code is to see the differences between what the code says and what happened when the regulations came out. Paragraph G of this section refers to separate lines of business.

"At the election of the employer and with the consent of the secretary, this paragraph may be applied separately with respect to each separate line of business of the employer. For purposes of this paragraph, the term separate line of business has the meaning given such term by Section 414(r) without regard to paragraph 7 thereof." I will add at this point that needless to say, we do not have regulations on separate lines of business as of today. In the regulations, the secretary may by regulation provide that any separate benefit structure, any separate trust, or any other separate arrangement is to be treated as a separate plan for purposes of applying this paragraph. Summarizing then what the code says is that in order to satisfy these minimum participation requirements, your plan must cover the lesser of 50 employees or 40% of all of the employees of the employer, and that the secretary may deem under certain circumstances that separate benefit structures exist and therefore each of these separate structures must satisfy this test. Now the regulations have come out.

The regulations were 118 pages which seems to be a magic number this year because that's the same length that the integration regulations were. But they were far smaller than the Section 89 regulations so we do have something to be thankful for. The proposed regulation stated that a plan must cover the lesser of 50 employees or 40% of the employees of the employer. In the regulation, they talked about certain terms. They talked about a plan, they used a term, a separate benefit structure, and they introduced the term prior benefit structure, and went on to say that each separate benefit structure and prior benefit structure in a plan must satisfy this 50/40 rule. Now, what constitutes a separate benefit structure?

A uniform benefit formula under which an employee's benefit attributable to the current year of service is determined. It goes on to say that if you have different formulas for different groups, these are separate benefit structures. If within one plan, you are giving a benefit of $15 per year of service to the employees of a particular plan and you are giving $20 per year of service to a second division, those are separate benefit structures, both of which must separately satisfy the test.

In order for a separate benefit structure to be considered just one structure, there must be uniformity of the following factors. Uniformity of subsidies of optional forms of benefits, of the rights of the participants under the plan, the features of the plan, eligibility for benefits (that is what age and service requirements you have to satisfy to get any provision), the factors in the plan, meaning actuarial equivalent factors, early retirement optional form, etc., the priority on assets, each employee must have an equal priority to the assets, vesting provisions, rate of accrual, definition of compensation and definition of service. If there is any variability in any of these factors, you have now created a separate benefit structure. What will cause separate benefit structures that will require separate testing? Differences in the formula, different formulas applying to different groups, as I've said, give you separate benefit structures. If you have Social Security supplements that are available only on the satisfaction of certain conditions, you have a separate benefit structure with respect to those employees who will or could become eligible for that. Differences in ancillary benefits could produce a separate benefit structure as could differences in optional forms or early retirement subsidies or early retirement windows
This is something that is very important that has provoked a great deal of comment. An early retirement window is considered a separate benefit structure so in broad terms if those eligible for the early retirement window do not satisfy the 50/40 rule, you may have a problem with this early retirement window. If there are any self-directed investment options in a defined benefit plan, you have a separate benefit structure. And if there are differentials in the availability of loans, this could produce a separate benefit structure. However, there are certain permitted differences which will not cause separate benefit structures. To actuaries many of these things are going to be kind of obvious but this is what the regulation says. Differences in entry age do not produce separate benefit structures. If you have a plan where you are offsetting by account balances in another plan, that does not necessarily provide for a separate benefit structure. Differences caused by the integration formula under 401(l) where, for example, the maximum permitted disparity is either .65%, .70%, or .75%, depending upon the Social Security retirement age. If you ' ave a formula that varies like that, that is not considered a separate benefit structure.

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The application of the top-heavy rules where certain people at certain times will get the top-heavy minimum benefit or only certain people may get that benefit does not cause a separate benefit structure. Target benefit plans by definition are OK. Benefits provided in the event of death, disability, or having to have a certain marital status do not cause a separate benefit structure; having to die to get a benefit doesn't make it a separate benefit structure either. Just the availability is OK. Age and service conditions do not produce them and grandfather benefits will not produce them. There is a differentiation made between an active employee, current benefit structure, and a former employee current benefit structure. These are separate benefit structures. This could produce a problem in the future if your former employees get to be less than 50. There is one technique in the proposed regulation in terms of testing the formula that is a great deal of help where they permit you to restructure a benefit formula in testing it. For example, if you have a formula of 1% of final average earnings that applies to 30 employees and another formula of 1.5% of final average earnings that applies to 100 employees, on the surface this might look like you have two separate benefit structures and the one applying to 30 employees does not satisfy the test. You are permitted to restructure the benefit by saying you have a 1% formula that applies to all 130 employees and then an additional .5% that applies to 100 employees; since we have more than 50 in each of those groups, we have no problem. It's considered two separate benefit structures, but they both satisfy the test.

There is a separate rule which looks like the Internal Revenue Code gave us something but when you read it carefully they really didn't. Where they say that in measuring a current benefit structure you can replace the 50 people by 20 people but then the conditions are that at least 70% of the people in that group are non-highly compensated employees and that current benefit structure must be contained in the plan that has at least 50 people in it and satisfies the 50/40 rule. I'd like to say at this point that this proposed regulation is so complex, we could probably spend five hours discussing it and still not get through too much of it. It's extremely complex. There are a great deal of mathematical tests, and I'm just trying to sort of give you a broad overview of it.

DEFINITIONS

The current benefit structure exists whenever there is an increase in accruals for a current or prior benefit due to a change in service base, compensation base, cost-of-living, etc. So when you give an increase to past service, a past service update, or an increase to retirees, you create a separate benefit structure which must separately satisfy the test.

You must have a uniform formula in a separate benefit structure, otherwise you have more than one structure. This uniform formula defines rate of accrual, and there must be uniform conditions and bases of the benefits or the contributions under the plan. As I mentioned before, the service requirements must be the same, the definition of compensation, the benefit limits must be the same, the levels of mandatory employee contributions must be the same. If you have different levels of mandatory employee contributions, you have different benefit structures. Eligibility must be the same and actuarial assumptions must be the same. However, if you have a plan formula where you are giving the greater of A or B, that is considered one benefit structure. You don't have to say those who get A are in one structure, those who get B are in the second structure. It's OK to say the greater of the two. That doesn't give you more than one structure.

You can project age and service to the end of the time frame. So if you have a subsidized early retirement provision, let us say, where the requirements may be the attainment of age 60 and completion of 30 years of service, it's not only those who are currently eligible but those who can be eligible in the future that determine whether you satisfy the 50/40 rule. Unfortunately, those who fall outside of it will be in a second structure, and you can have a problem.

The 401(k) plans have their own rules. Eligibility for the plan is sufficient to satisfy the test as to whether you are benefiting from the plan, but then the 401(k) elective contributions is one separate benefit structure. The 401(m) employee contributions, the voluntary after-tax contributions, is a second benefit structure, and the matching employer contributions which you have to test under 401(m) is a third benefit structure. So, if you have a 401(k) plan where you can have elective deferrals, voluntary after-tax deferrals, and an employer match, you get three separate benefit structures which have to satisfy the 50/40 test. Another provision which I will describe is with respect to offset arrangements (a floor plan). It is OK to offset a formula with benefits under another plan from the same employer and the employee must also benefit under the offsetting plan. You can offset only one plan though, meaning you can't have an offset coming

from two plans. And for purposes of determining whether an individual is benefiting from this floor-plan formula, you look at the positive portion of the formula before the offset. Before these regulations came out, fears were expressed that the definition of benefiting from a formula might be, did you actually accrue a benefit during the year under that offset formula or did you actually have an accrued benefit as of the end of the year. They didn't go that route, they just look at the front half of the formula so to speak, to see if you are benefiting from the formula.

Under a profit-sharing plan in general, all employees are considered to benefit under the plan if they satisfy the conditions to get an allocation. If the employee did not receive an allocation or the maximum allocation due to the employer's failure to make a contribution, that doesn't mean he didn't benefit under the plan.

We've talked a little bit about prior benefit structures. They start out by saying in general, each plan has one prior benefit structure. They are trying to be simplistic. Each plan has one prior benefit structure. For a defined contribution plan, by definition, they are all OK. That all prior benefit structures pass even if it's a frozen structure, but there are six possible tests for determining whether a defined benefit plan satisfies this prior benefit structure test. Frozen plans have to pass one out of two tests and ongoing plans have four tests to do or they can use one of the two tests for the frozen plans, and basically, it comes down to, "Is there a meaningful benefit accrual in the future?" If you have a meaningful benefit accrual in the future, and they go on to define what a meaningful benefit accrual is, then your prior benefit structure is deemed to pass. For 1989, though, they are only asking for reasonable compliance.

Who is covered? Multiple employer plans must test 401(a)26 on an employer-by-employer basis rather than participating employers in the aggregate. That is a multiple employer plan, not a multi-employer plan. If the benefit structure benefits only employees who are not or who have never been highly compensated employees in the last five years, and the structure is not relied upon by any other plan to satisfy the coverage requirements under 410(b) or the discrimination requirements under 401(a)4, then they are excluded from the test. Also excluded is the portion of a multiemployer plan which covers employees in collective bargaining agreement. However, this does not apply if more than 2% of the collectively bargained agreement employees are professionals.

There were certain 1989 transitional provisions written into this proposed regulation. With respect to defined contribution plans, they are only measured on allocation formulas and factors. With respect to defined benefit plans, they are only measured, for 1989, on the benefit formulas and factors, the early retirement benefits, and the availability of joint and survivor annuities. All of the other ancillary benefits and provisions and features are ignored for 1989 in defining a separate benefit structure. And finally, what happens if you have a plan which does not satisfy the new 401(a) 26 regulations? You have two choices. You have to amend your plan basically to freeze the highly compensated as of the end of the plan year before 1989 or with respect to the plan in effect as of December 13, 1988, or you have to terminate the plan either by May 31, 1989 or prior to the first day of the 1989 plan year, if later. There is an excise tax waiver with respect to any diversions that come back if the plan was in existence August 16, 1986, but there is a restriction with respect to the interest rate.

There have been many comments made already about this regulation and I would say that the pension area has not been too pleased with this regulation. The comments in general have been that the regulation is too complex, it's redundant, and it's retroactive. Some of the comments made have been to the extent that these rules are very complex and detailed and that they have no basis whatsoever in Section 401(a)26 in the code or in the legislative history underlying this section. The prior benefit structure, for example, is completely alien to the statute and its legislative history and it's felt that this, along with many other things, is beyond the scope of the statute. Another comment is that the regulations limit the use of many ordinary non-abusive practices that are designed for the benefit of rank and file and other non-highly compensated employees. Things that have been done for a number of years which many actuaries feel and many plan designers and lawyers feel are non-abusive are restricted by these regulations. Also it's felt that these regulations are excessively and needlessly complex. I've heard someone make the comment, "don't worry about it, the IRS is never going to be able to enforce all of this and follow up on the testing." In the beginning I said that the purpose of 401(a)26 was to eliminate plans that benefit only a limited number of employees and to assure that benefits are available or reasonably

available to all potential participants. That was the aim, but it seems that the regulations and their complexity have gone quite a bit beyond this. The testing of a plan's prior benefit structure in effect requires the application of these new qualification requirements retroactively. This is a regulation which we are going to have to deal with in the future. There will be comments made, there may be changes, but we've a lot of learning to do with respect to this.

MS. ELIZABETH KING: I will be speaking about the minimum coverage rules under Section 410(b) of the Internal Revenue Code. I have set forth three alternative tests that one may try to satisfy under 410(b) and some of the definitions and some of the exceptions in 410(b).

I should point out at the start that an employer who maintains one plan covering all of its employees, other than perhaps employees who do not meet the statutory age 21 and one year of service requirement, will easily satisfy the minimum coverage rules.

The employer with the potential problem is the employer who either has only one plan covering less than all of its employees or the employer who maintains several different plans for different groups or divisions of employees and the plans provide different levels of benefits.

The problem for related corporations is that under prior law, employees of all trades or businesses which are under common control (generally 80% or more common ownership unless you also are a member of an affiliated service group, where there is a lesser percentage applicable) must be aggregated and treated as if employed by a single employer for purposes of determining compliance with the minimum coverage rules. This is an important point to remember throughout my discussion of the coverage rules.

Under prior law, an employer generally satisfied the coverage rules if each plan of the employer either benefited a significant percentage of the employer's work force which is called the percentage test or each plan benefited a classification of employees determined by the IRS not to discriminate in favor of employees who are officers, shareholders, or highly compensated employees. This test was referred to as the fair cross section test or the classification test. For reasons I will describe later, many employers maintaining multiple plans for different groups of employees were able to squeeze by and comply with the coverage rules by qualifying under the classification test.

However, for plan years beginning after 1988, TRA-86 has toughened the coverage rules. Under the new coverage rules, a plan will not be considered qualified under Section 401(a) of the Internal Revenue Code unless the plan satisfies one of three tests, the percentage test, the ratio test or the alternative benefits test. I will discuss each of the three tests.

The new percentage test is much tougher than the old percentage test. Under the old percentage test, the plan generally had to benefit at least 70% of all employees. Under the new percentage test, the plan must benefit at least 70% of all non-highly compensated employees.

A plan which flunks the percentage test should be tested under the second alternative, the ratio test. Under the ratio test, a plan must benefit a percentage of non-highly compensated employees, that is at least 70% of the percentage of highly compensated employees benefiting under the plan. Therefore, if a plan covers 70% of all highly compensated employees, the plan will satisfy the ratio test if at least 49% of all non-highly compensated employees also benefit under the plan. A good example that I've had experience with of an arrangement that qualifies under the ratio test is the law firm that wants to cover partners and non-legal staff in its pension plan but wants to exclude associates. If the associates' compensations ranges from $65,000-$100,000, some of the associates will be highly compensated employees and some will not be highly compensated employees. Assuming the associates who are highly compensated employees represent 20% of all highly compensated employees of the law firm, including the partners, the plan will comply with the ratio test even if the plan excludes the associates and even if the excluded associates represent more than 30% of the firms non-highly compensated employees if at least 56% of all non-highly compensated employees (represented by the non-legal staff) are still eligible to participate in the plan. This is because at least 80% of the highly compensated employees are participating in the plan.

For purposes of the Coverage Rules the definition of highly compensated employees contained in Section 414(q) of the Internal Revenue Code applies.

Prior to 1989, large- and medium-sized employers which maintained separate plans for different groups or divisions of employees relied on the old classification test to satisfy the coverage rules because they could not qualify under the old percentage test. Many of these employers will have a problem satisfying the new test which has replaced the old classification test.

Under the old classification test, an employer could maintain separate plans for separate groups of employees as long as the employer could show that the plans covered a classification of employees which was not discriminatory in favor of officers, shareholders, or highly compensated employees.

The following factors, as set forth in IRS revenue rulings, were considered relevant: (1) whether the plan covered employees and all compensation ranges; (2) whether the compensation of the employees participating in the plan was substantially the same as that of the excluded employees; and (3) the proportion of the employer's total work force covered by the plan.

Since the term "highly-compensated employees" was not defined and the IRS rulings merely required that the compensation ranges be reasonable, practitioners had a certain amount of flexibility in complying with the classification test.

The new test which replaces the old classification test is called the average benefits test. The average benefits test is made up of two parts (both of which must be satisfied), a classification test and an average benefits percentage test.

The new classification test is really the old classification test with a few modifications. Under the classification test, the plan must benefit employees who qualify under a classification set by the employer and found by the IRS not to be discriminatory in favor of highly compensated employees as defined in Section 414(q). The legislative history to the TRA-86 as outlined in the Blue Book, which provides us with some guidance while we wait for regulations under 410(b), indicates that the new classification test will generally be based on prior law. That is, they said, using the new definition of highly compensated employee contained in Section 414(q) of the Code.

The legislative history indicates the following factors will be relevant in determining whether the classification test is met: the difference between the coverage percentages of the highly compensated employees and the other employees, the percentage of total employees covered under the plan, and the difference between the compensation of the covered employees and the compensation of the excluded employees.

Since the term highly compensated employee has now been defined, the employer's flexibility in complying with the classification test is much more limited. Moreover a major roadblock has been added by the addition of an average benefits percentage test which also must be satisfied in order to qualify under this test. Under the average benefits percentage test, a benefit percentage must be calculated for each employee of the employee's benefits under all qualified plans maintained by the employer expressed as a percentage of such employee's compensation. The average of these benefit percentages must then be calculated separately for the group of employees who are highly compensated employees and the group of all other employees. The average benefit percentage test is satisfied if the average benefit percentage for the group of employees who are not highly compensated employees is at least 70% of the average benefits percentage for the group of employees who are highly compensated employees. The problem is that the benefits provided to all employees under all plans of the employer must be counted, not just the plan being tested. Furthermore, the benefits provided under plans of the employer which satisfy the ratio test or the percentage test must also be included. All employees must be considered this in this test even if the employee is not a participant in any plan.

Since the testing must be done based on benefits or contributions, all employer provided benefits must be converted to contributions or all employer contributions must be converted to benefits. The legislative history indicates that the general approach taken in Revenue Ruling 81-202 for testing for comparability will be followed for this purpose. This is where you, the actuary, will be called in. The legislative history indicates that the rules contained in Revenue Ruling 81-202 will be modified in several respects. For example, the new limits in the TRA-86 on the extent to which a plan may be integrated with Social Security will apply. In addition, the new $200,000 limitation

on compensation and the new definition of compensation in Internal Revenue Code 414(s) will apply. The legislative history also indicates that 81-202 will be modified to take into account other significant plan features. The legislative history states that in appropriate cases, determinations may take into account the existence of different plan options such as loans or lump sum distributions that are available to highly compensated participants but not to a proportionate number of non-highly compensated participants. The legislative history also indicates that as an exception to the general rule under 410(b), the average benefits percentage test will be applied by taking into account the actual benefits of employees under a plan, not whether the employee is eligible but not making contributions to plans such as a 401(k). Unfortunately, we will have to wait until regulations are issued to get a better idea as to how the average benefits test will be applied. I should mention that for purposes of the percentage test, the ratio test, and the average benefits test, certain employees may be excluded.

If the employer's plan fails the percentage test, the ratio test, and the average benefits test, the employer may still be able to comply with the 410(b) coverage rules by aggregating plans.

As under prior law, for purposes of determining and applying the percentage test, the ratio test, or the average benefits test, more than one plan may be designated as a single plan and contested as a unit, if the plans designated as a unit provide benefits that do not discriminate in favor of highly compensated employees. Under prior law, Revenue Ruling 81-202 provided guidelines for comparing the benefits under two or more plans. The legislative history indicates that the approach taken in 81-202 will be applied to determine comparability as modified by IRS regulations.

Congress added an exception to the 410(b) coverage rules which will benefit large employers involved in different lines of business. If under Section 414(r) an employer is treated as operating separate lines of business for a year, the employer may apply the requirements of Section 410(b) separately with respect to employees of each line of business. But this applies only if the plan also satisfies the classification test as I have described earlier. Thus, many large employers who had separate plans for separate lines of businesses which qualified under prior law under the classification test may comply with the new coverage rules if the definition of separate line of business contained in Section 414(r) of the code is satisfied.

The code does not provide much guidance with respect to the definition of separate line of business. The legislative history indicates that a line of business will generally include all employees necessary for the preparation of property for sale to customers or for the provision of services to customers. Thus, the legislative history indicates a headquarters or home office will not be treated as a separate line of business.

Internal Revenue Code 414(r) states that a line of business will generally be recognized as separate if it is separately maintained for bona fide business reasons. A separate line of business also includes an operating unit involved in the same line of business if the operating unit is separately operated for a bona fide business reason in a separate geographic area. However, a line of business or an operating unit will not be treated as separate unless it satisfies the following three requirements: (1) the line of business must have at least 50 employees, which is a real problem for small businesses; (2) the employer must notify the IRS that such line of business is being treated as separate; and (3) the line of business or operating unit must satisfy guidelines prescribed by the IRS or the employer must obtain a determination letter from the IRS that the line of business or operating unit may be treated as separate. The problem is we don't have regulations now defining the third category.

The code contains a special safe-harbor rule which a number of employers may want to rely on now while we are waiting for regulations to come out. Under the safe-harbor rule, a separate line of business will be treated as meeting the third requirement (i.e., the satisfaction of IRS guidelines or receipt of an IRS determination letter). A line of business will satisfy this safe-harbor if what is called the highly compensated employee percentage of the line of business is not less than one-half, nor more than twice, the percentage of all employees of the employer who were highly compensated. The 50% rule will be deemed satisfied if at least 10% of all highly compensated employees of the employer are employed by the line of business. For this purpose, the highly compensated employee percentage is the percentage of all employees performing services for the line of business who are highly compensated employees.

History provides that for purposes of determining the number of employees in a line of business, the highly compensated employee percentage in the safe-harbor rule and the percentage of all employees of the employer who were highly compensated for purposes of the safe-harbor rule, the employer must disregard certain employees.

As I mentioned before, the 50-employee requirement is a real problem for small- or medium-sized businesses which may maintain a separate division which looks like it would qualify as a separate line of business except that the separate business employs fewer than 50 employees. The legislative history in this Section 414(r) states that a line of business may be combined with another line of business to satisfy the 50-employee requirement and the safe-harbor rule if any plan maintained for employees of one of the combined business satisfies the non-discrimination rules with respect to the aggregate entity. However, this is not stated in the Internal Revenue Code itself. Therefore, until regulations are issued, it will not be clear how we can combine businesses to satisfy the separate line of business requirement and thus the coverage rules.

The code contains a special transition rule for certain acquisitions or dispositions of the business which offers some help to employers involved in acquisitions. Under this rule, if a person becomes or ceases to be a member of a controlled group of corporations as a result of an acquisition or disposition, the coverage rules will with respect to the plan maintained by the person or group, be deemed satisfied during a transition period provided that the rules were satisfied immediately before the acquisition or disposition and the coverage under the plan does not change significantly during the transition period other than because of the acquisition or disposition. The transition period is defined as the period beginning on the date of the acquisition or disposition and ending on the last day of the first plan year beginning after the transaction. Thus, an employer may have between one and two years after a sale to redesign its benefit plan to comply with the new coverage requirements depending on when the sale occurs.

The ZZ corporation is a good example for showing how a plan that previously qualified under the coverage rules now has a problem qualifying. ZZ corporation maintains five different pension plans and let's assume for this purpose that ZZ corporation does not have separate lines of business which qualify under Section 414(r) and that none of the plans may be aggregated for purposes of complying with the coverage rules because of the disparity and the benefits provided under the plans. The hourly pension plan which covers 100 participants, all of whom are non-highly compensated, will comply with the coverage rules because it covers only non-highly compensated employees. XY pension plan which covers 90 non-highly compensated participants and five highly compensated participants will satisfy the ratio test because the percentage of non-highly compensated employees participating in the plan exceeds the percentage of highly compensated employees participating in the plan. The real problem lies with respect to the salaried pension plan, the salaried 401(k) plan, and the salaried Employee Stock Ownership Plan (ESOP). These three plans were able to comply with the coverage rules prior to 1989 by squeezing by under the old classification test. However, the three salaried plans will not qualify under the new average benefits percentage test because the benefits provided under the salaried pension plan, the salaried 401(k), and the salaried ESOP far exceed the benefits offered under the hourly pension plan and the XY pension plan and the percentage of highly compensated employees participating in the three-salaried plans, is far in excess of the percent of non-highly compensated employees participating in the three-salaried plans. Furthermore, the salaried plans will not satisfy the ratio test because the percent of non-highly compensated employees participating in the plans, 61.22%, is less than 70% of the percent of highly compensated employees participating in the plans. Therefore the coverage rules will not be satisfied. This, I should mention, too, is a real-life situation.

The sanctions for failure to comply with the Internal Revenue Code 410(b) coverage rules have been modified by the TRA-86. Under the new rules, highly compensated employees will be taxed on the full value of their vested accrued benefits rather than simply being taxed on employer contributions made to the plan after the loss of the plan's qualified status as was the law prior to 1989. Non-highly compensated employees, however, will not be taxed on employer contributions merely because the plan fails to satisfy the coverage requirements. The other sanctions applicable under prior law have not been changed. Thus, in the event of disqualification, the trust will lose its tax exempt status and the employer's tax deductions for contributions made after the plan ceases to qualify will be disallowed except to the extent that the employees are vested in such contributions. Thus, an employer who maintains a plan which flunks the coverage rules will either have to terminate the non-qualifying plan or comply with the coverage rules, either add

additional non-highly compensated employees to the non-qualifying plan or reduce the benefits provided to highly compensated employees under the plan, or last, increase the benefits provided to non-highly compensated employees under one or all of the employer's plans.

MR. LALL BACHAN: I took a very narrow look at these two sections from the point of view of the multiemployer plan. Let's first take a look at Section 401(a) 26, the minimum participation rules. As you know, under these rules, the plan must cover the lessor of 50 employees or 40% of all employees. You also know that these participation rules do not apply to collectively bargained employees covered under a multiemployer plan. This is clear. However, multiemployer pension plans often cover non-union employees and they must comply. When this first appeared in TRA-86, everyone thought this was a mistake and that this would be corrected. However, Technical Correction and Miscellaneous Revenue Act of 1988 (TAMRA) did not do it and the proposed regulations affirmed that multi employer plans must comply. So, if a multiemployer plan includes only collectively bargained groups of employees and these employees are not professionals, there is virtually no testing to be done.

Often, however, employees of the union such as a business agent are included in the multiemployer plan, and it is not uncommon for employees who work in the office which administers a plan to also be included in a multiemployer plan. It is in this respect that the employer of these employees must have this test met. If a problem exists, it could be corrected by either extending coverage to all employees of the offending employer or eliminating coverage for those who are now in the multiemployer pension plan. This may not be so easy.

Consider a case of the merger of two pension plans. As you know it's not so uncommon these days for even unions to merge. Let's say that the staff of each union was participating in different multiemployer pension plans. While the unions have merged, the pension plans remain separate. Let us say, in addition, that benefits under one pension plan are much greater than the benefits under the other, and so are contributions. This could pose a major problem.

This same scenario could be played out for the employees of the Fund Offices because plans may not be aggregated to meet this requirement, there may have to be a transfer or consolidation of membership to satisfy this section. So to which plan should the employees be shifted? What happens to contributions? What about the different benefit levels? A little bit more obscure but nonetheless important issue is a situation where there are people who move out of bargaining unit positions but are allowed to participate in the multiemployer plan. Such people might be those who become foreman or people who go into business for themselves. The multiemployer plan could simply eliminate coverage for these people. However, in certain areas, allowing these people continuity of coverage is what assures a stable base of contribution support for the plan as the union members alternate on a regular basis between working for others and taking jobs on their own (that is, working for themselves).

Another sort of obscure issue is raised by paragraph (d)2(iii) of this section. This paragraph cancels out the multiemployer exemption for employees covered by a collective bargaining agreement if more than 2% of those participating under the collective bargaining agreement are professionals and they define professionals as including actuaries, attorneys, accountants, and "executives." An executive is not defined but it makes some sense to limit this to highly compensated employees if possible. The proposed regulations indicate that individual collective bargaining agreements will be affected by this test, however, rather than the employer. While this could pose a problem, I suspect that few if any collectively bargained people covered by multiemployer plans will satisfy the professional classification.

The proposed regulations generally allow employers to elect whether or not to count collectively bargained employees in applying the test to its non-collectively bargained employees and vice versa. However, that section seems to require that collectively bargained people covered by multiemployer plans be disregarded in applying the test to the non-collectively bargained employees of that employer who will cover in the same multiemployer plan. That is the non-collectively bargained employees must be tested separately. Let's take a look at Section 410(b) Coverage Requirements and its possible application to multiemployer plans.

As you know, this section of the code was designed to ensure that an adequate number of non-highly compensated employees have coverage if any highly compensated employees do. In the old days, before tax reform, a plan could meet the requirements of this section if it satisfied

either of two different minimum coverage tests for qualification: the percentage test or the classification test.

As a result of tax reform, more stringent tests were reintroduced. Again, Liz described these tests. If these new rules were applied in the same way as prior to tax reform then multiemployer plans would have no trouble passing. However, the legislative history of the TRA-86 raises questions about whether the IRS will continue to apply the coverage requirements in the same way. Section 410(b) itself both before and after tax reform provides plans with an exclusion from having to consider employees covered by a collective bargaining agreement. However, it also states that the exclusion of collectively bargained employees shall not apply with respect to coverage or employees covered under a plan maintained pursuant to a collective bargaining agreement. This could mean that collectively bargained plans must consider employees outside the plan for coverage testing. Such an interpretation would create a great burden of data gathering for multiemployer plans. As you know, multiemployer plans by definition include more than one employer, and in many instances, hundreds and maybe even thousands of employers. In the past, the IRS had recognized the futility of applying the coverage rules in this way, amid clear deregulations under Section 413, that bargained plans do not have to take into consideration employees who are not in the bargaining unit for which benefits are bargained. As a result, collectively bargained plans have had little problem passing the coverage test.

Now legislative history to tax reform calls these long-established rules into question and implies that collectively bargained plans must take into consideration employees outside the bargaining unit. The legislative history does not have the force of law and appears intended for single-employer collectively bargained plans. Nevertheless, there is concern that the IRS may take this legislative history as requiring a revision of the rules under Section 413. Such an interpretation would be disastrous for multiemployer plans. The funds do not control the employers and the employers do not control the funds. As a result, the data-gathering requirements and actions necessary to bring a plan into compliance would be almost impossible to accomplish. We are hopeful that the IRS will reaffirm its prior position in applying these rules to multiemployer collectively bargained plans. If the IRS follows the literal interpretation of the legislative history, we see major difficulties. Multiemployer plans will be required to gather pay and benefit information on employees outside of the bargaining unit for each employer. In order to pass a 70% test, all of the employer's plans will have to be shown to be comparable or the average benefit test will have to be applied. It is highly unlikely that employers will be willing to share data on other plans especially data regarding plans of another employer within the same controlled group. Multiemployer plans will have to identify highly compensated employees of each employer.

It is likely that the employer may have a different plan year from the multiemployer plan. This means that the multiemployer plan could not simply use the data on highly compensated employees which have been compiled for the employer's own testing. Employees who switch employers may be highly compensated employees of one employer but not the other. It will be near impossible to identify an employee who becomes a highly compensated employee after he or she has stopped participating in the plan. It is not clear whether the collectively bargained plan should take into account other collectively bargained plans in which employees of an employer participate. If it must do so, this will present another data-gathering problem.

On the other hand, if collectively bargained plans were tested separately so that each collectively bargained plan is tested with the non-bargained employees, the plans of the high-paid trades may fail because the employer was not able to take into account the contributions made into more broad-based collectively bargained plans such as the laborers. Should there be by employer testing or plan wide testing? In employer by employer testing, the test would be limited to employers with highly compensated employees and thus would not require the gathering of data for more employers. However, a plan wide testing may permit all plans to pass a test. But if a plan fails a test, it may be difficult to tax only a specific employer's portion of the plan's assets. It seems impractical to apply these rules to multiemployer plans because there is no reasonable way to bring these plans into compliance under this rule.

If a plan fails a test, the multiemployer plan will not be able to remedy the situation by extending coverage to new groups of employees since this is a decision to be made by the contributing employer. Plans will not be able to compile the information until after the end of the plan year, and at that time, it will be too late to expel the offending highly compensated employees. Finally, if coverage cannot be expanded, it seems hardly justified to disqualify the entire plan because of

a few highly compensated employees. If the IRS does not reaffirm the objectability of Section 413(b), there will be many questions that the IRS will have to answer before we can apply these rules to multiemployer plans.

MR. SEGAL: I think it's fair to say that even though the TRA-86 has been around for almost 2.5 years now, we still find ourselves in the position of presenting a session such as this one; we're really taking up most of our time talking about the problems as opposed to describing what the code says. Let me speak a little bit about comparability, one of my favorite subjects.

Prior to the TRA-86 and basically through the 1988 plan years, the bible to comparability was Revenue Ruling 81-202 as modified by 83-110. The concept of comparability was to determine a normalized benefit as a percentage of compensation and show that for your high-paid person, the normalized benefit is the percentage of compensation that did not exceed the benefit for the lower-paid person. Theoretically, you were supposed to test each of these in the worst possible case that no highly compensated employee (or what we now call highly compensated employee, because at the point comparability was introduced, the concept of highly compensated employee did not exist) would receive a normalized benefit that would exceed the lowest benefit of any non-highly compensated employee. However, in doing these tests, you were permitted to band by salary.

The basic concept was that you could do this comparison either on a contribution basis or a benefit basis and that everything was supposed to be compared in terms of a life annuity payable at age 65. Therefore adjustments have to be made for form of annuity, for retirement age, for death benefits before retirement, and for disability benefits. The comparison was to be made on the employer-provided benefit. This comparison could be made on a flat benefit basis where you are looking at the gross normalized benefit as a percentage of compensation or on a unit benefit basis where you would be looking upon the benefit or contribution made per year of service. The way it was constructed, there were 13 possible ways of doing the comparability. You were also permitted to attribute the Social Security benefit in any number of ways. When you put all the combinations together, you really had 13 ways of doing it depending upon whether you count the years of service, years of participation, whether you did it with our without Social Security, and which Social Security base you were using. And, as I say, you could then group by salary. This was a very important concept prior to TRA-86 and many actuarial meetings, typically EA meetings, discussed the question of how wide do the bands have to be. The IRS never gave an answer.

Probably the biggest fault with comparability was that it was done without any salary scale, such that a 1% career average plan could be proved to be exactly comparable to 1% final pay plan and I don't think there is anybody here who would agree that those two plans are comparable.

Now we have the TRA-86, and what I call two types of comparability: the 70% comparability and the 100% comparability. Liz spoke about the average benefits test where you have to prove that the average benefit for the non-highly compensated employee is at least 70% of the average benefit for the highly-compensated employee. This is basically doing comparability similar to the way it was done under 81-202 using two huge salary bands, the non-highly compensated and the highly compensated. The committee reports talked about some modifications that should be done in this new son of 81-202. They talked about recognizing the form of annuity which is the same, the retirement age, the existence of a pre-retirement death benefit or disability benefit. They also talked about recognizing any differences in vesting which a good actuary would have recognized before. They talked about recognizing differing rates of accrual which again a good actuary should have recognized under the old rates and they even talk about recognizing the availability of optional forms which is very interesting. Under the old rules, the IRS insisted that the same optional forms be available in the two plans that you were comparing. This topic was discussed at the EA meeting about a year ago and at the Society meeting in Anaheim about a year ago.

Since then we've heard absolutely nothing about what the new comparability is going to be. About the only thing we've heard is that when the 410(b) regulations come out, they will not address how comparability is to be done for the average benefits test, but they are saving this for the 401(a)4 regulations which are the basic non-discrimination regulations. That's where what I call the 100% comparability comes in because in order to combine two plans for purposes of testing non-discrimination, or in order to combine two or more plans if you want to test under 410(b), the eligibility and coverage, you have to prove that the plans are comparable, and that's

what I call 100% comparability. What we did learn last year was that the IRS is thinking of instead of doing groupings by salary bands, they were going to be looking at groupings by the unit percentage bands. If you had a normalized benefit that was 2% for a unit, 2% of compensation for that year, they might permit you to group the 1.9 and the 2.1 in with the 2.0, but then within that specific band, what was the percentage of highly compensated, and the percentage of non-highly compensated and then you would have to do this for all the bands. This is about the limit of our knowledge on the new comparability to date. It will be very interesting to see what the regulations finally say because I don't know what will happen if, for example, you get into a lower percentage band, such as the 1.4 band that has only highly compensated employees. Does this mean your plan's discriminatory because there are no highly compensated employees getting a low benefit? In terms of imputing Social Security, I think it's fairly obvious that the imputation of Social Security will be totally consistent with 401(l); that you'll be imputing probably .75%, .70%, or .65% of covered compensation per year of service subject to the 2-for-1 rule. So I think we could take that fairly safely. So again this leaves us in the position of having these wonderful regulations on 410(b) or the code on 410(b) with broad knowledge as to what it is but we don't know how to do the tests or what the details are. It's further complicated by the fact that under the proposed regulations under 401(l), the new integration regulations, if you don't satisfy 401(l) you can still qualify and prove non-discrimination by proving it under 401(a)4, for which we have no regulations. And even if you do satisfy 401(l), you still may fail 401(a)4.

Comparability can take into account differences in availability of optional forms such as vesting. Yet at the same time, we are told that the availability of the optional forms, different vesting, different rate of accruals, which can be recognized in comparability, also creates separate benefit structures which must be tested individually under Section 401(a)26 to satisfy the 50/40% rule. It's just going to make our work much more interesting and fun in the future.

MS. KING: I have an example in the office that I thought might be good as a description of a problem in how the new 401(a)26 rules really hurt small businesses. I have a client that is a small textile business with 20 employees. They were acquired in the Fall of 1988 by a large conglomerate which has both foreign and U.S. corporations. The U.S. corporations are in the retail business and employ about 150 employees. Now my textile business has a very rich target benefit plan which was designed principally for the founder of the business who earns more than $200,000. However, the company covers employees of all salary ranges from about $15,000 up to the over $200,000 amount of the founder. However, contributions under this target benefit plan range because it's a target benefit plan from 3% to 15% of pay. The three U.S. corporations of the conglomerate in the retail business, maintain a 401(k) plan which simply has a salary deferral feature and a 50% match up to the first 6% of deferrals. Because the textile business employs less than 50 employees and its target benefit plan would cover fewer than 40% of all U.S. employees of the entire control group, the target benefit plan will now no longer comply with 401(a)26. Because the textile business employs fewer than 50 employees, even though it's in a totally separate kind of business from the retail corporations, you cannot take advantage of the separate line of business exception. I tried to see if I could use some of the exceptions in the 401(a)26 regulations. There is one exception which says that a plan which doesn't cover any highly compensated employees is exempt from the 401(a)26 requirements. However, the way the exception is worded, it provides that no highly compensated employee can be now or ever in the last five years a participant in the plan or in a predecessor plan. Therefore, even if I take the founder and all other highly compensated employees out of the target benefit plan, I still can't keep the target benefit plan in place under this exception because the founder will have been in the plan in previous years. There is another exception that I thought that I might try to use which says that if you have a separate benefit structure in a plan that complies with 401(a)26, but the separate benefit structure doesn't cover highly compensated employees, the separate benefit structure will be deemed to satisfy the 401(a)26 rules. So then I thought, well, I can terminate the target benefit plan, give up on the target benefit plan, but I'll see if I can add additional contribution provision just for my textile employees and I won't include the founder in this provision. Take him out entirely from all qualified plans so that the only employees in this separate benefit structure under the 401(k) plan will be the non-highly compensated employees of the textile business. However, this exception requires that the plan comply with 410(b) and 401(a)(4), which wouldn't be a problem but also requires that I test the plan without regard to the separate benefit structure for this separate group of people under the alternative benefits test. This would mean testing the plan every year under the alternative benefits test to see if I could keep the separate benefits structure in for this small group of 10 or 15 employees who are working at the textile business and it doesn't become practical to have to test every year so I gave up on that idea. So basically I'm left with having to

terminate the target benefit plan. We may be able to comply with one of the transition rules and wait until the end of 1989 to terminate it rather than having to terminate it by May 31, but we will have to terminate the target benefit plan. A certain number of employees of the textile business going into the 401(k) plan will suffer a substantial reduction in their pension benefits and I'll have to set up a non-qualified plan for the founder.

MR. SEGAL: In discussing that particular situation, this alternative was offered. What if you spin-off the founder into a separate plan and then terminate his plan because it doesn't satisfy 401(a)(26). Could you then keep the remaining plan, the plan for the remaining textile employees as it consists of only non-highly compensated employees or do you still run into that trap? Is it considered a predecessor plan where you had the founder in there who was highly compensated or can you say OK he's been spun off, I now have two separate distinct plans and with respect to those remaining plans I now don't have nor have I ever had any highly compensated employees in the plan? I don't know.

MS. KING: I think that there would be a problem there because I think that the argument would be made that prior to the spin-off, it had been one plan and the founder had been in the plan at that point and during the previous five-year period there had been a highly compensated participant.

MR. SEGAL: Even though my spin-off is effective the first day of the 1989 plan year?

MS. KING: Yes, because it's a question of whether you are currently a participant or in any of the five preceding years had been a participant in the plan.

MR. RIAN M. YAFFE: Address yourself, if you would please, any of the panelists, to a situation with exclusively single-employer plans but several of them or one or more covering employees in collective bargaining groups but they are all single-employer plans. How do the coverage rules impact on that kind of a situation?

MS. KING: First thing, under 401(a)(26), if the collectively bargained plans do not cover any highly compensated employees, and never did, then you'll probably qualify under that exception. Also, there's a rule in 401(a)(26) that you test collective bargaining plans separately; that you do not take into account employees who are not in the particular local that is maintaining the plan or the employees who are covered under the plan. So I think in many collectively bargained single-employer plans you won't have a problem with 401(a)(26).

MR. YAFFE: So in the plan or plans covering non-collectively bargaining employees you would exclude, as I think we always have in the past, the bargaining unit plans.

MS. KING: That's correct. You do exclude union employees when you are testing under 401(a)(26) and 410(b) non-union plans.

MR. SEGAL: And if for some strange reason you had more than one of these groups under one plan document, you would be testing them separately as separate benefit structures.

MS. KING: That's right. It is common to have different locals in the same plan with different benefit formulas for the different locals.

MR. MICHAEL E. CALLAHAN: If you had three separate locals under one multiemployer plan, and each one of the locals had different contribution rates, you would be looking at three separate benefit structures and at that point would we have a problem with the coverage requirements? I wasn't quite sure.

MS. KING: Well, in the single-employer situation where you have a union plan with different locals with different benefit structures, as I said, the regulations say that you test each benefit structure with respect to a particular local separately. So therefore each would be tested separately and you wouldn't have to take into account the employees who are not covered under that particular local.

MR. CALLAHAN: That's in a single-employer plan. How about a multiemployer plan?

MR. SEGAL: My reaction to that is it's one multiemployer plan, separate collective bargaining agreements with the different locations; I would assume that the separate collective bargaining agreements have separate contributions which identify separate benefit structures and therefore each one would be tested by itself, excluding the other collective bargaining agreements. What do you think about that, Lall?

MR. BACHAN: Well, I hope that's not the way it is. It's quite common for multiemployer plans to have separate contribution rates and different benefits. We also have situations where you have different contribution rates with the same benefit structure.

MS. KING: I'm not sure I understand what the problem is. If you are testing the employees under each collective bargaining agreement separately to the exclusion of all other employees and you are covering, all employees in that local, in the plan, why would you have a problem under 401(a)(26) or 410(b)?

MR. BACHAN: I guess you're saying that there is a collective bargaining agreement test.

MS. KING: Yes.

MR. BACHAN: Rather than a plan-wide test.

MS. KING: In the 401(a)(26) regulations, there is a provision that says it's by collective bargaining agreement.

MR. SEGAL: I found it in a 401(a)(26)-4(b)(4) statement. This rule may be applied separately with respect to each collective bargaining agreement.

MR. CALLAHAN: One other question that I just wasn't clear on. You mention that the 401(a)(26) tests had to be met on a 401(k) plan in respect to the elective contributions, after-tax voluntary contributions and the matching contributions. You mean just for eligibility purposes at that point, not for actual utilization?

MR. SEGAL: Yes.

MR. ROBERT E. CIRKIEL: Another question about benefit structures is about an actual situation where we have a controlled group of companies with the singular defined contribution plan, but each separate group allows one of the investment choices to be the stock of that particular company within the controlled group. Is that a separate benefit structure?

MR. SEGAL: I believe that the individual investment discretion of the defined contribution plans does not make it a separate benefit structure.

MR. CIRKIEL: Except that the employee of Company B can't elect stock in Company A.

MR. SEGAL: In that case I think it's a separate benefit structure.

MS. KING: It may be a separate benefit structure then if they are excluded from participating in one of the investment options.

MR. SEGAL: I think that would be similar if the employees of Company A could select, let's say funds A and B and Company B had funds C and D, that would give you two benefit structures.

MR. CIRKIEL: That's what we think also.

MR. CURTIS HARRIS, JR.: You mention that there are certain permitted differences in a single benefit structure. Let's say I have a plan where my crude benefit is on a projected prorated basis. There is a 20-year cap on the service, and because of the new integration regulations I am allowing m[illegible] retirement age under the plan to be 67 and therefore each of the individuals with their Soc[illegible]curity normal retirement age would have to have adjustments in their benefits

because of permitted disparity. Do I have one single benefit or do I have three different benefits for purposes of 401(a)(26)?

MR. SEGAL: Just to repeat it, your normal retirement age is now going to be 67?

MR. HARRIS: Right, and the reason I have to do that is that since I have this projection proration in terms of accrued benefit, that's going to be a deferral age for all benefits. But actually for each individual you are prorated over a different period of time.

MR. SEGAL: That's a permitted difference. In other words, they permit differences in age and service. In the general case, if you are saying the accruals are prorated over the total period of service somebody's got 20 years, somebody's got 30 years, that's considered one benefit structure. I think you may have a problem with respect to an age 67 normal retirement age because ERISA still says 65.