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ELIGIBILITY, COVERAGE AND PARTICIPATION RULES UNDER TRA 86

Moderator: JOHN E. BARTEL
Panelists: CAROL D. GOLD*
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Recorder: EDWARD L. BARAD

- o Review of:
  - -- Proposed Reg. 1.401(a)(2b) -- Minimum Participation Rules
  - -- Proposed Reg. 1.410(b) -- Minimum Coverage Requirements
- o Preview of Proposed Reg. 1.401(a)(4) -- Discrimination Comparability, etc.
- o Effect the above have on plan design and other practical problems encountered by plan sponsors
- o Time will be allotted for questions from the floor.

MR. JOHN E. BARTEL: One of the issues that was on the agenda for discussion was the review of Section 401(a)(4). We will probably not be delving into 401(a)(4) primarily because although the regulations have been drafted, they are still in the process of advancing through the approval procedure and it's not clear when they will be issued.

I would like to summarize the sequence of events. Initially back on October 22, 1986, the Tax Reform Act of 1986 was signed into law. The next date that is particularly crucial is February 1, 1988. That was the date that regulations were to have been issued dealing with the Tax Reform Act. Prior to February 1, there were some regulations issued on a variety of topics, none of which were the essence of what we are going to be talking about. After February 1, 1988, the next important date is December 13, 1988, when IRS Notice 88-131 was issued. That Notice provided some compliance relief for plan sponsors. The next date of importance was February 14, 1989 when the 401(a)(26) regulations were issued. Next, May 18, 1989 was the date that the 401(a)(26) regulations were modified. It was also the date that the proposed 410(b) regulations were issued. Subsequently on August 14, 1989 IRS Notice 89-92 was issued which further extended the compliance date. The situation that a lot of us are in is that we have a fair number of questions and very few answers.

Our first speaker on 401(a)(26) is a lawyer from the Washington, D.C. area, Evelyn Petschek. Evelyn is a partner in the firm of Patterson, Belknap, Webb Tyler.

MS. EVELYN A. PETSCHEK: As John indicated, I am going to discuss Section 401(a)(26), which was added to the Internal Revenue Code as part of the 1986 Tax Reform Act. The IRS proposed regulations on February 14 and proposed certain modifications to the proposed regulations with the 401(b) regulations that came out on May 18. The regulations indicate that they may be relied on pending the issuance of final regulations, and that to the extent the final regulations are any more restrictive than the proposed regulations, they will be imposed prospectively only. One additional note on the proposed regulations: On October 30, there will be a hearing with the IRS. I think there are a number of people who have requested the opportunity to speak with regard to the 401(a) (26) regulations. If you look at 401(a)(26) in the Internal Revenue Code it looks very simple. It is. It is one basic rule that is couched in the alternative. There are five special rules that are applicable in the application of that rule, and there is a broad grant of regulatory

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authority to the IRS. To go briefly through the statutory framework in a bit more detail, 401(a)(26) requires that in order to meet the 401(a) qualification requirements a plan must, on every day of the plan year, benefit the lesser of 50 employees of the employer or 40% or more of all employees of the employer. If a plan, as it is defined for purposes of 401(a)(26), fails to meet these minimum participation requirements, the entire plan will fail to meet the qualification regulations. There is no aggregation of plans that is permitted under 401(a)(26) as there is in other areas like 410(b). Each plan independently on its own must meet these regulations. The special rules that are provided in the statute are as follows.

The first special rule relates to which employees are excludable for purposes of 401(a)(26) testing. These include union employees, the ever-present airline pilots and nonresident aliens, and certain employees not meeting the minimum age and service regulations. We will get into those rules in a bit more detail later.

The second special rule relates to multiemployer plans and provides that, except to the extent provided in regulations, 401(a)(26) will not apply to multiemployer plans.

There is a third special rule for corporate transactions which piggy-backs on the 410 rules and provides for a special post-acquisition transition period.

The fourth special statutory rule provides that at the election of the employer, and with the consent of the Secretary, Section 401(a)(26) may be applied to separate lines of business of the employer. The last special rule relates to police and firefighters.

As I indicated, the last part of the statute delegates to the Secretary of the Treasury, a broad regulatory authority to provide that any separate benefit structure, any separate trust, or any other separate arrangement may be treated as a separate plan for purposes of 401(a)(26) testing. Legislative history is quite clear in indicating that Congress intended that the term "plan" be interpreted in such a way as to carry out the purpose of the new minimum participation rules. In terms of wending one's way through 401(a)(26) testing, I've sort of broken it down into 9 simple steps.

First, you need to determine what a "plan" is for Section 401(a)(26) purposes.

Once you've determined what the plan is, the second step is to determine whether or not that plan is exempt from testing. If you have a plan that is exempt, as provided in the regulations, you can forget about the rest. But most plans, I think, will not be exempt.

With respect to each plan that is not exempt from the 401(a)(26) testing, the next step is to identify what your current benefit structure is. I'll go into quite some detail later on what a current benefit structure is. That's really a key concept in these regulations.

Once you have determined what your current benefit structures are, the next step is looking from the perspective of the employer. Identify which active employees and which former employees are excludable under the regulations. There are a number of types and categories of employees, both active and former, that can be excluded when you do your 401(a)(26) testing. Then you go back to looking at your current benefit structure, and with respect to each benefit structure, you need to identify the nonexcludable employees who benefit under the structure. Then you apply the 401(a)(26) tests separately to each current benefit structure for active employees. With respect to each current benefit structure, you also have to identify the nonexcludable former employees who benefit under that structure. Then you apply the tests separately again to each current benefit structure for former employees. Lastly, if you have a defined benefit plan (not if you have a defined contribution plan), you need to identify the prior benefit structure as opposed to the current benefit structure, and apply the specific tests that are applicable to prior benefit structures. Each current benefit structure and each prior benefit structure, with respect to a defined benefit plan, must meet one of the tests set forth in the regulations. If any current benefit structure or if the prior benefit structure does not meet one of the enumerated tests, the entire plan will fail to meet the qualification regulations under Section 401(a).

If the tests are not met initially with respect to a current benefit structure, consideration needs to be given to restructuring the benefit structure or testing based on separate lines of business. I'll discuss the restructuring rule later. If neither of those two alternatives helps you pass the test, then the proposed regulations permit corrective action. Alternatively, you'll need to consider either merging the noncomplying plan into another plan that will, as a merged plan, meet the test, or terminating the plan.

Now go back and put a little bit of flesh on all those rules. As I said, first what you need to do is determine what is a plan. The basic rule is that you look to the 414(l) definition of a plan. There are some rules in the regulations which provide for desegregating plans that might otherwise be considered a single plan under 414(l). First, suppose you have a combination individual account plan and a defined benefit plan i.e., some of the benefits are defined benefit type benefits, but the same plan has a portion of the benefits based on amounts allocated to individual accounts. For Section 401(a)(26) purposes, these must be treated as two separate plans. Another disaggregation rule applies in the collectively bargained plan area. If a plan covers both collectively bargained employees and noncollectively bargained employees, that may be treated by the employer as two separate plans. This rule would appear not to be mandatory, but it can be applied on an elective basis by the employer. Where you have several collective bargaining agreements that apply in the case of one plan, the rule also may be applied separately to each collective bargaining agreement. The third special disaggregation rule applies in the case of employee stock ownership plans (ESOPs). The portion of a plan that is a Section 4975(e) ESOP must be treated as a separate plan from the remaining portion of the plan. There is a special delayed effective date if you have a problem with this rule that will apply for the 1989 plan year. You are not required to disaggregate these plans for the current year, if that's a problem. There is a special rule for plans benefitting excludable employees in the case of a multiemployer plan, a Section 413(c) plan, which is essentially a noncollectively bargained plan maintained by unrelated employers. That sort of plan is treated as being comprised of separate plans with each separate plan being maintained by an individual participating employer. This means that in the Section 413(c) area, each separate unrelated employer is treated as maintaining a separate plan and that separate plan must meet the regulations of Section 401(a)(26), or the entire plan is disqualified. Many times in the 413(c) area, it is difficult for the plan administrator to police compliance. The preamble to the proposed regulations indicates that the Commissioner of Internal Revenue can permit the continued status of the plan for the innocent employers by requiring corrective or remedial action with respect to the offending employer. I think this is generally the position taken by the IRS and most of the regulations as they relate to 413(c) plans.

Moving then to deciding what a current benefit structure is. The statute and legislative history apply the regulations of 401(a)(26) on a plan-by-plan basis. The preamble to the regulations indicates that the IRS has gotten to that point by applying the test to each current benefit structure separately. It could have gotten to the same point by defining each current benefit structure as a separate plan, but instead they have taken the tack of looking to current benefit structures. Basically, a single current benefit structure will exist within a plan with respect to each portion of the uniform benefit formula to the extent that subsidies, optional forms of benefits, and rights and features are provided on a uniform basis to all employees eligible to participate. If any subsidy, optional form, right or feature is not provided on a uniform basis, two or more single current benefit structures will exist. Where an otherwise single current benefit structure is included in separate plans, as plan is defined for 401(a)(26) purposes, it will be treated as a separate benefit structure that must separately comply with 401(a)(26). A benefit structure is considered to be a current benefit structure whenever there is an allocation or an accrual of a benefit during a plan year. That can occur because of an accumulation of additional years of service. It can also occur where changes in compensation are taken into account currently. A uniform benefit formula is pretty narrowly defined. The regulations define a uniform formula as one where all features affecting the availability of the benefit and the amount of benefits or contributions to be taken into account are uniform. The regulations do provide for a number of special situations where, although there is some variation in the benefit formula, it will not be considered to fail to be a uniform formula.

The first special rule is that a benefit formula will not fail to be uniform because the rate of contribution allocation or benefit accrual varies on a uniform basis for all employees with years of service, with years of participation, or varies with entry age.

Secondly, a benefit formula will not fail to be uniform because the rate at which benefits accrue, above a stated compensation level, differs from the rate at which benefits accrue below a stated compensation level. This special rule will apply for 401(a)(26) purposes regardless of whether or not the formula satisfies the requirements of 401(l).

As a third special rule, a benefit formula will not fail to be uniform merely because it provides an employee will receive the greatest contribution allocation or benefit accrual produced under one of several formulas, provided the various formulas are reasonably available to all employees. So if you have a plan that provides an employee will get the greater of Formula A, Formula B, and Formula C, that does not fail to be a uniform formula provided all employees have the same possibility of having the greater of A, B, or C. A benefit formula that makes an allocation based on account balances will not fail to be uniform. Ad hoc costs of living adjustments benefitting former employees will not fail to be uniform merely because of differences that reasonably and on a uniform basis take into account cost of living increases which have occurred after the employee retired and/or after their benefits have commenced.

There are some special rules also relating to uniform subsidies, optional forms, rights and features. Basically, a subsidy, optional form of benefit, right or feature is considered uniform if all participants are eligible to benefit. Where a subsidy, optional form, right or feature is conditioned on a certain fact or occurrence, the determination of whether a participant currently benefits is determined on the basis of the employee's current facts and circumstances. There are two exceptions to that rule:

- Age and service conditions are generally treated as satisfied for purposes of the foregoing rule. While the uniform subsidy rule appears to require that most forms of early retirement windows are tested separately for 401(a)(26) purposes, all those who fall within the age and service condition will be treated as benefitting.

- Conditions requiring termination of employment, death, satisfaction of a particular health condition, disability, hardship, etc., are considered satisfied when you are determining whether or not the right, feature, or subsidy is uniform. There are roughly eight or so special rules that apply.

The first special rule relates to plans subject to 401(k) and 401(m). Any differences that exist in the availability or the maximum rights of salary reduction contributions subject to 401(k), after tax employee contributions subject to 401(m), or matching contributions subject to 401(m) would give rise to an additional benefit structure that will need independently to satisfy 401(a)(26). In addition, the regulations segregate each of those provisions into separate plans so that if you have a 401(k) plan that has matching contributions, that will be two separate benefit structures requiring independent satisfaction of 401(a)(26), even if the provisions have uniform applicability. However, if an employee is eligible to contribute or have a contribution made on his or her behalf, he'll be treated as benefitting under the provisions for purposes of 401(a)(26) even if he or she does not elect to participate.

Where a plan contains the required top-heavy provisions, the plan will not be considered to have a separate benefit structure merely because it includes a formula that provides top-heavy contributions or benefits to nonkey employees.

There is a special rule relating to contributions during total disability. A separate current benefit structure will generally not result where contributions are made on behalf of nonhighly compensated employees who are permanently and totally disabled.

There are special rules relating to grandfathered benefits. A defined benefit formula under which a participant will not accrue any additional benefits under a current formula until he or she has accrued a benefit under the current formula in excess of the benefit under a prior formula which is based wholly on prior years will not give rise to a separate benefit structure.

If you have a right or a feature, for example, a loan provision, that is eliminated prospectively, a current benefit structure will not result merely because the right or feature remains available with respect to the benefits that were accrued as of the date the right or feature was eliminated.

There is another special rule for retroactive benefits. A retroactive benefit increase with respect to active employees in the current year, as well as benefit increases in the current year provided to former employees, will result in one or more current benefit structures for the year in which the increase is provided. It's not a benefit structure with respect to the year for which the benefit is provided, so, if you are giving someone a current contribution or accrual attributable to a prior year, it is a current benefit structure in the current year.

The regulations also provide two special facts and circumstances rules which are basically designed as an anti-abuse type situation. They look to the facts and circumstances under the plan and determine if an arrangement, whether inside the plan or outside the plan, has the effect of creating a current benefit structure. If it does, the regulations provide the Commissioner to find that a current benefit structure exists.

Earlier, I mentioned if you test 401(a)(26) based on those structures that you have identified as being current benefit structures, and if you flunk the 401(a)(26) test, there is a possibility of restructuring your current benefit structure. It provides the employer with the option of *restructuring the formula for purposes of testing, but for no other purpose.* The restructuring option is available only if the formulas are identical in all respects, but provide for different rates of accrual or contribution allocation. It permits you to treat as one benefit structure those portions of the formula that are common to each of the formulas, and a second benefit structure as those portions that are not common. Probably the best way to illustrate this is by way of an example.

Let's say you have an employer who has 200 employees. Thirty of those employees under one plan are provided with a contribution of 5%. The remaining 170 employees are provided with a contribution of 7%. If we were to test the 5% contribution and the 7% contribution separately, the 5% contribution that applies only to thirty employees would fail the test. The restructuring provision permits us to look at the plan as one benefit structure that provides a 5% contribution to all 200 employees, and a second benefit structure that provides an additional 2% for 170 employees. So by restructuring the plan in this fashion, you come up with two benefit structures that will satisfy 401(a)(26).

As I indicated, you also have to identify prior benefit structures. Only defined benefit plans have prior benefit structures. This means that you can maintain a frozen defined contribution plan without regard to the 401(a)(26) regulations. Each defined benefit plan has one prior benefit structure and that benefit structure is all those benefit structures that were current benefit structures under the plan or under any other plan that are taken into account at any time for determining an employee's benefit under the plan.

Now that we have identified what our current and prior benefit structures are, the next step is to really identify those employees who benefit under the current benefit structure. The regulations indicate that an employee will be considered as benefitting only if he or she accrues the maximum benefit that is available to such employee or in the case of a defined contribution plan, receives a maximum allocation for that plan year. If you have a defined benefit plan that requires a mandatory employee contribution, the fact that an employee does not make the mandatory contribution will cause the employee not to benefit under the current structure.

There are a number of special rules. One special rule permits certain partial benefit accruals to be considered as a maximum benefit accrual. As I mentioned earlier under 401(k) or 401(m) tests, eligible employees are considered to benefit even if they do not actually elect to participate. If you have an employee who is subject to the Section 415 limitations, that will not cause the employee to fail to meet the maximum benefit accrual rule. Similarly, uniform benefit limits such as a cap on the years of service will not cause an employee to fail to be treated as having met the maximum accrual rule. And there is a special minimum service accrual rule that is a little bit tricky. If you have an employee who is eligible but who does not meet minimum service accrual rules or year-end participation requirement, that employee will be treated as not benefitting under the plan. However, if the participant fails to accrue maximum benefits because of a minimum service requirement, or because of a last day of the plan year requirement, if that employee terminates service with less than 500 hours, he does not need to be counted. For the 1989 plan year there is a special rule that would replace the 1,000-hour rule for the 500 hour rule.

It is also important for 401(a)(26) to determine which employees are excludable. By and large these are the same exclusions that are available under Section 410 and so I will defer to Carol to give you a greater explanation of those rules.

There are two more special rules that I will just briefly mention. There is a special rule for government plans during an initial five-year window period that essentially deems governmental plans to be in compliance with 401(a)(26) during that transition period. And with respect to former employees there is a special 401(a)(26) rule that permits you to exclude them if the value of their vested accrued benefit is less than $3,500.

So, now we have identified our current benefit structures. We have identified, with respect to each of those structures, which active employees benefit under the structure and which former employees benefit under the structure. We now go to testing.

As I indicated, a plan must meet the regulations of 401(a)(26) on each day of the plan year. The tests very briefly are as follows.

First, as to active employees, as to each current benefit structure, you must have 50 employees benefitting under the structure or if a lesser number results, 40% of the active employees of the employer. Similar tests apply separately to former employees. But remember with respect to former employees, we are testing a current benefit structure. A current benefit structure will exist only where there is an additional accrual or allocation during the current year. There is a special 20 employee, 40% test that will apply if you meet the minimum nonhighly compensated tests and the minimum participation tests that are spelled out in the regulations. Basically, this special 20 employee, 40% test is helpful where a current benefit structure benefits those who are primarily nonhighly compensated employees where that structure is included in a plan that provides meaningful benefits for at least 50 employees. There is a special nonhighly compensated employees test. Basically, a current benefit structure will be deemed to satisfy the 50 employee, 40% test for the plan year if the current benefit structure benefits no active employee who is or has ever been a highly compensated employee. If you have a controlled group that is a mix of tax-exempt and taxable employers, there is a special 401(k) test that permits you to disregard those employees who are precluded from maintaining a Section 401(k) plan.

As I mentioned earlier, there are certain plans that are exempt from 401(a)(26) testing altogether. Three types of plans need not satisfy Section 401(a)(26).

The first type of plan is a plan for nonhighly compensated employees. There is a different rule that applies depending on whether or not it's a defined contribution plan. For a defined contribution plan, it will be deemed to meet Section 401(a)(26) requirements if the plan is not a top-heavy plan and, for the current year, does not benefit any employee who is or ever has been a highly compensated employee. For that purpose, you can exclude employees who were highly compensated for plan years before January 1, 1984. In the case of a defined benefit plan, an equivalent rule applies except that you look not only to the current year to see if you have a highly compensated employee benefitting, but also you look to the five preceding plan years as well.

Certain multiemployer plans are exempt from Section 401(a)(26). A multiemployer plan that covers only collectively bargained employees does not need to meet Section 401(a)(26) unless more than 2% of the collectively bargained employees are professionals.

The third type of plans that are exempt are certain underfunded defined benefit plans. If you have a defined benefit plan that is frozen and does not include meaningful benefits for sufficient numbers of employees to meet Section 401(a)(26), if the plan is subject to Title four of ERISA, and an enrolled actuary certifies that the plan does not have sufficient assets to satisfy liabilities under the plan, if all benefit accruals have ceased, and if the plan does not rely on this rule for more than three plan years, you need not satisfy Section 401(a)(26).

If you have a plan that fails to meet any of these alternative Section 401(a)(26) rules, the plan may be amended by the last day of the plan year to retroactively satisfy Section 401(a)(26), subject to the anti-cutback rules of Section 411(d)(6). Depending on the nature of the failure, retroactive correction could include expanding coverage under the plan, improving benefits, or modifying the eligibility standards. Plans that are merged will not be treated as failing to satisfy 401(a)(26) because they failed as independent current benefit structures prior to the merger.

As I indicated, you test the prior benefit structure under a defined benefit plan. There are six alternative rules that one can meet. The plan must satisfy only one of these specific alternative tests. The tests have basically been designed to ensure that the plan either provides meaningful current benefit accruals or provides meaningful accrued benefits to a sufficient number of employees. In my experience they are relatively easy to satisfy.

There are some special transition rules that I think are important. First, when you are determining what your current benefit structure is during the 1989 plan year, you need really only concentrate on the bases and conditions that are applicable for determining the contribution allocation, in the case of the defined contribution plan, or the benefit accrual in the case of the defined benefit plan. Thus, most optional forms of benefits, loans, self-directed investment options, ancillary benefits may be disregarded during the 1989 plan year in determining whether or not you have a single or multiple current benefits structure. There is a special relaxation rule for the 1989 plan year again in determining what your prior benefit structure is. There is a special transition rule that permits you to terminate certain plans during the 1989 plan year without satisfying Section 401(a)(26). There are two special transition rules if you have elective deferrals under a 401(k) plan or if you have an early retirement window program. You need to look at the transition rules because you may find some help there. Rumors have it in Washington, and I hope Carol will be able to give us some further insight on this, that the IRS is considering issuing additional guidance that will provide us either with an extension of some of the existing transition rules, and/or some new transition rules that will be helpful.

MR. BARTEL: Our next speaker is Carol Gold, who is a Group Chief with the Project Branch Employee Plans Technical and Actuarial, IRS. Carol is going to discuss the proposed Section 410(b) regulations. She worked with the group that drafted the proposed regulations.

MS. CAROL D. GOLD: I suppose it's obvious by now that coverage is no longer the easy matter it used to be. Coverage is no longer just a matter of providing eligibility to benefits to a number of people. It's a multi-tiered series of hurdles that an employer has to pass in order to maintain a qualified plan.

The first hurdle was just described by Evelyn. It's the 401(a)(26) requirement. That's a threshold. You can't get to the 410(b) test unless you pass 401(a)(26). You can't aggregate plans to meet that test.

The second series of hurdles is provided by 410(b) -- the coverage test.

First we have the ratio/percentage test, which is basically a numerical comparison of the percentage of highly compensated relative to the percentage of nonhighly compensated benefitting not merely eligible to benefit, but benefitting under a plan. If an employer can't prove that the plan passes the ratio/percentage test, there are several options available, and I suppose it depends on the makeup of the employer to determine which path to take next. The employer could combine plans under an old comparability analysis in order to pass ratio/percentage using what we hope will be new rules under 401(a)(4). The employer could pass the average benefits test, which again involves the employer in a benefits analysis, and perhaps the employer will be able to isolate the components of the employer group into separate lines of business. And perhaps that might be the easiest approach for some employers who actually do have disparate groups of employees within the employer-controlled group because that might avoid the benefits analysis that is essential with the comparability analysis or the average benefits test.

The basic operating principles in using the 410(b) requirements or in applying the regulations under 410(b) are what I would like to go through first. What I'd like to do in going through this regulation is to think about it in terms of what the employer needs to know before running the numerical test. First, you need to know what categories you are talking about, what the employee/employer universe is, what the plan is, who the employees are that you count, the ones that you don't count, and then we'll talk about the test.

The employee/employer universe, as a general rule, is applied by using 414(b)(c) and (m) -- controlled groups of corporations and affiliated service groups. That is the employer universe and all employees working for that employer group. A plan is by definition, the 414(l) concept of a plan. It doesn't matter how many plan documents compose that plan or how many trusts are part of that plan. A plan is a pool of assets that is available on an ongoing basis to provide benefits to all participants in the plan. Many people don't think of this as an applicable concept to defined contribution plans. And yet, when you think about the fact that defined contribution plans have at least one valuation date during the year, and benefits may either increase or decrease, and yet an employee may receive a benefit based on that one valuation date, it becomes clear that what you're talking about, even with a defined contribution plan, even with the defined contribution plan that permits participants to earmark their account and invest the assets in their account, is still a 414(l) pool of assets. In other words, if after the valuation date, assets declined in value and everyone came to the window at the same time, there wouldn't be enough for everyone.

Once you have understood what the 414(l) concept of the plan is, then you get to determine under the regulations what must be disaggregated, and there are certain rules for mandatory disaggregation and division of a plan. There is the division of employees from former employees. You also divide those employees who are covered by a collective bargaining agreement and consider them part of a separate plan from those employees who are not covered by a collective bargaining agreement. And with respect to those employees who are covered by a collective bargaining agreement, you separate out those who are covered by different agreements. Those are considered to be different plans. In looking at a plan that's maintained by more than one employer in the case of a multiemployer plan, you look at the bargained employees separately from the non-bargained employees. They are considered parts of separate plans. Then you look at the employees who are covered by the bargaining agreement and determine whether they benefit from a single benefit computation formula. All employees in that multiemployer plan who are benefitting are covered under a single computation formula and are considered employed by one single employer. Nonbargained employees are tested on an employer-by-employer basis as if they were in a multiemployer plan. And a multiemployer plan is tested separately on an employer-by-employer basis with the same draconian result that Evelyn described in the 401(a)(26) regulations; if one participating employer in that multiemployer plan fails to meet the test, the entire plan fails. The preamble to the coverage regulations points out that it's possible that the plan may make some provision for easing out the employer that would otherwise cause the plan to fail.

Again, with respect to the 414(l) concept of a plan, you divide with respect to certain plan features. If only a certain part of the plan is subject to ESOP requirements, you divide the ESOP from the non-ESOP part of the plan. Those are two separate plans. If only a portion of the plan has the availability of deferrals under 401(k), that is a separate plan as opposed to the other part of the plan where employees can't have elective deferrals. This is also true with respect to employer matches under 401(m). You have different plans unless all employees have the availability of matching contributions. Finally, if an employer can establish that it maintains separate lines of business, and the employer maintains a company-wide plan, each separate line of business, each portion of the plan benefitting employees in the separate line of business, is considered a separate plan.

Those are the mandatory disaggregation rules. How about aggregations? You have the separate 414(l) pool of assets. Suppose you want to bring them together. You must bring them together in order to run the average benefits test unless they are plans that must be disaggregated. You may bring those plans together in order to run the ratio/percentage tests or to establish a non-discriminatory classification which is the first step of running the average benefits test. An employer, as we've known for a long time, can designate two or more plans as one plan in order to pass the ratio/percentage test or in order to pass the reasonable classification test. As long as that single plan meets the requirements of 401(a)(4), that's a comparability analysis. And the regulations provide that a plan cannot be aggregated more than once. For example, if you have plans A, B, and C, you can't aggregate A with B and A with C in order to provide that all three plans pass the ratio/percentage test. A plan can only be aggregated with a plan once.

Now once you understand which plan unit you're testing, you have to determine who you're counting. Which employees do you count in running the test? You look at those who are benefitting, not merely those as a general rule who are eligible to participate in the plan. In the case of a defined contribution plan, you're looking at the allocation. If an allocation is available with respect to participants in the plan, they are benefitting under the plan. If there's no allocation, if no forfeitures can be allocated in a defined contribution plan, those who participate in the plan and those who are eligible to participate are considered covered for that plan year. Similarly with respect to a defined benefit plan, if an employee accrues the benefit, he is considered to benefit under the plan. And, if there is no benefit accrual, for example in a frozen plan, then all employees who are benefitting otherwise under that plan are considered to benefit in the frozen plan. However, top-heavy minimums that may be required even in a frozen plan are considered increases. Or increases in compensation in a formula that is based on compensation are considered increases in the benefit accrual and only those who receive them are considered to benefit.

There are certain exceptions to this general rule that you only are considered to be covered by the plan and to count for 410(b) purposes if you actually receive a benefit accrual, and that is with respect to 401(k) plans or matching contributions. The eligibility to defer compensation or the eligibility to receive a matching contribution is all that's necessary to benefit in those types of plans. You don't actually have to defer compensation or have employees defer compensation in order to count them as benefitting, as long as the eligibility is extended to them. Similarly with respect to the 415 limits, we have rules similar to those in 401(a)(26); employees benefit even though they've bumped against the 415 limit and actually don't accrue a benefit in the current plan year. This is not such a neat exception, however, because most employees who are bumping up against the 415 limit are highly compensated and in order to pass coverage, employers may wish that they had fewer highly compensated in the plan who are considered to benefit. As for plan limits, a plan may establish that benefits accrue only up to 30 years of service. Employees who have more than 30 years of service are still considered to benefit under the plan even though they no longer accrue a benefit. And finally, if a plan's benefit is offset by a benefit accrual in another plan, employees are still considered to benefit in the plan whose benefit is offset by that other plan. Many plans have a rule that provides that there will be no benefit accrual until the employee has 1,000 hours of service or perhaps is present on the last day of the plan year. There is no exception for employees who have completed 900 hours of service and don't accrue a benefit. They must be counted in terms of running the tests and they don't benefit, so to the extent they are nonhighly compensated, that means that the percentage of nonhighly compensated benefitting is reduced by those employees who haven't achieved 1,000 hours of service. There is a special rule, however, similar to the one that Evelyn described for 401(a)(26); if an employee is terminating and terminates with not more than 500 hours of service, and is not an active employee on the last day of the plan year, you can exclude him for purposes of testing under 410(b).

Those are the employees who are benefitting. Who are the excludable employees? You can exclude those employees who are excludable by reason of age or service. Now the way the proposed regulations are drafted reflects what is considered by many a technical glitch in the 410(b) statute which says that if the employer uses the two years of service 100% vesting rule, you can't exclude those employees who have not yet achieved two years of service. I think people at the Service have been persuaded that we have the authority to correct that technical glitch, and perhaps soon you will see us say that you can also exclude those employees who are not in a plan that provides 100% vesting after two years of service. Other excludable employees are employees who are covered by a collective bargaining agreement. Again with respect to separate lines of business, you can exclude employees who are considered employed by other lines of business when testing the line of business that you're considering. Nonresident aliens can be excluded, and excludable actives become excludable formers. These tests are very similar to the ones Evelyn described, and again, the threshold test is the minimum participation test.

Once you've determined what your employer universe is, what the plan is, how you divide up the plan, how you bring plans together, who you're counting and who you're not counting, then you determine whether or not you meet 401(a)(26).

The basic policy reasons behind 401(a)(26) were to promote the distinctions between defined contribution plans and defined benefit plans, to prevent a defined benefit plan from operating as an individual account plan for one or a small group of employees. It was intended to promote nondiscrimination, to limit the extent to which plan design changes could afford different benefit formulas for different groups of people, and to limit the time a frozen or substantially frozen plan is able to remain in existence, thus delaying the receipt of a reversion.

So once you've established that your plan is big enough to pass 401(a)(26), then you get to 410(b).

The basic rule is the ratio/percentage test. The statute specifies three tests -- the percentage test, the ratio test and the average benefits test. If you look at the percentage test you'll realize that it's just a variation of the ratio test. The rule is that the percentage of nonhighly compensated employees benefitting under the plan must be at least 70% of the percentage of highly compensated employees benefitting under the plan. In other words, if you're benefitting 100% of your highly compensated employees, to pass the ratio/percentage test you have to benefit 70% of your nonhighly compensated employees. If you can't do that, then you may be forced into a benefits analysis which may be costly and administratively burdensome because it involves determining on an employee-by-employee basis what the benefits are with respect to compensation. The next step might be, however, to run a comparability test, to bring plans together that are otherwise separate

414(l) plans, and to show that under 401(a)(4) the benefits provided are not discriminatory under that single plan. That might be the right result if you could then pass the ratio/percentage test. In any case, however, it involves a benefits analysis.

Let me remind you of what the legislative history suggests with respect to the comparability analysis. Of course, you compare all benefits or contributions on the same basis. If you are combining defined benefit and defined contribution plans, you have to unify or normalize it so that you are comparing either benefits or contributions. The analysis should reflect the new integration rules and the $200,000 limit on compensation in 401(a)(17). It should take into account significant plan features such as accrual rates, single sum distribution availability, the availability of loans, and whether or not the same actuarial assumptions are used with respect to determining optional forms of benefits.

If the employer does not want to, or can't run a comparability analysis, the next step would be to run the average benefits test, which is a two prong test. First of all, you have to establish that the classification of employees benefitting under the plan being tested is nondiscriminatory. In order to be nondiscriminatory, the classification must be reasonable. It must be established for bona fide business reasons. It may not be a randomly chosen group of employees. Once you have a classification, you have to establish that it's nondiscriminatory. A nondiscriminatory classification can easily be determined by referring to the chart in the regulations, but the basic principle is that you have a corridor of acceptable coverage of nonhighly compensated employees, bearing in mind that the plan has already failed the ratio/percentage tests (it is not benefitting 70% of the percentage of highly compensated employees benefitting under the plan). So you have a safe harbor that starts off at 50% of the highly compensated employees benefitting under the plan and a nonsafe harbor which is always 10 points below the safe harbor. If the employer meets the safe harbor, he's home free and has won the right to go on to determining whether or not he's passed the average benefits test. If he's within the 10-point corridor, he can establish that there is a nondiscriminatory classification by facts and circumstances that the plan covers a broad range of people, that they are fairly close to the safe harbor percentage. There are a number of factors listed in the regulations in order to determine whether or not you meet the facts and circumstances test of the open seas between the safe harbor and the unsafe harbor.

Once you have established that you have a nondiscriminatory classification either by passing, showing that you've covered a safe harbor percentage of nonhighly compensated employees relative to the highly compensated employees under the plan, or that your facts and circumstances justify or prove that you have a nondiscriminatory classification, you go on to the average benefits test.

The average benefits test is run on an employer-wide basis. It's not done on a plan-by-plan basis. The average benefit percentage is the percentage that benefits are to compensation for each employee in the employer group. That figure is then averaged for all highly compensated employees and for all nonhighly compensated employees in order to determine what that ratio is.

The third choice available to an employer whose plan does not meet the ratio/percentage test is to establish separate lines of business or to establish that they have, in fact, maintained separate lines of business. The general concept here is that there are, in fact, separate businesses -- separate products and services provided by independent components within the employer group. These businesses must be established for bona fide reasons and the employers must, in fact, be separate. The reasons that an employer might be able to show that they have separate lines of business are obvious -- for costs or competitive reasons. The formal requirements are that each separate line has to have 50 employees and that separate line of business be organized and operated separately. The substantive requirements are that the separate line either pass the statutory safe harbor, pass guidelines which will be in the regulations, or receive a determination letter that they have, in fact, justified separate lines of business. The statutory safe harbor states that the separate line of business is acceptable if the highly compensated employee percentage of the separate line is not more than 200% of that of the whole employer group, nor less than 50% of the whole employer group. The guidelines you can expect to see will be variations on that, bearing in mind that what we are looking at here is separate lines that do not have concentrated groups of either highly compensated or nonhighly compensated employees. Perhaps you might expect to see in the guidelines some variation on that with respect to whether or not the benefits provided are perhaps better for the nonhighly compensated and therefore justify the distinction. Once an employer has established that there are separate lines of business, you run the 410(b), ratio and average benefits tests, based on the separate line of business. The nondiscriminatory classification test, however, is done on an employer-wide basis. And again you can use separate lines of business in order to pass 401(a)(26). But because there is a statutory requirement that you have at least 50 employees in the separate line, its applicability to 401(a)(26) is somewhat limited.

There are some obvious gaps in these rules. You can't run certain tests until you have the 401(a)(4) or separate line of business regulations. So what does this mean in the 1989 plan year given the fact that we are now in October 1989? I think, or I hope, it's been obvious in some of the things that we've issued and in some of the transition rules that we've provided, that we're not going to say in December what you should have done in January. I think you can expect to see rules providing for reasonable transition. Clearly the legislative history anticipates that we're going to revise the comparability standards, but we haven't done it yet. You can probably expect to see some extension of the 401(b) period. The 401(b) period was extended the summer of 1988 by adding to the term disqualifying provisions anything that needs to be done or may be done as a result of tax reform, Omnibus Budget Reconciliation Act (OBRA) 1986, and OBRA 1987. That will give a calendar year plan generally through September 15, 1990. I think you might expect to see, or you should be aware that we have under active consideration, a significant extension of that 401(b) period. On the other hand, we recognize the fact that there are a lot of employers with fairly basic plans -- employers who have made the decisions that they need to with respect to plan redesign. We expect to have the program open to issue determination letters early in 1990.

At the same time that you see an extension of the 401(b) period, you might expect to see some extension of transitional relief that has been provided in regulations issued to date. Specifically, I'd like to talk about something that Evelyn alluded to and that is what is included in a current benefit structure. I think you might expect to see an extension of the fairly liberal rules for the 1989 plan year to see those extended beyond 1989. As you recall, the current benefit structure in 1989 is the basic benefit accrual or contribution allocation rate without regard to separate rights and features under the plan. I have an example that I hope will pull all of this together. In the example nonhighly compensated employees are covered under four different plans, 200 in each plan. So we don't pass the ratio/percentage test based on this plan alone. Our next step in testing is one of three choices and it really depends on what the employer looks like. We could pull three plans together (two won't do it), and do a comparability analysis, we could do an average benefits test assuming that we can find a nondiscriminatory classification, or we can establish that this employer has maintained separate lines of business. The third choice may be preferable in certain cases because it may avoid a benefits analysis.

Suppose we do find two separate lines of business. In this example I've used, there is a geographical distinction as well as a distinction with respect to products. One company, Company A, is in the northeast U.S. and is involved in computer software design, and we'll assume that all the excludables are there. The other company, Company B, is in the South and is involved in light manufacturing. A has 150 highly compensated employees; B has 50. A has 400 nonhighly compensated employees; B has 400 nonhighly compensated employees. Both separate lines of business satisfy the 50 employee test, and we'll assume that they also satisfy operational, organizational, and bona fide requirements with respect to separate lines of business. Let's see if they satisfy the statutory safe harbor for separate line of business. The employer's highly compensated employee percentage is 20% -- 200 highly compensated employees with respect to 1,000 employees. Company A's highly compensated percentage is 150 over 550; that's 27% -- that's O.K. because it's not more than twice the employer's highly compensated employee percentage. Company B's highly compensated percentage is 50 over 450; that's 11% and again that's O.K. because it's not less than half the employer's highly compensated employee percentage. Separate line of business A has plan one and two -- one covers all 150 highly compensated employees and 200 nonhighly compensated employees. It doesn't pass the ratio/percentage test. Plan two covers 200 nonhighly compensated employees and no highly compensated employees and it passes the ratio/percentage test. Perhaps you could combine plans one and two in a comparability analysis and show a nondiscriminatory classification, and that benefits of nonhighly compensated in plans one and two are 70% of the benefits of the highly compensated in #1. Or you could merge plans, or you could transfer some of the highly compensated to plan #2 or perhaps stop covering some of the highly compensated in plan #1. Separate line of business B has plans three and four, neither of which benefits highly compensated, so they pass. I didn't take it a step further. The next step would be to determine whether or not you can establish on an employer-wide basis without regard to separate line of business, that you have a reasonable classification. The nonhighly compensated employee concentration percentage in the employer group is 80%. That gives you a safe harbor percentage of 35% and an unsafe harbor percentage of 25%, which means that if you cover somewhere between 150 and 210, you're in the facts and circumstances test. If a plan covers more than 210 nonhighly compensated employees, it has established a nondiscriminatory classification.

MR. NORMAN R. MINOR: To establish a separate line of business, you mentioned that it would be necessary to make a showing of such and such. Will the regulations on 414(r) require a filing of some sort with the Service, or would this just be something that an employer will determine for himself and take his chances?

MS. GOLD: The statute requires that the employer indicate that he is using a separate line of business. At this point I really can't say what that notification would be. It might be in the Form 5500. On the other hand, I can give you a general idea that what we are looking at and hoping to do in the separate line of business regulations, that is to establish very bright lines so that employers and practitioners will be able to determine whether or not they have a separate line without coming to us. We don't have the resources to determine separate lines of business for many employer groups. Of course, if you can't establish that you have a separate line of business based on those bright lines, you might have to come in and, based on certain facts and circumstances, determine a separate line of business maybe by means of the determination letter process.

MR. SAMUEL D. HARRIS: This is more a question to the group. One of the strategies that I've heard to meet 410(b) requirements is to remove highly compensated employees from the plan. I'm curious if anybody in the audience has really done that.

MR. BARTEL: Just for the record, we'll show that we had three hands go up out of about 175 in the audience.

MS. GOLD: The only thing to bear in mind if you're doing that is to remember that 411(d)(6) prevents cutbacks of accrued benefits, so to the extent your highly compensated have accrued a benefit, you can't remove them, at least during this plan year.

MR. MICKEY G. MCDANIEL: Is there any truth to the rumor that 401(a)(26) may be repealed?

MS. GOLD: I've heard rumors that all of TRA 86 is going to be repealed. I don't know of any specific legislative action to repeal 401(a)(26). You should bear in mind that the 401(a)(26) regulations are proposed regulations and that what you see now as the rules may in fact be quite different after next week's hearing.

MR. RALPH J. BRASKETT: What is the real definition of a frozen benefit in a 401(a)(26) situation? We've got a career-average plan. We've met the integration requirements. Now we're going to have a new formula. It's still going to be integrated, but clearly the future service benefits starting January 1, 1989 are going to be different than your service benefit for average plan participants prior to that point. What is the definition of benefit structure in that situation?

MS. PETSCHEK: As I understand the question, going forward you will have a new formula. That would be a current benefit structure for 401(a)(26) purposes. In a defined benefit plan, anything that was a current benefit structure in prior years or would have been a current benefit structure had 401(a)(26) been around, is considered a prior benefit structure that has to meet the prior benefit structure test.

MR. BRASKETT: You mean down the road there's an ongoing problem because I have all my people who have past service, I have this different formula going forward that's different?

MS. PETSCHEK: No, when testing for the current year you look at the current benefit structure; i.e., what people accrued or the formula under which people accrued a benefit during the current year for your prior benefit structure. Well, let's say that your new formula has been in effect for one year. We're now testing in year two. So now we have a prior benefit structure that is comprised of all the years that you had under your old formula, plus the one year that you had under your new formula. When you're looking in year three, our prior benefit structure is comprised of what had been a current benefit structure in year two, what had been a current benefit structure in year one, and what had been a current benefit structure in prior years. All of your past years get lumped into one prior benefit structure that is tested under the six alternative tests in the regulations.