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COMPARABILITY

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- How to do the average benefit test under IRC Section 410(b)
- Comparability under IRC Section 401(a)(4)

MR. LANE B. WEST: Our subject is comparability. We'll also be talking about the average benefit test. We're only going to cover a portion of 401(a)(4) and 410(b). We won't cover the safe harbor rules. However, during the question and answer time you should feel free to ask questions about 410(b) or 401(a)(4).

My name is Lane West. I'm a consulting actuary in the Richmond office of William M. Mercer, Inc. Joining me are Paul Strella, an attorney with Mercer in the Washington Resource Group, and Nick White, a consulting actuary with Towers, Perrin, Forster & Crosby, (TPF&C) in Atlanta. I want to give special thanks to Kathy Potter. Kathy is our recorder. She is an actuary in the Richmond office of Mercer.

Paul joined our firm in May 1990. He took an active role in the development of the 401(a)(4) regulation. He's going to give us insights into some of the reasoning and some of the thoughts that went into those regulations. Prior to joining Mercer, he was an associate tax legislative counsel and attorney/advisor for three years at the U.S. Treasury in the Office of Tax Policy. Before that, he assisted a member of the Senate Finance Committee as tax counsel. In that regard he worked on the Tax Reform Act.

He's participated in the development of numerous pension and welfare benefit regulations, including the permitted disparity rules, the minimum coverage rules and the general nondiscrimination rules. Paul is a Phi Beta Kappa graduate of the College of William and Mary, and has a JD degree from the University of Chicago. Paul will be speaking on the subject of comparability.

Nick joined the Cleveland office of TPF&C in 1980 and transferred to Atlanta in 1984. During his career he's provided consulting services to a variety of clients in private industry. He has a bachelor of science degree in mathematics from Marshall University. He studied actuarial science at the University of Iowa and also Georgia State University. He's an Associate of the Society, and a Member of the Academy.

MR. PAUL V. STRELLA: I'm going to walk through some of the basic steps you're going to use whenever you do any testing. I'm going to try to focus on some of the issues that will arise in the comparability context. First I have what I call a testing flow

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chart which is really the four, basic steps that an employer is going to go through when he tests any plan for the various minimum coverage, 401(a)(4) rules. The first step is to identify what I call the testing universe. Who's the employer? In the small employer case that may be fairly obvious. In a large employer case it may be fairly onerous. Start with a controlled group who's employed with the entire employer, bring in any substantially related entities, subsidiaries that are owned, affiliated service groups, and soon, using the common law employer test.

The second step is to identify all of your employees. We start with the common law employee, and we move on to identify any leased employees to the extent that you know. Who is a leased employee? We really don't know the status of those rules right now. The IRS has regulations out, but it has been backing off its regulations. Take the pool of employees and identify those among them who are highly compensated and those among them who are not highly compensated. That is a controlled group determination. It is done once for the entire employer. It's not a plan-by-plan test. It is not a separate line-of-business test. It's done once for the entire employer. Now you've tagged every employee as either highly paid or low paid. We'll be looking at those tags for the rest of this session. That's what I call the testing universe.

The third step is to identify the plan that you want to test. Historically, we all felt comfortable that we knew what a plan was. I think now we really won't know what the plan is until we're done doing all the testing. The new rules have given us a lot of flexibility in aggregating plans, taking apart plans, restructuring plans, and doing lots of things to plans to come up with the little pieces of plans which are the pieces that we ultimately run through the test. Nominally, you start with a 414(l) plan, the pool of assets plan. Ultimately, you'll be taking apart plans and putting them back together in lots of different ways. There are a couple exceptions to this flexibility. Union pieces of a plan and nonunion pieces of a plan must be treated separately, as if they were separate plans, even if they are maintained in one, single plan document with one, single trust, and with the same formula. You must test them as two, separate plans. The union plan, by the way, will always pass all the rules. The 401(k) plans must be mandatorily treated as a separate plan from any non-401(k) plan. The same rule goes for employee stock ownership plans (ESOPs). If you have an ESOP in with a non-ESOP portion, you must treat them as two, separate plans. There's no freedom to put them back together. They must be taken apart, and they must be maintained apart. With those exceptions you can otherwise put together any and all plans that you want or take apart plans in certain ways that we'll see later. We don't know yet what the plan that we're going to test is going to be ultimately, but you have some starting point. You have the pension plan. We'll look at that and call it the plan for the moment. The next step is to test the plan for 410(b) minimum coverage. The minimum coverage is just asking who's in the plan and who's not in the plan.

It's comparing the plan population to the testing universe, just ask, "Are you in or are you out?" It doesn't care how much you're getting. You're either in or you're out. Now, the 410 regulations that were issued about a year and a half ago came out with a little bit of a surprise. They say you're only counted as covered if you actually accrue a benefit. Mere eligibility is not sufficient to be counted as in the plan. Thus, for example, you have a plan that says no allocation if you're not there on the last day of the

year. An employee quits in November. He is not covered. Even though he was fully eligible, he is not counted for coverage because he did not receive an allocation.

The last step will be to go to 401(a)(4) and actually test the plan. We're going to look at who gets what. Whereas, coverage compared the plan population to the whole testing universe, 401(a)(4) looks only at the plan population and compares what the low paid people and the highly paid people within the plan are receiving. So, the question we're asking now is, "Who gets what?"

Let me very quickly walk through those latter two tests, and I'm hoping this will all be familiar to most of you. Minimum coverage has two alternative tests. One is the ratio percentage test, which looks at what percentage of your low paid employees are covered, that is, those who actually accrue or receive an allocation, and what percentage of highly paid employees are covered, and expresses the first percentage as a percentage of the second percentage. It's a ratio of percentages or a ratio of ratios. If your ultimate ratio is 70% or more, you pass. It's a very simple, mechanical, objective test. If it's 69.9% or you fail. If it's 70%, you pass.

The alternative test is the average benefits test, dreaded by some because it's a much more complicated test. It's really a three-part test. The first part is to look at the classification of employees that is covered and to determine whether it's a reasonable classification. By reasonable the regulations mean that there be some bona fide business reason for setting up that classification: where they work, separate subsidiaries, different plans, different facilities. Salaried/hourly is a reasonable classification. Naming people, Betty, Mary and Joe, is unreasonable according to the regulations. You cannot identify people by name and have that constitute a reasonable classification.

The second step is to look at the classification and ask, "Is it favoring the highly compensated group?" We make that test looking at the coverage ratio, but instead of a 70% test, it's a much lower number, and the number can vary. I'm not going to go through the rules in any depth, but the number can go as low as 20%, and it will vary with the demographics of the employer. There are safe harbor levels and unsafe harbor levels, and it's all very complicated. The last part is the 70% average benefit percentage test.

This is what makes this test very complicated, and it's also what backstops the fairly weak second step. Your coverage of low paid people can go as low as 20%. That's a fairly weak test. This is the strong part of the test. This tests asks, On average, what are your highly paid people getting, and what are your low paid people getting?

It's unusual for a coverage test because it looks at all employees, not just the plan population. It looks at all employees of the employer who are not excludable, and it looks at all plans of the employer. People who are covered in several plans, and people who are covered in no plans are all taken into account in this test. On average are the low paid people getting 70% of what the highly paid people are getting on average? You can see mathematically there's a rough equivalence between this 70% and the first 70% test.

Let's assume a very simple case. I have a plan covering 100% of my highly paid people, and they all get one unit. It also covers 70% of my low paid people, and they get one unit. Well, that will pass the first test because I've got 70% of my low paid people in there, and that's 70% of the 100% of my highly paid people in there. That will also pass the 70%, the last test, because if you average it all out, highly paid people are getting one unit. The low paid people on average, when you take into account the other 30% who are not covered, are getting .7 units. The two tests are roughly equivalent. That's where Congress came out in the 1986 Act.

Once you've taken your plan through coverage, you're going to go to the next test, Section 401(a)(4). Section 401(a)(4) really can be broken down into three, distinct requirements. One is to test the plan with respect to the amount of contribution or the amount of accruals, the amounts test. Who's getting what in terms of dollars? The second test is to look at all the other miscellaneous optional forms: benefits, rights and features, ancillary benefits, lump sum options, loans, in-service withdrawals. Are those rights and features being made available to a good group, a representative group, of employees? And the last step is to test the plan in special circumstances. When there is an event in the life of a plan which is outside its ongoing operation -- the plan's amended, the plan is terminated, there is a grant of past services, any unusual event in the life of the plan -- the regulations ask, Was it done in a way that's favoring the highly compensated? We'll be spending most of our time on the amounts testing.

You can test the plan on either basis. You can test a defined benefit (DB) pension plan on a contributions basis and vice-versa with two exceptions. An ESOP can only be tested on a contributions basis, and a 401(k) and a matching arrangement can only be tested on a contributions basis, passing the special rules in 401(k) and 401(f). In all other cases, you can take any plan and test it either way. That gives us a fair amount of flexibility. Lane is going to go through the mechanics of doing those conversions and comparisons.

The classic comparability situation in the past was always addressed by Revenue Ruling 81-202. It told us what to do when we had two plans and one of them didn't pass coverage. We wanted to put the two plans together and treat them as a single plan. Well, how do you do that if one's a defined contribution plan and one's a pension plan? They're different plans. Revenue Ruling 81-202 stood for about eight years as the only rule that told us how to convert and compare. I hope some of you are familiar with 81-202, but if you're too familiar, you've lost a lot of knowledge because the rules in 81-202 have been very drastically altered.

Probably the most significant change in the new 401(a)(4) package by and large, was to eliminate the methodology from 81-202. I want to talk about the changes and a little bit why they were made. The hallmark of 81-202 is that it allowed you to compare plans on a projected basis. You could project out to age 65, or whatever the normal retirement age was, and compare what all employees would get at age 65, or you could take that amount and then spread it back over service and compare their annual rate. Either way, it did allow you to project. The current regulations have eliminated any projected method when you are doing conversions. There's no longer any projected method, and I think the theory of the regulations was we want to test comparability on what people are

actually getting today, not what they might get 20 years from now. The very classic, two-plan design was to take a highly paid group, pretend it to be older, and put its members in a defined contribution (DC) plan which is a very front-loaded vehicle. Take the low paid group and put its members in a DB plan which is a relatively back-loaded vehicle. Relative to a DC plan a DB plan is back-loaded. So, you put your highly paid group in a front-loaded plan. They're getting all their dollars up-front today. Their low paid group will eventually get the same or equivalent dollars but not till they earn it some time in the future. That allowed for planning opportunities that the IRS ultimately felt tended to favor the highly paid group because companies were justifying dollars that the highly paid employees got today with dollars that the low paid employees might get some point in the future. I say might because they might quit, the plan might be terminated, the employer might go out of business, or the plan might be amended. Any number of things can happen. The new methodology focuses on, "What have you done for me today?" Don't talk to me about what you might do for me 10 years from now. That's the first significant change.

The next significant change is 81-202 compared what it called the most valuable annuity. It took all the benefits, anything with value in the plan, ancillary benefits, subsidiaries, and of course, the normal retirement form, and folded them into one, big package and said, This is the most valuable package for this employee. Then it compared everybody's most valuable packages. The new regime forces you to break out the subsidiaries and the ancillary benefits and test them separately. So, in other words, you're going to find yourself often testing a plan twice, once with regard to just the normal retirement benefit form and a second time with regard to its most valuable form. Let's go back to my example. The highly paid people are in the DC plan. There is no subsidy in their plan. They have an account plan. They've got their money fully vested. There it sits. The low paid people are in a DB plan with a lot of subsidies. It's been loaded up with early retirement subsidies, ancillary benefits, that they may or may not ever get. They have to work 30 years to get the early retirement subsidy. Revenue Ruling 81-202 permitted you to assume that everyone would get the full subsidy, which is a fairly optimistic assumption. In fact, what was happening was low paid people were having their potential contingent benefits being used to support core, truly pure, vested accruals for the highly paid employees. The new regulations say we're not going to allow that to happen.

We're going to make you look at those separately, and there are some exceptions, but as a general matter you test separately, so that you can no longer use contingent benefits for the low paid group to support core benefits for the highly paid group. The third aspect that was changed, and it's really a part of the second, is that ancillary benefits were taken out of the picture altogether. You no longer have to value disability benefits, death benefits, social security supplements, etc. They're tested as another right or feature. They're tested on an availability basis alone. They do not enter into the conversion methodology at all. So, you no longer weigh them and value the disability and then assign it some factor and fold it in. Those are the significant policy changes in how we do comparability analysis under the new rules.

Whenever you aggregate plans, convert a plan and test it (what we call cross-testing), or take a pension plan and test it on a contributions basis or vice-versa, you're going to do

restructuring. I hope if you've worked with these regulations at all, you're a little familiar with restructuring.

What is restructuring? It is taking a plan apart, and it is taking a plan apart in a way that you know will pass 401(a)(4). You're going to basically look at your plan and identify pieces of it that are, by definition, uniform so that they will pass 401(a)(4). There are three methods. Most comparability analysis will be focused on the rate methods, the total rate method and the rate segment method.

Total rate method says let's look at each individual's rate under the plan, and let's group people or cluster people by their rate. Here's an example (Chart 1). Assume that you need two low paid people in this plan for each highly paid person to pass coverage. I'll get to why you have to pass coverage. We're looking at a plan under 401(a)(4), and it failed the general rule because the general rule says if you have one highly paid employee getting any more than any low paid employee, you fail. We have a highly paid person getting 8%, and we have a low paid person getting 5%. You fail. That's it. You're out of the general test. You just failed 401(a)(4). But then you can go restructure the plan, which is basically breaking it up into component pieces and testing each piece separately as if it were maintained as a separate plan. Now, the catch here is you also have to test that component piece under 410 minimum coverage. So, for example, we might have a plan covering everybody, 100% coverage. You sailed right through the coverage hurdle. Now we come to 401(a)(4). Turns out we've got these rates. We failed the general test. Now we're going to restructure the plan, and then we're going to go back to coverage. In the total rate method we would treat everyone who's getting 5% as being in one plan. By definition, since they all have the same rate, that plan now satisfies 401(a)(4). Then you take that plan and you go back to minimum coverage, and you test it under minimum coverage because again we're assuming now that it was a separately maintained plan, and we're going to test it as such.

CHART 1

Restructuring Example 1

Assume 2 NHCEs and 1 HCEs satisfies the ratio percentage test		
Allocation Rate	HCEs	NHCEs
8%	2	4
7%	1	2
5%	2	4

One of the ground rules here is whatever plan passes 410(b), minimum coverage, has to be the same plan that is passing 401(a)(4) and vice-versa. So, when we, under 401(a)(4), decide to break our plan up into three plans, we've got to take each of those three plans and go back to minimum coverage (Chart 2). So, the first plan, the 5% plan, passes minimum coverage, passes 401(a)(4). It passes coverage, again, because I have at least two low paid people for every highly paid person. The next plan will be the 7% plan. It will fail.

COMPARABILITY

CHART 2

Restructuring Example 2

Allocation Rate	HCEs	NHCEs
8%	1	4
7%	2	2
5%	2	4

We have two highly paid people and two low paid people. It passes 401(a)(4) because everyone in that plan is getting 7%, the same benefit, but it fails coverage because we don't have enough low paid people in that 7% plan to pass minimum coverage. Then we look at the 8% plan. It turns out it will pass, but it doesn't matter. We have now found one component plan, the 7% plan, that fails. If one piece fails, the whole plan fails.

Before I go on to rate segment restructuring, which is the alternative, let me just make an observation. When you restructure you are, by definition, looking for a component plan that passes 401(a)(4). We've identified these people as people with the same benefit rate. That will always pass 401(a)(4). The problem's going to be in passing 410 minimum coverage, and what that means is virtually any plan can be broken into restructured plans and always satisfy 401(a)(4), but it may well fail minimum coverage which is why the regulations have changed the sanction. They said if you fail, you're really failing minimum coverage, and the sanction imposed is the sanction for failing minimum coverage, even though all these rules come up under 401(a)(4).

Now, let me run through rate segment restructuring, and what that does is it's again looking at the rates, but it's looking at them in a different way (Chart 3).

CHART 3

Rate Segment	HCEs	NHCEs
7-8%	1	4
5-7%	3	6
0-5%	5	10

It's taking each individual and slicing him up into bands of rates. For instance, who's getting 5%? Let's call the first band everyone who's getting from zero to 5%. Everybody in this plan is getting from 0 to 5%. The 8% people are, the 7% people are, and the 5% people are. So, we have five highly paid people and 10 low paid people in that first segment. That's our plan. Everybody's getting the full 5%. That segment passes 401(a)(4), and because we have 10 low paid people and five highly paid people that segment passes minimum coverage. The next segment is, Who's getting that next incremental 2%? Well, everybody who is in the 5% plan is not getting it. So, the only people who are in the next increment are people getting either 7% or 8%. So, that would include three highly paid people and six low paid people. That, again, will pass minimum coverage because I've got that necessary 2-to-1 ratio. And then the next

segment is, Who's getting the next incremental 1% which is between 7 and 8%. We have one highly paid person and four low paid people. That, again, will pass coverage. First, I restructured it on the total rate basis, and it failed. I restructured it on the rate segment method, and it passed. Now, let me make an observation that, by and large, if a plan will pass using total rate, it will always pass using rate segment. The opposite is not true, as we've just seen. So, you really need to know about the rate segment method. That will ultimately end up to be the most valuable restructuring tool. You can ignore total rates. It will never give you a pass on a plan that rate segment won't also pass. So, it doesn't add anything. It may be simpler to understand, and in that sense it's nice to have around, but if it doesn't help you pass, you're ultimately going to go to rate segment. Now, I want to touch on one more aspect of restructuring, and then I'm going to turn it over to Lane, and this is something that came out in the amended 401(a)(4) regulations.

As you know, the regulations were amended in September 1990, and, if you're not familiar with the new information, this may well knock your socks off. It's called sequential restructuring. You remember I said you have to test a plan both with respect to the normal rate or the normal retirement benefit form and the most valuable package. You've got a bunch of people with a lot of different normal rates and a lot of different most valuable rates, and it would be nice if you could at the normal rates, restructure the normal rates, run your test, and then go back and test your most valuable rates by restructuring the plan on the basis of the most valuable rate. You can't do that. That's called inconsistent restructuring. The IRS has given it a name that tells you it doesn't like that, and the IRS is unlikely to change that. And the old May 1990 regulations said you restructure once. Pick your method of restructuring. Do you want to restructure looking at the normal rates or restructure looking at most valuable rates? You have a choice. Well, that turned out to be pretty unworkable in just common practice. A lot of plans that probably should have passed were failing. So, they came out with what they call sequential restructuring, and this allows you to restructure twice, but it's not as simple as one might hope.

Let me walk through a very simple example (Chart 4). Assume I just plucked two employees out of a large population just to illustrate how sequential restructuring might work, and because there's some ambiguity in the way the regulation is drafted, and there's also some ambiguity in the way the Service expects it to come out in the future.

CHART 4

Sequential Restructuring

	Normal Rate	Most Valuable Rate
NHCE HCE	3 2	6 6
	Normal Rate Segment	Most Valuable Rate Segment
2-3% 0-2%	NHCE only Both ees	6% or 2% NHCE: 6% or 4% HCE: 6% or 6%

I've got two employees, a highly paid employee with a normal rate of two and a most valuable rate of six, a low paid employee with a normal rate of three and a most valuable rate of six. That could arise for any number of reasons. It might be age differences. It might be different levels of subsidies. There are various reasons why that can happen. Now, the way sequential restructuring works is it says you first restructure on the basis of the normal rate. You don't have to start with normal, but I think that will be where you tend to start. I'm going to do rate segment restructuring. I've got a zero to 2% segment that covers both employees, and then I've got this 2-3% segment, the next incremental 1% that covers only the highly paid employee, and that's fine. I restructure that, and that looks good, but I need to restructure it again to test the most valuable rate. I restructure it again within each component plan.

Let's look at the first column of sixes here. One approach is to say, Who's in the 0 to 2% segment? Both employees are in that. What is their most valuable rate? Both of them have a 6% most valuable rate. That looks nondiscriminatory. That segment has now passed on the basis of most valuable rates. Then we look at the next segment, the 2-3% segment. We find only a low paid employee there. We know we're going to be good no matter what happens. Now, that's one way of doing it.

An alternative way of doing it is the numbers on the far right. What you do there is you say, Who's in the 0 to 2% normal rate segment? Both employees are there. What portion of each of those employees' most valuable rate is allocable to their normal rate in that segment? What do I mean by that? Take the highly paid employee. He's got 2%. That's his entire normal rate. So, we allocate his entire most valuable rate to that segment. He gets a six. But look at the low paid employee. His normal rate is 3%, but within this segment we're only looking at the first 2% of it, two-thirds of it.

So, we only allocate two-thirds of his most valuable rate to that segment. Two-thirds of 6% is 4%. Now we test that segment by looking at the most valuable rate, and we fail because the highly paid person has 6%, and the low paid person has 4%, within that segment, and that's true even though the low paid person is getting a 6% most valuable rate. The problem is a piece of it will show up in his other incremental segment. Now, that's sequential restructuring. The latter method, we are told by folks at the IRS, is what they intended. The latter method, we are told by most anyone in practice, won't work. I mean when you really start thinking about what the allocable portion is, it gets complicated. For example, I might have been imputing permitted disparity. Does that get allocated pro rata? I don't know. And you've got to deal with all the optional forms and how to allocate them. It's a mess. We don't know where this is going to come out. I believe right now, and this is merely my opinion, that the regulations are ambiguous enough on the point that I think it's reasonable to go either way because, frankly, all the regulation says is, "The most valuable rate associated with the normal rate." That one word is carrying an awful lot of baggage if this is the result it meant, with no example, no explanation, and nothing in the preamble. In any event, that's sequential rate restructuring. When you get into a comparability situation you're going to have to end up doing it, and it's a complicated mess. I think we may have to wait until the IRS clarifies exactly what's intended there. Lane is now going to take over and go through the actual mechanics of how to convert.

MR. WEST: I'm going to be doing a case study, but before I do that, I want to go over a couple of preliminary steps just so that we're all in sync. We're going to be looking at conversion methodology. How do you convert a DB to a DC plan? We're going to look at a primary insurance amount (PIA) offset plan. How does the general test work? Then we're going to be looking at comparability. How can we show that DB and DC plans covering different groups of employees or different segments meet the test?

The first thing I want to look at is the conversion of a DB plan or the calculation of the DB rate. I found Chart 5 helpful, and I thought it would be helpful to you. There are three methods of calculating an accrual rate: the annual method, the accrued-to-date method and the projected method. There are three uses for that: (1) You've got to calculate accrual rates for the general test. (2) You want to convert the plan to a DC basis. (3) You want to perform the average benefit test. Those are the three ways that accrual rates are used.

CHART 5

	General Test	Conversion to DC	Average Benefit Test
1. Annual	$\frac{A_1}{P_1} - \frac{A_0}{P_0}$	$\frac{A_1 - A_0}{P_1}$	$\frac{A_1 - A_0}{P_1}$
2. Accrued to date	$\frac{A_1}{P_1} * \frac{1}{S_1}$	N/A	$\frac{A_1}{P_1} * \frac{1}{S_1}$
3. Projected	$\frac{NRB}{P_1} * \frac{1}{S_{NRA}}$	N/A	N/A

Let's look at the general test first. The three methods that are shown I've described this way. A_1 is the accrued benefit at the end of the year. A_0 is the accrued benefit at the beginning of the year. P_1 is your pay, which typically would be your average pay at the end of the year and then at the beginning of the year. If you had a formula such as 1% of final average pay times service, the result of this calculation would be 1%. Everybody's getting a 1% accrual.

FROM THE FLOOR: Is it pay, rate of pay, or pay over the last 12 months?

MR. WEST: It can be either one-year pay or three-year average pay, and it depends on which section you're reading. I typically use the same average pay that I use in the benefit formula, but I think there's some flexibility.

MR. STRELLA: Just to answer that one, you are not allowed to use rate of pay. It has to be some actual pay.

MR. WEST: It has to be an (f)(2) definition which is either a single year ending within that plan year or a three-year average. The disadvantage of the annual method is, if you

have a service limit, for example, 1% of final average pay times service to 30 years, once you reach 30 years, your accrual rate is zero. So, if I had a nonhighly paid employee with more than 30 years, I would have a zero accrual rate, but I would probably have a highly compensated employee with less than 30 years, and so he would have an accrual rate, and we would flunk the general test. This method is not very useful if there's a service limit. The next method takes care of that. The other advantage of the accrued-to-date method is you only have to look at this year's data. I don't have to go back and look at both last year's data and this year's data. I take the accrued benefit this year divided by the average pay this year and then divide it by service this year. In most cases this gives you the same answer that you have in the first method.

The final method is the projected method. That's the only time you can ignore the accrual pattern. These two items reflect the accrual pattern. In the projected method you take the expected normal retirement benefit divided by the average pay and divided by service at normal retirement. Again, I'm not meaning to go into details, but I thought I'd give you the formulas. I thought they might be helpful.

There's only one method allowed for conversion to DC. You take the change in the accrued benefit and divide it by this year's pay, either average or one year. There are two methods for the average benefit test. You can use the same method that you used for conversion to DC, or you can use the accrued-to-date method. You cannot use the projected method.

Paul talked about restructuring. I just wanted to mention that for the examples that we will be reviewing, we will use the rate segment method. Let's say there are 10 different rates of accrual. We now have 10 component plans. So, we'd be looking at these 10 plans to see if they are each nondiscriminatory.

First thing I would like to do is look at a Social Security offset plan (Chart 6). Take a formula that's 1.5% of final average pay less 1.25% of PIA times service to 40 years. We're going to use a front-end accrual pattern. That will help, if you want to keep a PIA offset plan -- to keep a front-end accrual rather than a pro-rata accrual. We're going to use this to illustrate how an offset plan can pass the general test.

CHART 6

Case: Social Security Offset Plan	
o	1.50% of FAC less 1.25% of PIA times service to 40 years
o	Front end accrual pattern
o	Illustrates use of methodology to show an offset plan passing general test

I've taken two employees (Chart 7), a highly compensated employee who's age 60 and a nonhighly compensated employee who's age 50, and Chart 8 tells us that this particular plan design, given that the data are correct, will pass.

CHART 7

Case 1

	Age	Pay	Social Security
HCE	60	200,000	11,000
NHCE	50	15,000	5,000

The highly compensated employee makes $200,000, and I've also assumed his average was $200,000. You've got a most valuable adjustment. That's for the qualified joint survivor and the early retirement factors. If you're failing under this type of plan, you can always reduce your early retirement factors. You can't reduce them for current accrued benefits. That can create some problems. The accrual in this one year for this person is 2.03%. This includes the adjustment for the most valuable, and it includes permitted disparity.

CHART 8

PIA Example

Formula: 1.50% - 1.25%			
	Pay	Most Valuable	Accrual
HCE	200,000	1.35	2.03% Passes
NHCE	50,000	1.35	2.07%
HCE	200,000	1.35	2.03% Passes
NHCE	15,000	1.35	2.16%

For a nonhighly compensated employee making $50,000, his accrual rate is 2.07%. Since the 2.07 is greater than the 2.03, the plan passes. I also ran the same test with a $15,000-ayear employee, and that one also passed. Notice this has a fairly small offset, 1.25% of pay, but after 40 years that is a 50% offset.

I then looked at a 1.5 less 1.5 plan (Chart 9). We've increased the offset. Compared to plans that we're accustomed to, this is a fairly modest offset, and in both cases the plan failed. That gives you an indication of the amount of offset that can actually be used.

CHART 9

PIA Example

Formula: 1.50% - 1.50%			
	Pay	Most Valuable	Accrual
HCE	200,000	1.35	2.01% Fails
NHCE	50,000	1.35	2.00%
HCE	200,000	1.35	2.01% Fails
NHCE	15,000	1.35	1.92%

COMPARABILITY

We're going to look at two plans for the comparability test. We're assuming our nonhighly compensated employees are in a DC plan, and our highly compensated employees are in a DB plan. Normally, there would be nonhighly compensated employees in the DB plan as well. For example, the second plan could be a salaried only plan. The first plan can be an hourly plan.

What our client would like us to do in the DB plan is have a formula of 1.4% of final average pay, plus the maximum permitted disparity, and our clients wants to contribute 5% of pay to the nonhighly compensated employees.

I chose 16 lives (Chart 10). I took four highly compensated employees. Their salaries run from $60,000 to $200,000, and their average age is 49. I took 12 nonhighly compensated employees with lower salaries, and you see their average age is 43. This particular average age is probably higher than you would run into. This also makes it more difficult to pass this particular combination of plans.

CHART 10

Demographics

	HCEs	NHCEs
Number	4	12
Salaries	60,000 to 200,000	14,000 to 45,000
Age	49	43

I'm testing this on a DB basis. We want to convert our DC, the 5% of pay, to a DB.

The way you do that is you determine the allocation in dollars, not as a percentage of pay. You take the allocation plus any forfeitures. You accumulate that with interest to what's called a testing age. The way the regulations work, the testing age is any reasonable age. In this case I used age 65. The accumulation does not have to be in the 7.5-8.5% range. It tells you in the regulations to use what I call a portfolio rate. What do you expect the plan to earn? I know in the testing I've done I've used an 8, 7.5, and 8.5%. I think it's a little easier to justify. Once you accumulate that -- again, that's without mortality, simply an interest accumulation to the testing age -- you divide that by an annuity purchase rate, and that determines the equivalent benefit. We're looking at the dollars going into someone's account in one year and saying, How much benefit will that buy? Now, that's a real problem if there's no contribution that year. All your highly and nonhighly paid people get a zero, and there is some relief, but it comes at a cost, and that's the accrued-to-date method. You can use the accumulated account balance, but you have to add back prior distributions. I think it was to 1985, but I'm not sure of the exact date, but you've got to go back a number of years and pick up all distributions. I believe it's in the last five years. You accumulate those again at what the plan had earned, and then you divide that by years of participation. That gives you a theoretical allocation for this year. If you have a situation where there are no contributions, you can use this approach, but you're going to have to go back to I believe, January 1, 1985 and pick up all the distributions that have occurred.

Just as an aside, if we were converting DB to DC, we've got to make some adjustments. One is that you only have to test the most valuable if you have a uniform DB formula. Now, that's not true in the case that we're looking at. What we're looking at is the situation where you have a DB plan for the highly paid people and a DC plan for the nonhighly paid. We're having to aggregate those plans to pass 410(b) -- not the average benefit test, but just to pass 410(b); we're going to assume the two plans are one. We're now going to the nondiscrimination rules, and then we have to prove that the benefits are nondiscriminatory. So, we're going to have to test this plan under both most valuable and normal. Now, in the example I've only done that under the most valuable, and some of the things that Paul pointed out shows you that there's some question about how you do the test when you have to test under both methods.

Again, you determine the change in the accrued benefit, and you convert that to a dollar allocation. That's done in a similar manner. You start with the DB at normal retirement multiplied by an annuity purchase rate to come up with a lump-sum value at that point, and you discount it back to the current date. At that point you have to use the safe harbor interest rate. So, it has to be between 7.5 and 8.5%. So, it's a very similar calculation.

Again, let's take this theoretical client (Chart 11). What the client would like to do is have a benefit formula of 1.4% of pay, plus permitted disparity. It would like to use an early retirement reduction factor of only 3% per year, and for the nonhighly compensated it wants to put in 5% of pay. We ran this under the rate segmentation method, and the plan failed. We had some highly paid employees who were getting more than the nonhighly paid. So, there are two solutions. One is to simply continue to lower that DB. In other words, start with a 1.4%. What if we went to 1%? Could we pass? And the answer was no. So then we dropped to .75%, and the answer became yes. So, in this particular case, if I'm willing to provide a DB plan of .75% of pay, plus my permitted disparity, with those early retirement factors, I can still contribute 5% for my nonhighly compensated.

CHART 11

	HCE		NHCE	
Basis	Formula	ERF	Contribution	Result
DB	1.4%	3%	5.0%	Fail
DB	1.0	3	5.0	Fail
DB	0.75	3	5.0	Pass
DB	1.4	3	6.0	Fail
DB	1.4	3	8.0	Fail
DB	1.4	3	10.0	Pass

Then I wanted to look at it the other way. What if I raise the contribution to the nonhighly compensated in the DC plan? So, I went to 6%. That didn't work. I went to 8%. That didn't work. I went to 10%, and that worked. I don't recall whether 9% worked or not. I don't think it did. So, if I want to maintain the separate plans, and I want to maintain the DB for my highly compensated employees, I'd have to go to 10%

on my nonhighly paid. I then decided that, maybe my early retirement factors really aren't that important, and I'll just go with a formula to comply with 401(l). It didn't seem to make any difference in the first set, in other words, if I wanted to keep the 5% contribution to the nonhighly paid people. I'm sure if I had tested every percentage point, every basis point, it would have been a little bit better. But it did make a difference in the second alternative where I keep the DB plan the same, and I increase the benefits for the nonhighly paid people. I only had to go to 8% to pass. So, that was good news.

We're able to group (Chart 12). You can have either a 5% on either side, or you can have a range of .1 of 1%. So, for example, at a DB rate of 1%, your 5% range is .95-1.05. The .1 corridor is also .95 to 1.05, and what this is telling us is that above a 1% accrual rate the 5% range is better, in other words, 5% on each side of the midpoint, but below that point, the .1, is better. Again, in grouping, for example, here, the 1%, you can assume everyone who's between .95 and 1.05 has a 1% accrual rate. The new regulations that came out say that you could use the greater of the two. It's a little more flexible than the old rule which was you had a choice of one or the other. In a DC plan the range is 5% or .5%. In other words, the range is .5 of 1%, which is a quarter of a point on either side of the midpoint.

CHART 12

Grouping

DB			DC		
	5% or .1%			5% or .1%	
Rate	5.00%	0.1%	Rate	5.00%	0.50%
1.0%	0.95%-	0.9-	3.0%	2.85	2.50%-
1.5	1.43%-	1.4-	5.0	4.75	4.50%-
2.0	1.90%-	1.9-	10.0	9.50	9.50%-
2.5	2.38%-	2.4-	15.0	14.25	14.50%-

That concludes my case study. Paul's now going to come back and talk about options, rights and features.

MR. STRELLA: You'll remember perhaps that in 1987 the IRS issued regulations on optional forms of benefits. An optional form is basically any way of getting your money out of the plan, a lump sum, an annuity, installment form, whatever, and what the rule said is that any optional form of benefit had to be available to a group of employees that was not discriminatory in favor of the highly compensated employees. What does that mean?

The regulation said it meant that as long as the optional form of benefit was made available to a group of employees that would satisfy minimum coverage, just looking at the group, then the optional form is good. What that means, as a practical matter, is you're going to look at the first of the two prongs of the average benefits test, the reasonable classification test, because that's the easier piece to pass, and you don't have

to worry about passing the 70% average benefit percentage test itself. You're just looking at the classification prong, what was known under old law as the fair cross-section test. That was the rule in 1987.

Let's go to my example from a little while ago where I've got all my highly paid employees in a profit-sharing plan and my low paid employees in a DB pension plan. My highly paid employees like to manage their money. They like to direct their own investments, and they like loans, lump sums, and in-service withdrawals. Well, the new regulations did a couple of things. First of all, they said this rule from 1987 that applied to optional forms of benefit will now also apply to every right and feature in the plan, the right for employees to direct their investments, the right to get a loan, whatever. Any right or feature in that plan is now subject to this test. Now, that's a pretty harsh rule when you get to the comparability situation.

Let's take the loan. Let's take the right to invest your money how ever you want. Your highly paid people have that right in the profit-sharing plan. Your low paid people in the DB plan don't have that right. They can't have that right. They don't have an account balance to invest. So, you have a feature that is now made available only to the highly paid population. Do you fail? Well, the regulation says no on that case because that's what's called a noncore benefit. The regulation has now taken these rights and features and broken them into two categories, core and noncore. The noncore, or less important, is an easy test. Basically, the test is that you can fail -- benefits can be available only to highly paid employees if there are no low paid employees in the same plan. So, in my case, because I have no low paid people in the DC plan, the fact that the right to invest your money is made available only to highly paid people is okay. You don't fail. Now, if there were some low paid employees in that DC plan, then they would have to have the same right. That's a fairly easy test to meet in most cases, but what if you have a core benefit?

Well, what's a core benefit? A core benefit, what the IRS views as the more important ways of getting your money, includes the lump sum and the loan. It includes an in-service withdrawal and all of the so-called ancillary benefits which have actual dollar value, for instance, disability benefits, Social Security supplement, and death benefits. Those are ancillary benefits. All of those are core. The rule for core benefits is you have to pass the general rule. Let's look at our DC plan. The highly paid people had some core options there. They had a lump sum. You can make the lump sum available in the pension plan. So, you can satisfy that one. But you're going to have to make that lump sum available to enough low paid people to pass coverage, just looking at who gets the lump sum. So, you're going to have to add that lump sum to the pension plan if it's not already there.

The highly paid group also have the right to make in-service withdrawals. There's no way you can make that available in the pension plan. A pension plan can't be a qualified plan and permit an in-service withdrawal. What do you do? There's only one option, and that's to get rid of the right for in-service withdrawals for the highly paid group. Another option is to move some low paids into the DC plan and give them the same right, but you'd have to move enough low paid people to get that profit-sharing plan up to passing coverage on its own, which may not meet with the employer's original

objective of setting up the two plans in the first place. It's the same issue for loans. The highly paid employees had a loan provision in the profit-sharing plan. The low paid people probably, in all likelihood, will not have a loan in a pension plan. Loans are very hard to do in a pension plan. So you have the same problem. Either get rid of that loan for the highly paid group or bring in some low paid people out of the DB pension plan and move them into the profit-sharing plan. This issue can kill most traditional, two-plan, comparability situations where you are putting the bulk of the highly paid people in one plan and the bulk of the low paid people in another plan because most highly paid people, if they're in the profit-sharing plan, for example, want those valuable rights and features. They often want the right to get their money out, at least through a loan, if not an in-service withdrawal, and taking those rights away might make this arrangement sufficiently unattractive that they just say, Let's go to one plan for everybody. So, that's the rule. It's a tough rule.

One interesting issue which I don't have an answer to is with respect to some of these so-called core benefits. The general rule existed in 1987 and technically applied to lump sum and to in-service withdrawals. That was the final regulation. So, theoretically, at least, these plans, if companies thought about it, should have been complying with this through 1988, 1989 and 1990. Chances are most didn't. I've never heard the IRS address that issue, whether it will provide any grandfather relief or just look the other way, but I think everyone is keeping their fingers crossed because now there's no way retroactively that you can cure that problem. So, technically there may be a lot of plans out there in noncompliance, and there's not much they can do about it but hope the IRS doesn't pursue the issue.

MR. DEMPSEY D. (NICK) WHITE: We're going to take a look at the average benefits test now. The first thing we want to ask is, When do you want to use the average benefits test? Well, there are basically two reasons to use the average benefits test. One purpose of the average benefits test would be if you had a coverage problem, and at least one of your plans does not pass the ratio percentage test that Paul talked about earlier. If that's the case, then you've got to find some way to pass the rules under 410(b), and you're going to be stuck with going through the average benefits test and hoping you pass there. The other purpose for using the average benefits test is when you really don't start off with the coverage test. You really start off with a 401(a)(4) problem. You have a plan that doesn't meet a safe harbor, and in order to pass 401(a)(4) you're going to have to go through rate segment restructuring, in which case you're going to find that you're going to be able to pass rate segment restructuring a lot easier if you're able to pass the average benefits test.

You may decide to do the average benefits test in that event, even if you can pass the ratio percentage test on the plan as a whole because for each segment you want to be able to use a lower criterion for determining whether or not you pass coverage with respect to that individual rate segment.

Let's consider the testing group. Basically, the average benefits test, and this has been discussed a little bit earlier to some extent, is an aggregate test. You're required to aggregate for purposes of the average benefits test all plans which you could

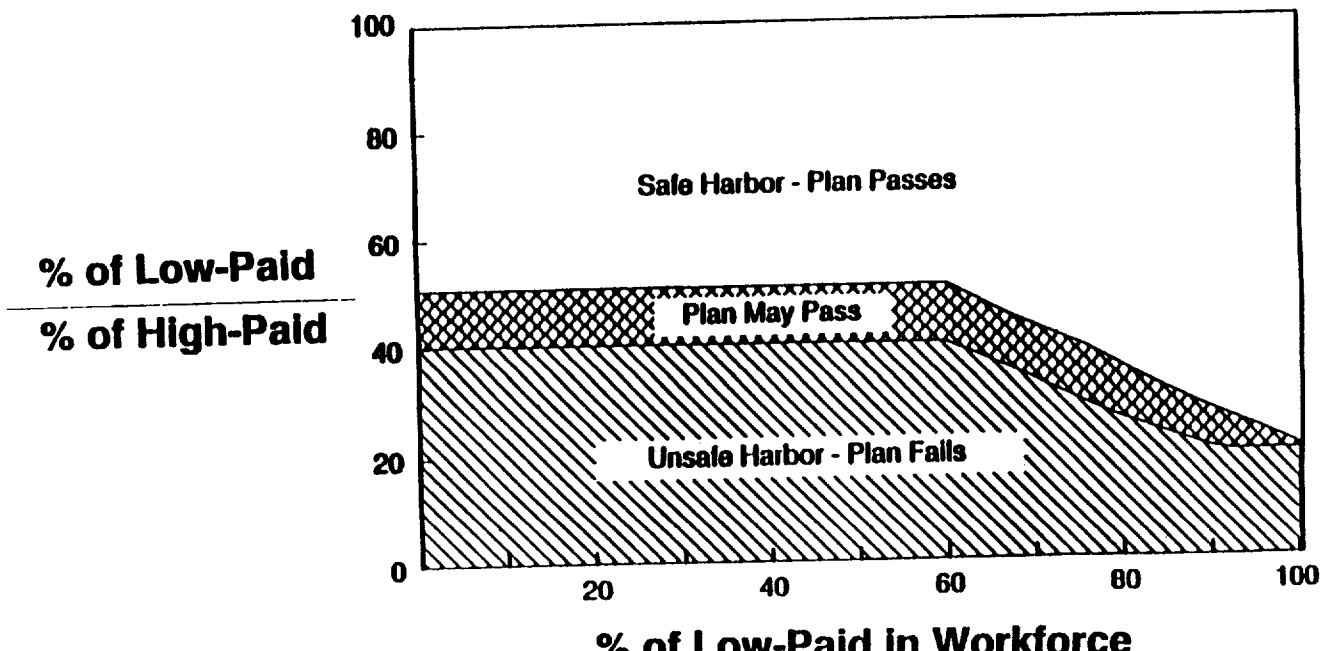
permissibly aggregate under Section 410. So, basically this includes all plans of the controlled group with the exception of very specific types of plans such as collectively bargained plans, and in the original version of the 410(b) rules you were also supposed to exclude ESOPs from your testing universe. That's been changed under the amended rule. What employees are included in the average benefits test? Basically all employees of the controlled group except for three exceptions: union employees, nonresident aliens with no U.S. source income, and employees not meeting the least restrictive age and service requirement of any of the plans that are aggregated for purposes of completing the average benefits test. For example, if you had a 401(k) plan that allowed participation on the beginning of the month following date of hire, and you had a defined benefit plan that provided for participation after a one-year waiting period, you basically would have to include everyone in the average benefits test who has been employed for at least a month because they could have met the requirements of the least restrictive plan that you're working with. There is a provision that would allow you to treat the people who don't meet statutory age and service requirements as a separate plan, but that plan would then have to be aggregated back into the average benefits test.

As we talked about a little bit earlier, there are two, and to some extent three, portions of the average benefits test. You have the nondiscriminatory classification test, which is a very modified version of the old fair cross-section test, and then you have the average benefit percentage test. To pass the average benefits test you must pass each of these two pieces. The nondiscriminatory classification test itself has two pieces. There's the subjective test, and unless you're restructuring based upon rates that have a specific exception, you must have a legitimate business reason for the specific group of employees. This nondiscriminatory classification test is conducted on each plan individually. You must have a legitimate business reason for covering the group of employees who you cover under that specific plan, whether it be based upon employee job position, status, geographical reasons, line of business or what have you. You must have a legitimate business reason. You're specifically exempted from worrying about that legitimate business reason in the event of doing rate segment restructuring or total rate restructuring because clearly there's no way that can make any legitimate business sense to have these little bands of rates floating around. The IRS was cognizant of that and said in that event you did not need to worry about the specific legitimate business reason for that band.

In addition to the subjective test you also have an objective test. Basically, this is a relaxed version of the ratio percentage test, and Chart 13 shows how that works. You look at the concentration of nonhighly compensated employees in your work force, and you find that across the x-axis, and then you look at your coverage ratio, finding that along the y-axis. If both items intersect in the white area, then you've passed the safe harbor. If they intersect in the diagonal lined area, there's no way on earth, without aggregating plans, that you're going to have any chance there. And if they fall in between, then you'll fall into a facts and circumstances situation.

The average benefit percentage test itself is pretty simple on the face of it, especially once you understand 401(a)(4). In fact, if you're going to be doing 401(a)(4) general rule testing anyway, it's really not a substantial additional effort to go through the

NONDISCRIMINATORY CLASSIFICATION TEST



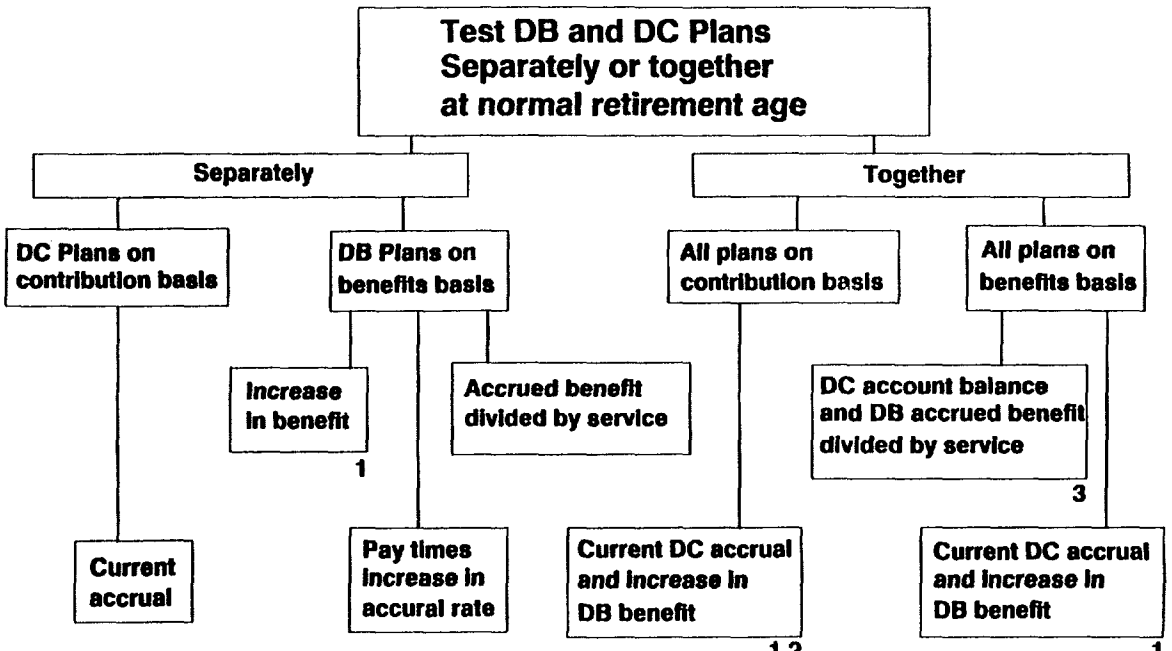
calculations for the average benefits test because you'll already have most of the components that you need to do the test. Basically you calculate the average of the benefits percentages for all the nonhighly compensated employees. Calculate the same average of the benefits percentages for all the highly compensated employees. Take the ratio, and if that's greater than or equal to 70%, then you pass.

How do you calculate the percentages? Basically you add together all the normal retirement age accrual rates or allocation rates, if you're doing this on a contribution basis, for plans which could be integrated under 401(l) irrespective of whether the plan is integrated or not. So, in the situation where you have a DB plan and a 401(k) plan, or perhaps you have two or three DB plans and the 401(k) plan, you'd look at those DB plans, calculate benefits under the DB plan, and then you can adjust those accruals for permitted disparity. You could not include in that top item the accruals or the allocations under the 401(k) plan at this point. You have to adjust for permitted disparity before you include those accruals because a 401(k) plan could not be integrated with 401(l) and, therefore, cannot have permitted disparity imputed to it. So, you add that in. Then you note that the denominators for all these rates have to be based on the nondiscriminatory definition of compensation as is the case with the denominators in all these tests, and that's defined under Section 414(s). It can either be a safe harbor, or it can pass the actual testing under 414(s). You come up with a benefits percentage for each individual. This could very easily be zero and typically will be zero for some participants or some employees who may not participate in any plan. The typical situation where you're getting into a coverage problem is when you have either plans that cover nonunion, hourly employees or perhaps have a group of nonunion hourly people floating around out there who don't have any plan at all. Employees who aren't covered by plans are included in the test, and they're included as zeros.

Chart 14 gives you some feel for whether you test the plans together or separately, exactly what rules apply and how you can calculate the percentages.

Basically you're given the right to either do the testing under the average benefits test together for your DB and your DC plans or separately. Which you elect to do will typically depend upon why you're going through the average benefits test. If you're going through the average benefits test because you have a coverage problem, then in the case that I've typically seen, if you've got a coverage problem for a salaried pension plan, and you've also got a coverage problem for a 401(k) plan that covers a similar group to what the salary pension plan covers. In that case you're really not going to have any choice but to do the tests together. It doesn't make any sense to do the tests other than together because otherwise both of those would have to pass individually, and when you put them together you're going to get an answer that's somewhere in between the two answers you'd get if you did them individually. So, you're going to find that you're going to be more likely to pass if you put them together if you have a coverage problem, unless you don't have a coverage problem with respect to a specific 401(k) plan, in which case it's probably going to help you pass on the DB side anyway. If you're doing the average benefits test because you have a 401(a)(4) problem, you may well decide to actually do the testing separately with respect to the DC plans and the DB plans. Let's suppose that you have a 401(k) plan that covers everybody, and you've got a DB plan that also covers everyone, but the DB plan is a PIA offset plan which doesn't satisfy a safe harbor under

410(b) - Average Benefits Percentage Test



Disadvantages:

1 - magnifies effect of current pay on DB past service

2 - gives more weight to older DB participants

3 - needs DC account balances

401(a)(4). In that case I would suggest that you probably would want to split those two. On your DC plan side, you're not even actually going to have to go through the average benefits test because it's going to pass the ratio percentage test, and on the DB plan side you're going to go through the average benefits test with the full expectation of passing so that you can use the relaxed criteria for purposes of determining whether your bands pass the coverage rules.

Just to go through a few miscellaneous details that I didn't cover earlier, the DB accruals are determined on the normal retirement basis unless very highly subsidized early retirement benefits are available to a discriminatory group. Very highly subsidized means that the early retirement factor at age 60 is greater than or equal to 80%. The DB accruals are determined only under the annual accrual approach or the accrued-to-date approach. You cannot use the projected accrual approach for purposes of determining the DB accrual under the average benefits test. As I mentioned earlier, ESOPs are now in. They were originally out. You're allowed to average the percentages for each individual over a three-year period if you wish. If you don't wish to deal with annual percentages, this would obviously be a good bit more complicated and require you to keep more information that may reduce the volatility in your testing results. I would argue that if you're doing this testing, and you have to resort to something like this in order to get the plans to pass, then you're probably living too close to the edge anyway, and maybe it makes sense to look at a different plan design. You're not allowed to average the compensation for the denominator if you're testing on a contribution basis. Other than that, you're allowed to either use average compensation for the denominator or single-year compensation for the denominator.

MR. VINCENT F. SPINA: There's a section in the regulations that refers to when you do your banding, that the highly compensated employees have to be spread throughout the band. What does that mean? Reasonably dispersed, what does that mean?

MR. STRELLA: I don't think anyone knows. Lane talked about what he called grouping, which is when you have people who have rates. Someone's got 1.01%, another 1.02, and another 1.03; the rates are kind of huddled together. If you had to look at each and every rate and restructure on that basis, you would drive yourself crazy. So, the regulations permit you to take people who are clustered around a range, and the range can be about 5% above or under a midpoint, but it's a fairly narrow range. Everyone within that range can be treated as having the same rate provided that the highly paid and the low paid employees within that cluster are reasonably dispersed. In other words, you don't have all the highly paid people at the top of the range and all of the low paid people at the bottom of the range. To give an example, say you're looking at a formula where all the low paid people get 2%, and all the highly paid people get 2.2%. Now, that looks bad on its face, but the grouping rule, that range, 2 to 2.2, is a single range. So, technically you could treat everyone in that range as having the identical rate, and you would pass the test, even though all your highly paid employees are getting 2.2%, and all your low paid people are getting 2.0%. The rule that the question was about said, you can't use the grouping rule if all your highly paid people are at the top and all your low paid people are at the bottom. There has to be some reasonably comparable dispersion of the two groups within the range. It's not an objective test. I think it's just sort of a facts and circumstances "gut" check, and really the IRS has not issued any sort

of clarifying guidance at all or even said anything informally in any talks that I've heard. You can view it, at a minimum, as an antiabuse. You just can't take the good formula and give the highly paid employees 10% more and then rely on the grouping rule to pass. But what will pass and what won't pass under that, I think it's just going to take time to tell. The rule will just have to evolve. I don't think there's a better answer than that.

MR. WHITE: I would agree with that. One thing to keep in mind is that the typical approach you would take in writing a computer program to do this is, you would go down to the highly compensated employee who had the highest accrual rate and start a band there. It's conceivable that could be an abuse because you're optimizing one of the most critical bands in determining whether you pass or fail the test. That's going to be one of the key bands to determine whether you pass or fail upon putting a highly compensated person at the very top of that band.

MR. STRELLA: Let's say you have 10 different bands, and one band looks bad to you, but the other bands look pretty good. Do you fail? Are you unable to use groupings now and your whole plan blows up?

I would argue that if only one band is failing, that doesn't look unreasonable, and it doesn't look abusive, and I wouldn't worry about it. I would at least argue that point. So, I wouldn't worry about having to look at every band, but I think that you may want to check the higher bands a bit more carefully.

MR. DAVID P. KENDALL: I have a question on sequential restructuring. Paul, I'm not sure if it was intended or not, but in the example that you gave, the original accrual rates, there aren't any highly compensated employees who have accrual rates in excess of nonhighly compensated employees' rates. The first part of the question, then, is mathematically, if you do have that situation, in particular if the most valuable accrual rates are not in sequence with the normal accrual rates, will you be able to pass on any basis, given that it's sequential versus starting over again? And then, second, do you have any insight as to any further guidance that we might be getting from the IRS if this is still a problem for passing the general test?

MR. WHITE: As you'll recall from Paul's example, that was a plan that passed the general rule. There aren't very many plans that pass the general rule, and even that plan that passed the general rule didn't have a ghost of a chance under the way we understand sequential restructuring from the current IRS line of thinking. I have not seen a plan that would pass sequential restructuring based upon the IRS's current approach to thinking of it unless it would also clearly pass the general rule, in which case you don't need it anyway.

MR. STRELLA: I have not seen that many numbers. I really can't speak from much practical experience. In answer to the other question on what the IRS might do, since I'm not over there anymore, it's even harder to guess. It was hard enough then. The IRS has, at least informally, indicated that it is aware that its new sequential restructuring may well be unworkable in practice, so that we probably have not heard the last word, and it is looking at something like the other alternative I laid out which I think

mathematically is also similar to something that TPF&C has publicly argued for which it calls the matrix approach. I think it's the same approach, and I do know that the IRS is at least looking at it. I won't predict what it might do, but I would expect some relief in that area.

MR. KENDALL: So, you are saying that, if you have that type of a problem with most valuable accrual rates, there is no way to pass the general test.

MR. STRELLA: Well, if you read the regulation the way the IRS says it intended it, and you can also try to read it another way and just say, Hey, this regulation is not crystal clear. That's very complicated test to load into one word. I mean I think the IRS is asking a lot of its readership.

MR. WHITE: Keep in mind that there's a special rule under 401(a)(4) that might let some plans get by. If they have a uniform benefit formula, and all the rights and features of the plan are available to everyone, and the definition of compensation used to calculate benefits meets the requirements of 414(s), then it's not necessary to restructure based upon both the normal accruals and the most valuable accruals. You need only test the most valuable accruals, in which case you only have to do your restructuring once. In that case the plan's got a shot.

MR. JAMES J. RIZZO: Can you describe how they're going to enforce this, at determination letter time or another four pages of the 5500 or on audit only?

MR. STRELLA: I will try. I don't think, frankly, that the IRS knows yet. What the people are saying at the IRS, at least, is that they are looking at giving the employer some option to pick how much protection it wants from its approval letter. In other words, you can go in and get a caveated letter and not provide a whole lot of data or substantiation that you passed the tests. Alternatively, you can check more boxes and say, I want protection on the following points, and then the IRS is going to ask for more documentation. I don't think it has made up its mind yet what levels it is going to rule on, or what kind of documentation it is going to require. I think the IRS is having a hard time trying to figure that out. I mean obviously we have objective tests now which, in theory at least, are enforceable. You can go and run the test and look at the numbers, and that's a big change from prior law where everything was kind of facts and circumstances. How did it smell to an agent? Now we've got an objective measure, and the IRS may well ask for a fairly lengthy submission of data, especially if you're doing the general test, or you're going to do an average benefits test. But I really don't know what the IRS going to be looking for, and that's one reason the program isn't open yet.

MR. WEST: I think one thing that you've got to be cautious of is your clients may not want to do the test each year, but they should at least collect the data to perform the test. If they're going to comply under the general rule, and you do the test initially, and they pass with flying colors, that does not necessarily mean they're going to pass the following year. So, it's something that you at least must collect the data for. And the other question is, Can you retroactively make a correction? and I think that question's still open. So, I think the safe bet today would be to tell your clients that you're going to have to perform the test annually, and maybe our job is to assist them in doing that.

MR. MICHAEL D. SCHACHET: Would you just summarize the penalties for failing the test?

MR. STRELLA: What the regulations say is if you fail 401(a)(4), you really fail 410 minimum coverage, and the Internal Revenue Code now has a special sanction for failing minimum coverage. The first part of the sanction is that each and every highly compensated employee has to take into income in the year of disqualification the present value of his entire vested interest in the plan. So, that's a pretty heavy hit to your highly paid employees. Low paid employees suffer no sanction at all. And then the trust itself would become taxable on all of its income that is generated each year, and the employer could not deduct contributions to the trust. So, I think those are sort of the three major effects. That's assuming they want to hit you with a full bolt. Now, the IRS has in recent years been apparently willing to strike settlement agreements. Maybe the employer agrees to go back and cure the problem and pay a fine or something. I think we'll just have to see that practice evolve under these rules because I think the IRS is going to be unwilling or unlikely to load the full sanctions on any one employer. Maybe it will just hit the employer but not hit the employees. I think the IRS has some latitude.

MR. JON L. KING: Mr. Strella, if the IRS did end up imputing income to the highly compensated employees, how would the statute of limitations apply if the disqualification came three years later? Would it be possible that the highly compensated people would essentially get off scot-free both at that time and for future income as well?

MR. STRELLA: That's a good question. I'm not sure I know the answer. I don't know.

MR. WEST: One thing we haven't talked about is the transition rule for 1989 and 1990, and I know we've been performing some average benefit tests for 1989. I'm wondering if anyone here has some comments on that or would like to share their experiences. We found there are certain parts of 81-202 you can use and certain parts that you cannot use. It's very clear that you cannot use the old Social Security integration rules. You can't add in the full PIA. You have to reflect the new permitted disparity. The major difference seems to be, though, the projection. Can you project benefits versus the accrual? Paul says if you look at the Congressional committee reports, I believe they mention accrual, that would be one of the modifications, and I think the question is how you interpret that.

MR. STRELLA: I guess I would be inclined to be a little aggressive on that one. I don't think it's appropriate to hold an employer to the standard of reading the legislative history and divining from a sentence or two what the IRS might have done. Revenue Ruling 81-202 was out there. It was the only published guidance, really, that we had to rely on in 401(a)(4), and I guess I'm pretty comfortable relying on it in 1989 and 1990, with one major caveat, and that's that the integration rules did clearly change legally as of 1989, so you have to change the method of taking into account Social Security when you look at the 81-202 analysis.

That can significantly change your result, and a plan that might have passed under 81-202 might well have failed under the new integration rules. So, that's one important caveat. Otherwise, maybe I'm more out on the limb on this one, but I just don't think

the IRS is going to push hard on 1989 and 1990. It was late with its regulation. It knows that. I think the IRS would rather look the other way on 1989 and 1990, unless it's a really abusive situation, in the hopes of getting the ongoing, permanent rule that it wants.

MR. WHITE: In fact, I've heard that the IRS has informally stated that it is not specifically going to go after the years 1989 and 1990 to actively audit those years but that those years could clearly come up in the case of later audits or what have you. Now, whether that actually gets down to the field agent level, what really happens, who knows?

MR. STRELLA: If you have a pure excess-only plan, I wouldn't try to carry it through 1989 and 1990. I don't think that's a good basis for presentation. We've run it through the general testing. At least we've done the test, but I think there are a lot of plans that might well pass. And one other caveat on this is, even if you have an existing arrangement that you think you can make a good faith argument for 1989 and 1990, but it's going to fail in 1991 under the full-blown, new rules, you're going to have to change that plan at some point, and there are a lot of other reasons why it may just be easier to go back and make the change retroactive to 1989. For example, if you want to be in a safe harbor, the new rules may, in fact, require that your new formula be retroactive to 1989. It may be more of an academic question for a lot of employers, which as a practical matter, have to go back and amend the plan as of 1989 anyway.