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NONDISCRIMINATION ISSUES

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- o What does the Internal Revenue Code say?
  - -- Section 401(a)(26)
  - -- Section 401(a)(4)
  - -- Section 410(b)
  - -- Section 401(l)
- o How have consultants advised their clients to comply?

MR. DONALD J. SEGAL: I'm with the Martin E. Segal Company. Joining us on the panel is James Kenney from Coates, Kenney, Inc. in San Francisco and Debra Clark from William M. Mercer. We're going to talk about nondiscrimination issues, specifically Sections 401(a)(4), 401(l), 410(b) and 401(a)(26).

The target date for the release of the 401(a)(4) regulations and the republication of 401(a)(26) and the additional information on 401(l) is targeted for April 16. So it's a little difficult for us when we know that what we say may be valid for only 12 more days.

Let's start with a little background. Section 401(a)(4) has been in the Code for a long time. The 401(a)(4) regulation now reads that the requirements for qualification of a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of the employees or their beneficiaries shall constitute a qualified trust under this section if the contributions or benefits provided under the plan do not discriminate in favor of the highly compensated employees. And for purposes of this paragraph there shall be excluded from consideration employees covered by a collective bargaining agreement and nonresident aliens who receive no earned income from sources within the U.S. That's the general rule.

We're going to open up now with Debbie Clark, who's going to talk about 401(a)(26).

MS. DEBRA ANN CLARK: When I think of 401(a)(26) I immediately think of two challenges. One I pose to the IRS is how to simplify 401(a)(26) so that we're dealing practically with discrimination in employee benefit plans.

The other challenge was for myself, and that is, after it's been out a year, how do I make 401(a)(26) understandable and interesting? So please bear with me now while, to quote our speaker I "try to turn a moment of misery into a moment of magic."

Basically the 401(a)(26) regulation has three objectives: (1) to limit the operation of individual defined benefit plans that were operated as individual accounts for small groups of employees, (2) to limit the offering of different benefit formulas in qualified plans for different groups of employees, and finally, (3) to limit the use of plans to increase returns to employers or to highly compensated employees.

The approach I will take in my discussion of 401(a)(26) is to go through some steps that will provide a general outline of the regulations which will hopefully simplify them a bit.

You may go about looking at your plans in terms of 401(a)(26) by first identifying those plans that must be tested for compliance. There are certain plans that you can exclude from testing. Those plans that are deemed to automatically satisfy 401(a)(26) are those plans that are not top heavy and do not benefit, for at least six prior years, including the current, any active or former highly compensated employee. This is available only if the plan is not aggregated with any other plan for purposes of complying with Section 410(b). You can treat highly compensated employees for plan years prior to January 1, 1984 as if they were nonhighly compensated employees.

Other plans that can be excluded from testing under 401(a)(26) are multiemployer plans. If collectively bargained employees participate in the plan, you can deem these employees to be participants in a separate plan from the noncollectively bargained employees. The collectively bargained plan will automatically comply with Section 401(a)(26).

A problem that you run into with collectively bargained plans arises when noncollectively bargained employees participate in a collectively bargained plan. Sometimes there's an arrangement where fund office staff, which are noncollectively bargained participants, are being covered by a plan also covering collectively bargained employees. The noncollectively bargained participants must be separated from the collectively-bargained employees. The collectively bargained employees automatically comply with 401(a)(26), but you must test the noncollectively bargained group.

This exclusion from testing for multiemployer plans doesn't apply to a collectively bargained plan covering more than 2% professionals as it's defined in the regulations for 410(b) and 401(a)(26).

There is a third exception from testing for certain underfunded defined benefit plans that primarily benefit nonhighly compensated employees, and where all benefit accruals have ceased. The plan cannot rely on this rule for more than three years.

In the testing for compliance under Section 401(a)(26), there are some plans that must be disaggregated and some that you can elect to test separately. Plans that must be tested separately are individual account versus nonindividual account plans, collectively bargained versus noncollectively bargained plans and employee stock ownership plan (ESOPs) versus nonESOPS. For multiple employer plans, each employer must be tested separately. Compliance must be satisfied only with respect to each employer's employees. If one employer does not satisfy 401(a)(26), you may think that disqualification of the entire plan may occur. But the regulation discusses not disqualifying all plans if the employer who fails rectifies the problem.

Then there is optional disaggregation of plans. For example, you can elect to treat what's called otherwise excludable employees separately from those employees that are not otherwise excludable. An "otherwise excludable" employee is defined in the regulation, and I'll get to that in a little bit.

Once you've identified the plans that must be tested, the next step is to identify current benefit structures and prior benefit structures. This is where we start getting into the complexities of 401(a)(26) -- the unnecessary complexities.

Current benefit structures are tested separately from a prior benefit structure. What is a current benefit structure? To determine a current benefit structure, you look at benefit provisions or benefit rates that are provided on a uniform basis for all employees that are eligible to participate. This includes subsidies, optional forms of benefits, different definitions of compensation and different levels of employee contributions in a contributory plan. In looking at current benefit structures you can disregard benefit rates that vary with entry age, with compensation level not compensation definitions, permitted disparity based on Social Security retirement age and benefit rates that are the better of two formulas that are provided on a uniform basis.

Separate current benefit structures exist for 401(k) and 401(m) plans, if there are differences in the availability and/or maximum rates. Elective contributions under 401(k) are separate benefit structures from after-tax employee contributions under 401(m). Matching contributions under 401(m) are also separate current benefit structures.

There are some permitted differences which would result in a plan having a single current benefit structure. A benefit structure in a plan that is a result of the plan being top heavy can be disregarded in determining separate benefit structures.

A difference in the allocation of 401(k) or 401(m) contributions, at the employee's election, is considered one separate benefit structure.

Grandfathered benefits will not be considered a separate benefit structure, provided they are wholly based on prior years of service. In other words, you couldn't have a grandfathered benefit that was based on compensation earned in the future.

Benefit offset arrangements can satisfy the one separate benefit structure requirement. Employees must be benefitting under both formulas on a uniform basis. The offset must have been originally accrued under the offset plan. And the offset cannot be used under any other plan than the one being tested. This is to satisfy the nondiscrimination tests termed the antimultiple use condition.

Next there are prior benefit structures. Prior benefit structures are for defined benefit plans only. There is only one prior benefit structure for each defined benefit plan. Once you've identified the current benefit and prior benefit structures, the next step is to split your employee group into active employees and former employees. The general test for compliance with 401(a)(26), which is referred to as 50/40, is that a benefit structure must benefit at least the lesser of 50 employees of the employer or 40% of the employees of the employer. Testing must be done separately to active employees and to former employees. So in testing the active group, the benefit structure must benefit the lesser of 50 active employees of the employer or 40% of the active employees of the employer.

Employees that can be excluded from the testing of the active group are otherwise excludable active employees. They are employees that do not satisfy the minimum age and service requirements of the plan (i.e., age 21 and one year of service or the plan provisions). The regulations do not refer to the minimum allowable exclusion of any age and two years of service.

Otherwise excludable employees could be excluded due to not satisfying the minimum age and service requirements, but the plan chooses not to exclude them. They can be excluded from testing the active group if the plan benefits actives who are not otherwise excludable employees, the plan satisfies the 50/40 rule for otherwise excludable employees and the nonexcludable employees separately, the contributions or benefits for the otherwise excludable employees as a percentage of compensation are not greater than those for the nonexcludable employees and no otherwise excludable employee is a highly compensated employee for more than one year. There are similar rules for active and former employees in determining excludable employees.

The next step is to determine who benefits under a current benefit structure. An employee is deemed to benefit under a current benefit structure if the employee accrues the maximum benefits under a defined benefit plan or receives the maximum allocation under a defined contribution plan. An employee can accrue less than the maximum if he/she works less hours and the plan provides for the accrual of a prorated portion of a benefit for working less hours.

An employee will be deemed to be benefitting in a 401(k) or a 401(m) plan by just being eligible, regardless of whether they receive an allocation for the year. An employee that has no accrual during a year due to the application of Section 415 limits will still be deemed to be benefitting. If the plan limits the benefit as a result of a service maximum, an employee can still be deemed to be benefitting. Benefit offset arrangements and grandfathered benefits can result in an employee benefitting under that current benefit structure, regardless of whether there is an actual accrual.

The next step is to apply the tests. The general test is the 50/40 rule as I previously discussed; there are some alternatives. The current benefit structure will automatically satisfy 401(a)(26) if a plan never benefitted a highly compensated employee, the current benefit structure being tested was not to be relied upon to satisfy 410(b) or 401(a)(4) and the plan benefits the lesser of 50 total employees or 40% of the total employees of the employers.

A current benefit structure for former employees can be deemed to satisfy 401(a)(26) if at least five former employees benefit under the current benefit structure and either more than 95% of all former employees benefit under that current benefit structure or at least 60% of the benefitting former employees are nonhighly compensated former employees.

Already you can see how complex the regulations are. A current benefit structure for former employees may be an ad-hoc increase. In the past, an employer granted an increase to former employees. Now the employer must be concerned as to whether they're satisfying certain discrimination tests with regard to these adhoc increases.

I don't want to get into the testing of prior benefit structures. Prior benefit structure testing consists of two categories. One is prior benefit structures that provide meaningful benefits to actives. Any one of four tests can be satisfied. If the plan does not provide meaningful accruals, then there are two tests you can use. I'm hoping that prior benefit structures will be eliminated from the republished regulations so that we don't have to deal with this.

The regulations on 401(a)(26) discuss compliance on each day of the plan year. When I read this I immediately thought of Section 89, and so I had my hopes up that maybe they were going to repeal this one too. It's very unreasonable to require that you have to satisfy anything on every day of the plan year. So hopefully this will be modified.

The final step in the compliance process is remedial action if necessary. There are a few possible actions you can take. One, you could merge two plans. The second alternative is to put more people in the plan that fails. The third possibility is to terminate the plan. The regulations discuss no excise tax on any reversions being imposed if the plan is terminated by the end of the 1988 plan year as extended by Notice 88-131, which would have been May 31, 1989. Well it's now in 1990.

Are you too late for any of the actions that you could have possibly taken if the plan violated 401(a)(26)? Maybe not if you wanted to put more people in the plan on a retroactive basis. But what if you had a contributory plan, where the participant had to contribute to participate for 1989? The effective date for compliance is the first plan year beginning after December 31, 1988.

As Don mentioned, rumor has it that they are republishing the 401(a)(26) regulations hopefully in two weeks and hopefully in a much more simplified fashion. We've heard that probably who benefits under a structure won't change. But there has to be some simplification. What I would like to hear is back to facts and circumstances. Not all plans I believe were set up to discriminate. My impression of 401(a)(26) is taking mathematical formulas and applying them to real life situations that were never intended to do what the IRS thinks practitioners were intending to do.

Let's get rid of the current benefit structures and especially the prior benefit structures. Let's get back to facts and circumstances. Let's have automatic compliance with 401(a)(26) for frozen benefit plans, unless the plan was blatantly discriminatory. Again, back to facts and circumstances. Have automatic compliance if you take out the highly compensated prospectively. How could a plan be discriminatory then? Let's get back to facts and circumstances. I can't stress that enough. It seems to me that the regulations must address plans that are blatantly discriminatory versus one that was intended to benefit employees.

Finally, give us some relief on the effective date. Unfortunately we've seen so much legislation that's come out where we've had to deal with questions on their implementation being concerned about their effective dates. We really need some relief on the effective date as 1989 is gone and we're into 1990.

There are two other pieces of legislation that deal with nondiscrimination in employee benefits. The 411(d)(6) regulations deal with protected benefits and emphasize the elimination of employer discretion. I don't know that every employer means to be discriminatory when they're providing certain benefits at their discretion.

The Retirement Equity Act (REA) regulations discuss when disability benefits are considered auxiliary. They focus on disability pensioners not being given the same rights as normal retirement or early retirement pensioners. There may be discrimination in terms of disability pensioners. But sometimes disability pensioners get full benefits payable immediately upon disability. The plan may not be giving a disability pensioner the same normal form of payment under the plan as a regular retiree. For example, single participants may be given a three-year certain and life benefit as the normal form of retirement benefit whereas a disability pensioner may only get a life benefit. The plan may be giving the disability pensioner his or her full accrued benefit immediately upon disablement. So to give them a life benefit versus a three-year certain and life benefit is not neces-sarily discriminatory.

MR. SEGAL: I'm going to talk a little bit about 401(l). I was interested in the comments about 401(a)(26). It was bad enough that 118 pages was the magic number for both the 401(a)(26) and the 401(l) regulations. I've heard that's going to be nothing compared with what's coming out in a couple of weeks.

My own reaction to 401(a)(26) now, with respect to regulations, is if they are talking simplification, the best simplification they could give us is no regulations whatsoever. The offending plans in the eyes of the IRS are now gone. So why doesn't it give the rest of the plans that are left a break, and not give us any regulations at all. Leave it to the practitioner to interpret the code. I don't want to be worried about a prior benefit structure or a current benefit structure.

The general approach I'm going to take with respect to integration (I still refuse to call it permitted disparity) is, assuming by now all of you have some familiarity with it, to talk about the rules that have been issued, the rumors we've heard -- which I will call rumors one, and rumors we want to hear -- rumors two.

Section 401(l) defined permitted disparity. It gave us rules for defined contribution plans and defined benefit plans. The rules for defined contribution plans were rather simplistic, in that the excess contribution cannot exceed the base contribution by the lesser of the base contribution percentage or 5.7%. If you look at these new rules as a whole, all they really needed to prevent the discrimination that was perceived to be taking place was to put in the two-for-one rule.

The IRS was troubled by excess only plans on both the defined contribution and the defined benefit side. The two-for-one rule would have gotten rid of 90% of the problems if that's all they had put in. They could have stopped there, and everyone would have been left with a basically nondiscriminatory program.

Further guidance was issued after the initial regulations in Revenue Ruling 89-70. As we mentioned, we're getting further guidance in a couple of weeks. As originally drafted, you could only integrate a defined contribution plan at the taxable wage base. Now they're permitting us to integrate at other levels. If you go up to 20% of the taxable wage base you can stay at the 5.7%. Between 20% and 80% you have to drop to 4.3%. Between 80% and 100%, 5.4%. At 100% you go back to 5.7%. What's unsaid is that you cannot integrate a DC plan at a level over the taxable wage base, although I don't know of anybody who ever designed a plan like that.

For defined benefit plans, there is traditional differentiation between an offset and an excess plan, but there seems to be this underlying philosophy that the two must be equivalent. They have never been equivalent in the past when we were dealing with PIA offsets. But now, since we're dealing with offsets based upon covered compensation, there is this underlying philosophy that it must be the same. Part of the problem that we have with these regulations is uniformity. A lot of the problems could go away if they got away from this equivalency.

One thing you have to be careful of in trying to deal with these regulations is in the definition of an offset. I'm going to jump ahead a little in terms of a thought and come back.

Some people have been concerned that one of the transition rules basically froze the benefit as of the end of the 1988 plan year. People were concerned about it. We'll talk about it a little bit more.

Early on, people thought they could put in another level of benefit. For example, if you had a formula which was 1.5% final average earnings, minus 1.5% of primary insurance amount (PIA), you had to treat the December 31, 1988 accruals (if a calendar year plan) as if you had terminated at that point. So it means that for somebody who's going to retire 10 or 15 years from now, his salary, with respect to service through 1988, was frozen. Why don't we just layer a benefit in. Give them 1.5% of true final average earnings, times service through 1988, minus the benefit that they earned through 1988. It's a nonintegrated formula, so there should be no problem with it, but there is a problem with it.

If you read the regulations, that's an offset formula. You won't qualify. It's a bad solution, great idea, but it doesn't work. As I mentioned we have this concept of uniformity in the regulations. I couldn't find the word in the code, but it somehow crept into the regulations.

The only exception to the so-called uniformity was if you had a different Social Security retirement age, you were permitted to use a different disparity without violating the uniformity principle.

Again, the basic rule. The maximum permissible excess or offset cannot exceed the lesser of .5 of the base benefit or .75%, .70%, or .65% (depending upon the Social Security retirement age) of average compensation or final average compensation, depending upon whether you were dealing with an excess plan or an offset plan, final average compensation not in excess of covered compensation, times years of service not in excess of 35. Again, some people have interpreted this as saying you could never give more than 35 years of credited service in the integrated piece of the formula. That's not true. All it says is that the maximum integration was your appropriate percentage -- .75, .70, or .65 times 35. If you wanted to spread it as 0.5% over 50 years, fine; that works.

The covered compensation definition gave us a bit of an interesting problem. The Code said it was the average of the Social Security wage bases over 35 years ending in the year in which you attain Social Security retirement age. The committee report for Tax Reform Act (TRA) 1986 went on to say it is just like it is in the present law. And all the actuaries looked at it and said, "That's not the way it is in the present law." So we finally got regulations which made it closer to what was in the present law -- year ending prior to the year in which you attain Social Security retirement age. But, of course, they still said 35 years. The old law didn't get to the 35-year requirement for about five more years. And then in Revenue Ruling 89-70 they said no. There is a very famous IRS expression "The law is the law." It says, "ending in the year in which you attain Social Security retirement age." So here we are; we have three definitions folks. Some of you redesigned your plans based upon the proposed regulations, and now you have 89-70 coming out that says, oh, we've changed our mind. But they said you don't have to change that for six years.

And of course, there is the famous phrase, "Read my lips, no PIA offsets." How many actuarial meetings have you been to in the last couple of years where people have said, "Can I use a PIA offset?" And they say no. There's hope on the horizon yet.

We did some interesting testing at our firm where we were asking if there is a safe harbor for a percentage of PIA? There are certain formulas you can look at which you know are not discriminatory. Experience tells you they're not discriminatory. But according to the rules you can't use them. I'm not saying they're discriminatory, but you can't use them under 401(l).

Testing through about age 55, if you had a unit accrual of about 1.42% of PIA as your offset, you would always come out with an offset less than the covered compensation offset. What happens is it broke down at ages 60 and higher. We were testing at the quinquennial ages. Most of you, I assume, have worked with it and have seen that the offset under the covered compensation offset is much more favorable to the employee as compared to a PIA offset for the people very close to retirement age right now. So it would be nice to have a safe harbor; if your offset isn't greater than 1.5% of PIA, you're okay.

They gave us three transition rules which, when you looked at them, essentially broke down into one rule, similar to when they decided that the percentage ratio test was one test, not two, under 410(b).

The three transition rules are: (1) freeze the benefit at the end of 1988 using your new formulas starting with 1989, (2) use your formula for all years of service, but not less than the benefit accrued through 1988, and (3) use the better of the two. That is the only one to use if you're trying to design a good plan.

What are the issues? There have been many discussions at actuarial meetings. Hopefully the IRS was listening. There's an issue of uniformity. Again I mention the offset versus the excess plan. There is this basic philosophy, and if you understand the philosophy, you will understand what the IRS is saying. You may not agree with it, but you'll understand it. It is that they must be identical. When you turn the formula around from an offset into an excess plan, you get the same benefit. This is why they say that if you're using the maximum offset, that is .75% for those born prior to 1938, .70% for those born in 38-54, and .65% for those born after 1954, you could have your formula 2% minus those offsets. But if you're doing an excess plan, a step rate plan, it's not as simple as 1.25 plus those percentages. You have to go 1.25, 1.3, 1.35. We've never designed plans like that prior to 1988.

If you agree with the thinking that the two are equivalent, then you see where it comes from. We have this whimsical conflict, but slight difference between the definition of final average compensation versus average compensation. The offset is determined as a percentage of final average compensation, which is the average pay in three consecutive years, ending within the last year excluding pay over the Social Security wage base. Average annual compensation is defined as average annual pay over the three or more highest consecutive 12-month periods. So you could have an offset where the average annual compensation is not your last three periods, but the final average compensation is. Suddenly the uniformity breaks down. This was pointed out to the IRS fairly early. Yes, that's something we have to work on.

Early retirement. That was fun. I mean this was especially fun if people complied and drafted new plans in accordance with the proposed regulation that was issued. We had the original regulation with a nice table of the maximum disparity permitted, going from ages 65-55. And people said, "But that's not 1/15, 1/30; that's what the code talked about. That's what the committee reports talked about." So we got a change in 89-70. We now have a new table of permitted disparities. And what if you adopted a plan based on the old table? In some cases, the new table is a little bit less than the old table. You're now disqualified. Then there's the 1/15, 1/30 rule which I'm going to get to in a couple of minutes.

There's this issue of Social Security supplements and/or the delayed offset. Time and again we've heard discussions, what happens if I delay my offset to age 65? So far the response from the IRS has not been positive in terms of permitting us to delay the offset and the integration, so to speak, and thereby not have to make an adjustment for early retirement. I mean this is an issue where you have subsidized early retirement. It would make it a lot simpler in terms of the people retiring at normal retirement date if we could delay the offset. Of course, one of the major problems here, and I do kind of understand the IRS's problems with it, is you run into problems with the two-for-one rule. I'll give you an example. I have a plan which is 1.5% of final pay minus .75% of covered compensation. My early retirement factor will only apply to the front end because I'm not applying my offset until age 65. If I have a 50% factor at age 55, you suddenly have .75% of final average pay minus .75% of covered compensation for the basic benefit. The people under covered compensation get a zero benefit after age 65. I think that might violate the two-for-one rule.

Actuarially, it's equivalent. All of us here can make a fine numerical demonstration that actuarially, the participant has received the same present value of benefit. But on the face of it, it would seem to violate the two-for-one rule, although the same problem existed prior to TRA 1986 if you had a PIA offset when there was no reduction in the early retirement benefit. If there was no offset prior to 65, and you applied the early retirement factor, you could wind up with a zero benefit starting at age 65. I always had a problem with this because there seemed to be some violation of the qualified joint and survivor annuity (QJSA) rules here. You were really giving the spouse a zero benefit because typically the Social Security supplement didn't count in the spouses benefit.

Subsidized early retirement -- Contributory plans. We're not talking about 411(c)(2) and the problems of how to determine employee provided benefits. That's a whole different can of worms. It wasn't even addressed in the Dialogue with the IRS session at this meeting. And it was deliberate. They're working on it. I guess the only information we were given was that they're coming out with a new revenue ruling, sort of updating it, and trying to tie everything together. If you read the proposed regulations on contributory plans, you will find they're incomplete, because the only example they give you is with a nonintegrated employee contribution formula, and they talk about converting it into a benefit using the rules of 411(c).

The problem I have here is it seems to be a 180° turn with respect to what I call their old philosophy versus the new philosophy. Prior to TRA 1986 under Revenue Rulings 69-4 and 71-446, the philosophy was if the employee is contributing, this is increasing the amount of integration that was permitted under the plan, especially if you had an integrated contribution formula. They permitted you to give a greater excess benefit as a result of the excess employee contribution.

Now the philosophy seems to be by having an integrated employee contribution formula you are giving the highly compensated employee the advantage of providing more benefit, and therefore, you're discriminating in favor of the highly compensated employee. Therefore, you have to cut the amount of benefit that's permitted to them or the amount of excess benefit. It's a complete reversal in philosophy. I personally prefer the old philosophy.

Floor plans are another area where we're looking for guidance. Under the old rules we knew how to deal with them. Although, if you had an integrated defined benefit formula, offset by an integrated defined contribution formula, some people might argue that you had double discrimination there, whereas in effect you were really discriminating against the highly compensated employee, because you were subtracting a proportionately higher benefit for him or her.

The transition rules are another issue. They say, with respect to the number of years of service you can count, it's 35 years minus the credited service already received. What if the previous formula wasn't integrated? No exception for that. There have been lots of pleas for subtracting the number of years of integration used prior to 1989. The IRS's only response to that one so far has been they see some difficulties in working that out. So therefore it's easier to say, "No change."

Cash balance plans. Everybody's saying, "How do I integrate a cash balance plan?" The IRS is saying, "How do I integrate a cash balance plan?" We're all waiting for that one. Of course, the easiest way to deal with a cash balance plan is to have a nonintegrated cash balance plan. This is what I call the back-loading trap. You just have to be a little careful. If you have an integrated plan that you want to back load, you can't blithely increase the formula by one-and-a-third to satisfy the four-thirds rules, because you might run into a problem where the step is now greater than 75, 70 or 65 points. In other words, if you had a formula that was, let's say, 1.5-2% you can't blithely increase it to 2-2.67% because that 2.67% may be over .65 points difference. You can only go 2.65. So just be a little careful.

Rumors One -- what we know so far is what we've read various Treasury officials have said in public or at previous actuarial meetings.

With respect to the transition rule, I expect to see some allowance for updating the formula through 1988 which contains the PIA offset. Earlier I was talking about the frozen formula. Treating it as if the participants had terminated as of the 1988 plan year. And the rumor is that there'll be some sort of updating permitted which will be based upon the ratio of final average earnings to final average earnings as of 1988 applied to the accrual as of the end of the 1988 plan year, "with some strings attached." The strings obviously being the two-for-one rule. For example, if you had an excess only plan through 1988, they are obviously not going to permit you to update that to a true final average earnings. Again, it's reasonable, and I think it's a very positive response to the actuarial community. They've suddenly decided that what they call project prorate is not a violation of the uniformity rule. Now project prorate may be where somebody entered at 25 years old and has 40 years of service. The formula is based on 35 years of integration. Just take the projected benefit at retirement and multiply by the ratio of actual to total projected years of service. This means that the person entering at 30 would have a different rate of accrual than the person entering at 25. That's a violation of the uniformity rule. Apparently that will be an exception to the rule.

Another issue would be, what about permitting continued accrual after 35 years on a nonintegrated basis, possibly even stepping up to the higher level? Will this not be considered a violation of the benefit accrual rules? I mention that under "Rumors Two;" that's relief from Section 411. I think there's a chance we might see something like that. It has not received a negative reaction from the IRS. It's a double negative, but it's the best I can do.

Rumors Two -- what I'd really like to see. Let us have PIA offsets under 401(a)(4), the overall discrimination regulation. It was pointed out that 401(l) is just a safe harbor. We all seem to have forgotten that 71-446 was merely a safe harbor. It wasn't the final word, but I don't know of anyone whoever designed a plan that was in blatant violation of 71-446, yet not discriminatory, and tried to prove it under 401(a)(4). We all seem to have forgotten about that. Again, 401(l) is a safe harbor and I would hope they permit PIA offsets under 401(a)(4).

I want to talk about early retirement reduction using the 1/15, 1/30 rule (Table 1). This is what we have now in 89-70, the maximum permitted offset. If you go up the diagonal from one year to the next, looking at age 55 for the pre-1938, moving to age 56 for 1938-1954, and then to age 57 for post-1954, they are the same factors. That should be familiar.

TABLE 1

Maximum Permitted Excess/Offset

Age at Retirement	Year of Birth		
	Pre-1938	1938-1954	Post-1954
67	---	---	.750%
66	---	.750%	.700
65	.750%	.700	.650
64	.700	.650	.600
63	.650	.600	.550
62	.600	.550	.500
61	.550	.500	.475
60	.500	.475	.450
59	.475	.450	.425
58	.450	.425	.400
57	.425	.400	.375
56	.400	.375	.344
55	.375	.344	.316

Let's look at Table 2. If you were born pre-1938, you have 1/15, 1/30. In 1938-1954, it is 1/14 for four years, 1/28 for five years, and the actuarial equivalent thereafter. If you were born post-1954, it's 1/13 for three years, 1/26 for the next five years, and the actuarial equivalent thereafter. This is not a solution to the request for true 1/15, 1/30.

TABLE 2

Early Retirement Reductions From Age 65

Year of Birth	
Pre-1938	1/15 for 5 years; 1/30 next 5 years
1938-1954	1/14 for 4 years; 1/28 next 5 years; Actuarial Equivalent thereafter
Post-1954	1/13 for 3 years; 1/26 next 5 years; Actuarial Equivalent thereafter

Table 3 displays what I am asking for, a true 1/15, 1/30. The factors aren't equivalent when you go up the diagonal. I'll make my case two ways. First, they're not that different. Second, it was very interesting. I looked back in the original regulation under 401(l). The original factors were not uniform going up the diagonal. So why not give us a true 1/15, 1/30? Uniformity. It's not mentioned in 401(l). So why don't we just drop the idea? Again, because of no equivalency between offset and excess plans. They don't have to be. Permit us to design it. With 1.25% plus 65, 70 or 75 points, you can prove it's not discriminatory. The biggest problem you might have is that all of your executives and the highly paid are the older people, but probably a 70% test would give you something reasonable.

TABLE 3

A "True" 1/15, 1/30

Age at Retirement	Year of Birth		
	Pre-1938	1938-1954	Post-1954
67	---	---	---
66	---	---	---
65	.750%	.700%	.650%
64	.700	.653	.607
63	.650	.607	.563
62	.600	.560	.520
61	.550	.513	.477
60	.500	.467	.433
59	.475	.443	.412
58	.450	.420	.390
57	.425	.397	.368
56	.400	.375	.347
55	.375	.350	.325

I would like to be permitted to use delayed offsets and Social Security supplements. As I've mentioned there seems to be a problem with 1/15, 1/30. Hopefully we can be creative without violating the law. And as I mentioned I'd like to see some relief from 411.

Now, in this wonderful atmosphere that we're dealing with, what are we consultants telling our clients? What are we doing? What have we been doing? We have to review the plan provisions and identify problems. I know most of my clients say to me that in revising the formulas, they have only two objectives: that no one gets less of a benefit and that the cost to the employer is the same.

I guess the next question then is do you still want to have an integrated plan? If employers understand why you have an integrated plan, most of the time the answer is yes. For administrative simplicity they'll sometimes go with a nonintegrated plan. Another alternative is if you have a defined benefit and defined contribution plan, make the defined benefit plan the nonintegrated one. Integrate the defined contribution plan. Your overall objective might then be achieved.

A second way of handling it is to refer it to the plan counsel. If there is a clear problem, you might say, no matter what is going to come out in the regulations, even with our most optimistic hopes, let's address it now. For example, you have plans out there where the two-for-one rule is going to be a problem. The obvious ones are the excess-only plans. But there are some others. For example, I have a couple of plans. One is an integrated plan with a cap of $40,000 on the compensation with a Social Security offset. For younger people the projected benefit is zero. This is a problem even if you use the covered compensation offset. You'd violate the two-for-one rule. A second plan has an offset of 75% of PIA, regardless of the years of service. The two-for-one rule blew that.

The most prudent action up to now has been no action, but how much longer can we sit with this? We're getting more guidance in two weeks. I don't know how much help it will be. I hope it's useful.

I want to talk now about the interaction with Code Section 401(a)(4). Again we were talking about 401(l) as a safe harbor. Sometimes we seem to overlook the fact that if you have all highly compensated, or all nonhighly compensated in the plan, you don't need to test discrimination. By definition, the plan is nondiscriminatory. You can have a 100% PIA offset in that plan and it's nondiscriminatory. But I don't know how many plans we have like that. Still, that is a solution of which we should be mindful.
The proposed regulations told us that if you don't satisfy 401(l), you can still prove nondiscrimination by satisfying 401(a)(4). But if you do satisfy 401(l), that doesn't necessarily mean you will satisfy 401(a)(4). You could still be discriminatory. A wonderful bit of logic. The rationale seems to be that if there were two integrated formulas in the plan, formula A and formula B, and all the highly compensated use formula A, and all the nonhighly compensated happen to fall under formula B, that could be discriminatory. And that's why you could fail 401(a)(4). Section 401(l) is the safe harbor, but I ask, how deep is the harbor?

I want to talk about comparability a little. Our bible for comparability was Revenue Ruling 81-202. I've been playing with an example of how the offspring of 81-202 might work for the PIA offset.

Let's start with this formula:

1.6% of Final Three-Year Average Earnings * CS
minus
1.5% of PIA * CS (maximum 50% of PIA)

It is 1.6% of the final three-year average earnings times credited service, minus 1.5% PIA times credited service (maximum offset of 50% of PIA). For those of you who would like to tell me that this formula will violate the benefit accrual rule if you have more than 33 1/3 years of service, note that it's basically the projected benefit times the ratio of actual to total projected service to 65. We got that one.

Table 4 shows what comparability was using -- I call it the old method. This is 81-202, where you basically determine the average unit benefit percentage by normalizing the benefit. In this plan, it was unreduced early retirement at age 60 with a Social Security supplement going to age 62. So at age 60, I valued its maximum value. I took the normalized benefit as a percentage of salary, and divided by the number of years of service to produce a unit benefit percentage. For the highly compensated employees, the average unit benefit was 2.4%. For the nonhighly-compensated employees, it was 2.5%. That proved it. This plan is nondiscriminatory. And I even said, let's band it by salary, the way we were permitted to do it under 81-202. Even looking at the salary bands, it's fine. I don't care how you look at it. This is a nondiscriminatory plan. My gut feeling told me it was a nondiscriminatory plan before I even started testing it.

TABLE 4

Comparability -- Old

Salary Range	Number	Average Unit Benefit %
HCE	39	2.4
NHCE		
$45,000 - $54,479	29	2.5
35,000 - 44,999	70	2.5
25,000 - 34,999	137	2.5
15,000 - 24,999	30	2.4
Total NHCE	266	2.5

Let's take a guess at what new comparability rules might be (Table 5).

TABLE 5

Comparability -- New?

Average Unit Benefit %	# HCE	# NHCE	Cum HCE	Cum NHCE	% HCE	% NHCE	70% * % HC
3.1	0	1	0	1	0.0	0.4	0.0
2.8	0	2	0	3	0.0	1.1	0.0
2.7	0	3	0	6	0.0	2.3	0.0
2.6	7	78	7	84	17.9	31.6	12.5
2.5	12	120	19	204	30.8	76.7	21.6
2.4	11	42	30	246	76.9	92.5	53.8
2.3	9	11	39	257	100.0	96.6	70.0
2.2	0	9	39	266	100.0	100.0	70.0

This seemed to be a popular approach at the Enrolled Actuaries meeting. There must have been four or five different actuaries who had roughly the same approach. Again they're looking at unit benefit percentage. But then instead of banding by salary we're banding by the rate of benefit accrual units. The range of units in this plan was from 3.1-2.2%. I have shown the number of highly compensated and the number of nonhighly compensated in each band. Then I did cumulative totals starting from the highest. What this says is, for example, that for the participants who had 2.6% or higher, there were seven highly compensated and 84 nonhighly compensated. I then looked at the cumulative percentage of highly and nonhighly compensated.

Again, looking at the 2.6 line, 17.9% of the highly compensated had 2.6% or better. The 31.6% of the nonhighly compensated had 2.6 or better, the test being the percentage of nonhighly compensated is at least 70% of the highly compensated percentage. And you see the 70% test mark was 12.5%. So going right down the chart, in every case, the percentage of nonhighly compensated having that percentage or better was well in excess of 70% of what the percentage was for the highly compensated. Maybe it will look like this. There are very strong rumors that you will have to test on unit benefit percentage. They may not permit flat benefit percentage testing.

If it looks like this, we could live with it because it's reasonable and there is grouping permitted. When you're dealing with large groups of employees, it makes sense to group.

MR. JAMES A. KENNEY: I'd like to start out with a little quiz here. How many of you have clients who have salaried and hourly plans where the hourly people are not in the salary plan and vice versa? It looks like it is a reasonably common structure.

How many of you have attempted to do a nondiscriminatory classification test for these plans under the 1.410(b)-4 regulations? That's basically what my talk is about. And I'm urging you to start doing such an analysis, because I believe you will find when you do the analysis that there is a good chance that you may want to start thinking about alternative arrangements to your current structure.

I will focus on the nondiscriminatory classification test and the problems that it can create for salaried and hourly arrangements.

I've assumed that you've all read the 410(b) regulations, so I won't describe those regulations. The vehicle for my talk will be a case study of Sportco, an imaginary sporting goods manufacturer, headquartered in Chicago.

To summarize, Sportco has 14,000 employees. Of these 14,000 employees, 4,000 of them are union employees. It has four plans: a salaried defined benefit plan, a salaried profit-sharing plan, an hourly defined benefit plan, and an hourly profit-sharing plan.

The salaried work force consists of 2,000 employees, 800 of whom are highly compensated employees. That's approximately 40% of the salaried group.

Sportco also has two subsidiaries which it acquired in the early 1980s. One of them is Starlight and the other is Wildwind Shoes. Starlight manufactures camping equipment and has 100 employees, of whom five are highly compensated. It sponsors a defined benefit plan. Wildwind has 400 employees, 50 of whom are highly compensated and it sponsors only a 401(k) plan.

The first step in our procedure is to determine which plans you need to test. Now this sounds very simple. Unfortunately in this day it isn't. 410(b)-7 requires that certain plans be mandatorily disaggregated. Now that's a large mouthful. What it means is you have to cut plans into component pieces and test each piece of the plan separately.

I'd like to step back and give an overview of the problems created by the current 410(b) regulations. There are six problems that I see. The first problem is the issues created by mandatory disaggregation. For example, 401(k) plans and ESOPs may not be combined with any other plans. What this means is, if you have a client who sponsors a profit-sharing plan with a 401(k) feature for its salaried employees, and has a profit-sharing plan without a 401(k) feature for its hourly employees, the profit-sharing plans considered separately may be fine. However, if you look at the 401(k) features, since the salaried employees have a 401(k) feature and the hourly employees do not, you may be forced to add a 401(k) feature to your hourly plan, or you may be forced to eliminate the 401(k) feature for your salaried plan.

One of the problems this can create is it's almost impossible to deal with a 401(k) plan retroactively in the current environment where we have very little guidance, but the rules are effective. 401(k) plans and 401(m) plans are particularly dangerous plans, and are worthy of attention under the 410(b) regulations. It's going to be very, very difficult for you to go back and make up the problems on a corrective basis, because the opportunity to make the voluntary elections and to make the contributions, and to treat them as pre-tax contributions, has gone. So I urge you to take a good look at the issues revolving around mandatory disaggregation of 401(k) plans under the 410(b) regulations.

The second issue that I see, or the second problem that I believe is created by these regulations, is the nondiscriminatory classification test. Finally, they gave us a test that was pretty easy. And I think that's the general response from most consulting actuaries. We look at this test; it's simple; we can understand it. We can do it, so we think, fine we'll do it later. Let's look at 401(a)(26) problems, because those are more complicated.

I will primarily deal with the issues created by the nondiscriminatory classification test. And even though it is an easy test to perform, it is a difficult one to pass.

The third problem area created by these regulations is the average benefits percentage test. This is a phrase that's dear to my heart, I love the average benefits percentage test, even though I don't know how to do it. Unfortunately, although this test is in effect for 1989 plan years, which are largely over now, the regulations have not been issued. But when they are issued, they are likely to create major headaches. For those of you who are consultants, I suppose this is good news, because it means there's more work for you to do.

The fourth problem area is when you wish to permissively aggregate plans under the 410(b) regulations. If you are going to permissively aggregate a plan with another plan, both plans must satisfy 401(a)(4) when considered as a single arrangement. This is particularly complicated when you're aggregating 401(k) plans, because the sole test for 401(a)(4) is the average deferral percentage test. And so you may think that your 401(k) plans are operating fine, because you passed the ADP test on this plan, and you passed the ADP test on that plan. But when you get to the 410(b) analysis, and you realize you have to aggregate these plans together, you may well have failed the ADP test for your salaried plan, because you have not taken into consideration the deferral rates or deferral percentages of the largely nonhighly compensated hourly employee group. And when you finally are forced to consider those employees in your test you may well find that your deferral percentages for your highly compensated employees under your salaried plan are no longer permitted. Of course, the longer you delay finding this out, the more difficulties you face in correcting the issue.

Obviously for plans that are on a calendar-year basis, this test should have been satisfied as of the end of 1989. You still have until, I believe, the end of 1990 to make the corrections, although you'll have to pay additional penalties because the time to do without the penalties is past. Therefore, I urge you, particularly with the 401(k) plans, to look at them to make sure that you understand the issues that 410(b) will bring. I believe that the 410(b) regulations, although they may see fine tuning, and although there will be additional information issued hopefully when the 401(a)(4) regulations come out, are likely to be very close to the final regulations. I think they may tinker with it, but they are not likely to withdraw it and reissue it as they are apparently doing for the 401(a)(26) regulations.

One of the exciting things about permissive aggregation is it doesn't have to be on a plan basis. You can scoop out groups of people from one plan and move them over to the other plan and test them against the other plan to help that plan pass. You can even take individuals and move them over. And you could do this on a pretty creative basis so that you can take people from one data set, add them into another data set, and mush things back and forth so that you finally do pass the tests. Everything is rosy. The important thing to remember is, if you are moving individuals or groups of individuals, the benefits that they have under the plans you're attempting to qualify must be 401(a)(4) compatible with the plans that you are moving them to on a theoretical basis. Obviously you will not really move these individuals into that plan. But you can move them for the purposes of doing your tests.

The fifth problem is a practical problem and not a theoretical problem which is the issues revolving around the data you're going to need to do these tests. Salary data is usually pretty easy to obtain for the highly compensated employees. But for hourly employees, sometimes it's quite difficult to get the kind of data you will need. There are three elements of data that you may well need. One is who is a union employee and who is not. The second is, what is the W-2 compensation of the hourly employees. And the third is what were the 401(k) deferrals by the hourly employees.

The W-2 compensation may well be your major problem if the hourly employees have a dollar per year of service type of formula, because you do not need the compensation to administer and do the mathematics for that kind of plan.

It's important for you to contact your clients now and let them know of the data collection issues that you face in trying to administer the tests through which you are going to have to demonstrate compliance.

I think that the clients need the lead time in order to get the system set up to be able to provide you with W-2 data. In the Sportco example, they have manufacturing facilities throughout the country. It may be difficult to obtain W-2 data concerning some of these plants.

The sixth problem that I see is one of the most difficult problems. And that is that under 410(b), unless you wish to go the route of essentially merging your plans together, you are going to be basing the qualification of your plans on the demographic characteristics of your work force. Your work force will change. Compensation levels will change. Benefit levels will change. Sometimes these changes come quickly, and the qualification of your higher level plans will be based in the shifting sands of the demographics of your work force.

There are two basic strategies for complying with 410(b). One is you can simply merge your salaried and your hourly plans and create a single arrangement or a single set of plans with a uniform eligibility system. The second way, and the way that I believe most employers will tend to follow, is to swap people around from one plan to another -- from the salaried plan to the hourly plan or from the hourly plan to the salaried plan, in order to get through the nondiscriminatory classification test.

Of course, if the IRS does go back to the reasonable cross-section approach, and abandons the nondiscriminatory classification mathematical tests shown in the regulations, this will cease to be necessary. I think that this is a very unlikely thing for the IRS to do.

Your two basic approaches are to merge the plans. The two drawbacks of that are you almost certainly see an increase in funding requirements and that your hourly employees and your salaried employees have very different needs concerning benefits and compensation. You will finally wind up with a one-size-fits-all philosophy concerning benefits.

The issues involved in a demographic approach to continued qualification of your salaried plans are that you are essentially erecting a house of cards and that these cards can fall down depending on changes of which you may or may not be aware, such as the decision made to close a facility, a layoff among the salaried employees or a change in the salary structure of the highly compensated employees where certain monies which were treated as taxable income are no longer treated as taxable income.

Therefore, one of the most important things to do if the client chooses to go the route of maintaining separate hourly and salary arrangements is to take whatever steps are necessary to pass the demographic tests. You must be very careful to communicate to the client, in advance, the risky and changeable nature of the tests which prove that your plans pass 410(b). In addition, you must persuade the client to allow you to participate in the planning for such changes. You don't want to be caught by surprise and have the client say, "We just did this." And you say, "Do you realize what that does to your average benefits test? Do you realize what that does to the nondiscriminatory classification test. Your plan's going to be disqualified. Or you're going to have to double benefits." Get the client to let you in on the planning so that you can keep the client informed of the economic aspects of his decisions as they apply to the plans, so that they don't make decisions and then find out the results later.

I'd like now to move on to the case study, because I think this is one of the most exciting parts of the talk. Exhibit 1 is what I refer to as a 410(b) compliance map. The map shows mandatory disaggregation of plans as well as permissive aggregation of plans. The solid vertical lines represent the mandatory disaggregation and the dotted horizontal lines represent permissive aggregation.

Now permissive aggregation means what it says. You are not required to make a permissive aggregation. That's why those lines are dotted. You may cross the lines if you wish or decide that you need to cross the lines, but you are not required to cross them.

Let's take a look at this map. For example the salaried profit-sharing plan is really three different plans. It's a nonunion generic plan as well as a 401(k) and 401(m) plan.

There are rumors that the service is relenting a little bit and will not require mandatory disaggregation of 401(k) and 401(m) plans. But under the regulations as they stand, those plans must be cut apart and treated separately as different arrangements. You cannot aggregate these plans. That's what the phrase mandatory disaggregation means.

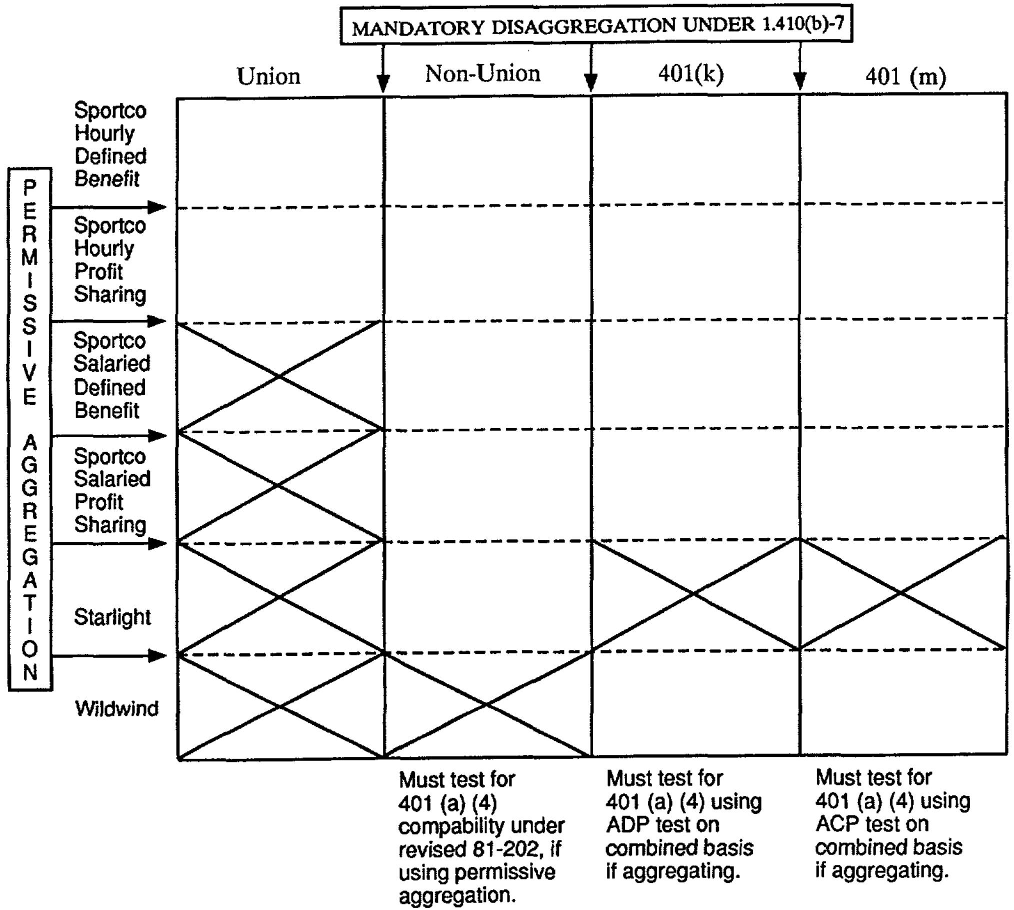
You can aggregate, for example, the salaried defined benefit plan and the Starlight defined benefit plan, if you meet the 401(a)(4) requirements, and treat them as a single arrangement. You could also, for example, treat the Wildwind 401(k) plan and the salaried 401(k) plan as a single arrangement. But if you were to do so you have to satisfy the ADP (average deferred percentage) test on a combined basis. So it is not enough to pass the ADP test for the Wildwind Company and the ADP test for the Sportco salaried arrangement. Separately you must pass this test on a combined basis in order to treat these plans for 410(b) purposes as a single arrangement.

Exhibit 2 shows how to do the calculations of the nondiscriminatory classification test. This is an example for the Sportco arrangements. And as you can see, item one tallies the number of nonunion, nonexcludable, nonhighly compensated employees. There are 9,645 nonunion, nonexcludable, nonhighly compensated employees. Item two tallies the number of nonexcludable highly compensated employees. I'm assuming that the union people are not highly compensated. And there are 855 highly compensated employees. If you take item one and item two and add them together and then divide that into item one, you get 91.9%. This is the nonhighly compensated employee concentration percentage. Basically what that says is that 92% of the work force is not highly compensated. That's great for the company. You then use the tables shown in the 410(b) regulations to determine the "safe harbor," "unsafe harbor," whatever that is, percentages. In this case the safe harbor percentage is 26%. And the unsafe harbor is 20%. These are shown in item four.

Items five, six and seven walk you through the calculations concerning the various plans to see whether they meet the requirements of the nondiscriminatory classification test under 1.410(b)-4. As you can see from this, you take the safe and unsafe harbor percentages and you multiply them by the highly compensated employee benefitting percentages under the plans that you are testing. Then you compare them to the nonhighly compensated benefit percentages under the same plans.

EXHIBIT 1

Sportco 401(B) Compliance Map



PANEL DISCUSSION

EXHIBIT 2

Sportco Controlled Group
Analysis of "Nondiscriminatory
Classification Test" under 1.410(b)-4

1.	Number of nonunion, nonexcludable NHCEs			
	(a) Sportco hourly NHCEs			8,000
	(b) Sportco salaried NHCEs			1,200
	(c) Wildwind NHCEs			350
	(d) Starlight NHCEs			95
	(e) Total NHCEs			9,645
2.	Number of nonexcludable HCEs			
	(a) Sportco salaried HCEs			800
	(b) Wildwind HCEs			50
	(c) Starlight HCEs			5
	(d) Total HCEs			855
3.	NHCE concentration percentage (= 1(e) + (1(e) + 2(d))			91.9%
4.	1.410(b)-4 Safe and Unsafe Harbor percentages			
	(a) Safe harbor			26%
	(b) Unsafe harbor			20%
5.	NHCE benefitting percentage under			
	(a) Sportco salaried plans			12.44%
	(b) Wildwind 401(k) plan			3.63%
	(c) Starlight Defined Benefit plan			.99%
6.	HCE benefitting percentage under			
	(a) Sportco Salaried plans			93.57%
	(b) Wildwind 401(k) plan			5.85%
	(c) Starlight Defined Benefit plan			.58%
7.	NHCE benefitting percentage required to meet Safe and Unsafe Harbor under	Safe Harbor	Unsafe Harbor	
	(a) Sportco salaried plans	24.33%	18.71%	
	(b) Wildwind 401(k) plan	1.52	1.17	
	(c) Starlight Defined Benefit plan	.15	.12	

8. Analysis:
   (a) Both Wildwind and Starlight plans pass Nondiscriminatory Classification test since the NHCE benefitting percentage exceeds the safe harbor requirement.
   (b) The Sportco hourly plan automatically passes test since it has no HCEs.
   (c) The Sportco salaried plans fail the test since NHCE benefitting percentage is less than the Unsafe Harbor requirement.
   (d) Item 5(a) could be increased to at least equal item 7(a) "Unsafe Harbor" by adding 605 NHCEs to salaried plans, or
   (e) Item 6(a) could be decreased by removing at least 269 HCEs from salaried plan, or
   (f) Some combination of (d) and (e) could be done.

The results are shown in item seven. It is the nonhighly compensated benefitting percentage that is required to meet the safe and unsafe harbors under the various plans. For example, the Wildwind 401(k) plan needs a nonhighly compensated benefitting percentage of 1.52 in order to meet the safe harbor requirements.

If you look at item 5(b) you will see that the Wildwind 401(k) plan has 3.63% of nonhighly compensated employees benefitting under it. Therefore, it does meet the safe harbor requirement.

We move on to item eight. You can see that the Starlight and the Wildwind plans pass the nondiscriminatory classification test, because the nonhighly compensated benefitting percentage exceeds the safe harbor requirement.

The Sportco hourly plan will automatically pass the test, because it has no highly compensated employees in it. The Sportco salaried plans, however, fail the test since the nonhighly compensated benefitting percentage is less than the unsafe harbor percentage.

The salaried plans need an 18.7% nonhighly compensated employee benefitting percentage. What that means is 18.7% of the total number of nonhighly compensated employees in Sportco and its affiliated groups need to be covered by the salaried plan in order to keep the salaried plan qualified. If you don't meet that, your salaried plan is going to be disqualified. That's a pretty tough price to pay.

Unfortunately for Sportco only 12.4% of their nonhighly compensated employees are covered under this plan. What do we do? Well there are several solutions. They boil down primarily to two basic categories of solutions (see Exhibit 3). One is you can move some nonhighly compensated employees into the salaried plan so that you reach the 18.7% requirement, or you can remove some highly compensated employees from the salaried plan, so that you reduce the required benefitting percentage. In other words, you can drive the 12.4% up, or you can take the 18.7% down. This is where you get to the basic, the most exciting part of the analysis -- calculating the number of employees you need to move from one category to another, so that you know what to do in order to keep your plans qualified.

Item one in Exhibit 3 shows how you calculate the number of hourly employees you would wish to shift into the salaried plan in order to meet the qualification requirements. Basically what you do is you take the 18.71% and multiply it by the total number of nonhighly compensated employees in the control group. The result is 1,805 employees; that's the number you need. You've got 1,200. The difference is the number you need to shift into the salaried plan, 605.

The second approach, which is to exclude highly compensated employees from the salaried plan is calculated in item two. Here you take the nonhighly compensating benefitting percentage under the salaried plan and divide it by the control group unsafe harbor. You can also do this analysis dividing by the control group safe harbor. And that'll tell you the number of people you need to exclude in order to make your plan air tight. But in this case all we wanted to do is to get this plan out of the unsafe harbor and into the "facts and circumstances" range.

PANEL DISCUSSION

EXHIBIT 3

How to Calculate Number of Employees
Who Must Be Shifted to Comply with 1.410(b)-4

1. Approach: Shift NHCEs from Hourly to Salaried plans.

a.	Sportco Salaried plans "Unsafe Harbor"	18.71%
b.	Total number of NHCEs in Controlled Group	9,645
c.	Number of NHCEs that must be covered under salaried plans to meet Unsafe Harbor (1(a) x 1(b))	1,805
d.	Number of NHCEs currently covered under salaried plans	1,200
e.	Number of NHCEs that must be shifted to meet Unsafe Harbor	605

2. Approach: Exclude HCEs from Salaried Plans

a.	NHCE benefitting percentage under Sportco Salaried plans	12.44%
b.	Controlled Group Unsafe Harbor	20
c.	Maximum HCE benefitting percentage under Sportco Salaried plans: (2(a) + 2(b))	62.20%
d.	Number of HCEs in Controlled Group	855
e.	Maximum number of HCEs that may be covered under Sportco Salaried plans: 2(c) x 2(d)	531
f.	Number of HCEs currently covered under Sportco Salaried plans	800
g.	Number of HCEs that must be excluded to meet Unsafe Harbor	269

If you take the 12.44% and divide it by 20%, you get 62.2%. That's the maximum number of highly compensated employees you can cover under the plan. You multiply that by the total number of highly compensated employees in the control group and you get 531 highly compensated employees who may be covered by the plan.

You've got 800. The difference between the two, 269 is the magic number of highly compensated employees you have to exclude from this plan in order to continue it's qualified status. This is going to be fun to explain to the people who are making the decisions, because typically they are highly compensated.

This analysis illustrates the basic approach for compliance with 410(b) on a demographic basis. The basic approach is that you must shift employees from one coverage class to another in order to continue the qualified status of your plans.

In this particular case, some of the things that you could do would be to take the Wildwind and Starlight employees, the subsidiary groups, and merge them into the salaried plan. Unfortunately, if you did this, you would still lack 284 nonhighly compensated employees. You could only get them from the hourly plan. So that doesn't really eliminate the issue of shifting employees from the hourly to the salaried plan.

Another thing that you could do is simply exclude 269 highly compensated employees from the salaried plan, and presumably you would want to cover them under a nonqualified plan. If you take a quick look at that, it means that you're going to exclude a very large number of your highly compensated employees. I think it's something like a third of your highly compensated employees will be forced out of your salaried plan. Again, I think that's going to be a rather hard sell to the management of the company.

A third approach would be to shift 605 hourly employees from the hourly plan to the salaried plan. Now one of the problems that you have here is that the classification must be reasonable. You cannot, for instance, name individuals by name. Presumably you could identify facilities, which would be covered under the salaried plan and not the hourly plan, but again you might be open to challenge there, if there's no demonstrable difference from one facility to the next. Again you have the benefit culture or philosophy issues created by shifting individuals from your hourly plan to your salaried plan. My favorite solution, because I'm an actuary and I like things that are complicated, is to create two sets of new plans. Take the hourly plan, split it into two and create two different hourly plans. You take the salaried group, and in this particular case there's an identifiable group which is the commissioned sales persons. You take the commissioned sales persons and spin them out and create a plan for them on their own. This plan and the second hourly plan, which is the smaller of the hourly plans, will then be permissibly aggregated and the benefit structures will be comparable under the 401(a)(4) regulations, which have yet to be issued. Basically what you're going to have to do is back into the plan designed for the second group of hourly employees so that their benefit levels will be comparable to the benefits that you are delivering to the commissioned sales persons under the 401(a)(4) regulations.

Why do I like this approach? One reason I like this approach is that what you do is you take the individuals involved and create a sort of third layer, a middle of the road group of plans. It's not as rich as your salaried plans. And you may wish to deal with this for the salespeople, for example, by increasing their compensation. You can or you may wish to just bite the bullet, and tell them, "Sorry." You can fine tune the benefit structures under these arrangements in order to meet the 401(a)(4) regulations without having to deal with larger and larger groups of people.

You can take the risks that the plan sponsor wishes to assume with these middle plans, and not with your entire salaried plan, so that if you find yourself in the position of being forced to increase benefits under one of these middle plans in order to continue the qualified status of the plans, you will not be increasing benefits to large groups of people, but you'll be increasing benefits to medium-sized groups of people. You can avoid "contaminating" your salaried plan by putting people in it who don't really belong in it. They just aren't salaried individuals, and they don't really belong in that plan.

This analysis assumes that you can find natural divisions in your client's work force so that you can extract from one another and put them into separate plans which can be aggregated. And there's no magic number of two new sets of plans. You might want to have three or four depending on the nature of the work force. What you are searching for and hoping to find are natural subgroups with their own benefit and compensation philosophies and structures and needs. This way you are creating a spectrum of plans dealing with natural groups in your work force, rather than taking the other approach of merging everybody into one big plan and having the same benefits for everyone.

That covers my analysis of the 410(b) regulations and I guess we're ready for questions and answers.

I don't believe that this nondiscriminatory classification was reasonably foreseeable. I personally have specialized in 410(b). I was really taken by surprise by the safe and unsafe harbor rules contained in these regulations. And I think they go way beyond the statute. I also feel that the most important thing is the problems that our clients will face. And I think that we need to be aware of the problems that are being created for our clients by the 410(b) regulations. One of the reasons I wanted to give this talk is that I think that actuaries are not paying sufficient attention to the 410(b) regulations and the problems created by them. For instance, in my poll in this group, although roughly a third of the audience has this type of arrangement, none of you have done this analysis.

FROM THE FLOOR: What about union plans?

MR. KENNEY: The issue on union plans is kind of tricky. Actually you do need to test union plans. But the good news is that in almost any conceivable set of circumstances you will find your clients in the union plans will pass.

FROM THE FLOOR: Even baseball?

MR. KENNEY: I can't comment on that.

MS. CLARK: Would they be considered professionals?

MR. KENNEY: They excluded professionals I'm told. I don't think they qualify as . . . collectively bargained. The professional sports people, basketball, baseball, football are all highly compensated. And you run into problems because they have a union plan.

FROM THE FLOOR: Just keep the referees out of the plans?

MR. KENNEY: Yes, but no. Then you have problems when, for example, you have the office staff in with the general managers and things like this. You must view professional basketball and baseball players as including multiemployer plans.

MR. SEGAL: I'd prefer not to comment on the issues involved in baseball union plans. But in general most of my experience is that if you have a usual type union, you're not going to face these particular problems; you should do the analysis. But I don't believe that you're likely to run into major problems with them.

FROM THE FLOOR: My comments are related to Debra's remarks on 401(a)(26). I know none of our clients, of course, are ignoring these rules. I'd like to know how many people in the audience know of at least one company, corporation or whatever that is in fact at this point totally ignoring these rules?

My other question is with regard to the shrinking group and 401(a)(26). What if our plan used to have employee contributions, and no longer have them. You have a shrinking group there.

MR. KENNEY: Yes, that's right, because technically that's a separate benefit structure. You know, common sense tells you that should be an exception. That should be grandfathered. Debbie, do you think that might be a prior benefit structure, which is automatically approved? Or do you still need 50 people in that prior benefit structure?

MS. CLARK: There are employee contributions out there for some participants, but are not required for others. So, it could be a prior benefit structure. That, to me, does not seem like it should be deemed discriminatory, because now you've not required employees to contribute to the plan. And you're doing it on a uniform basis. It's not like you are imposing a certain requirement on some groups versus other groups. I really don't have a definite answer for that.

MR. KENNEY: It depends because there's only one prior benefit structure in a plan.

MS. CLARK: For a defined benefit plan?

MR. SEGAL: For a defined benefit plan. Now, let's say in 1980, they went noncontributory. You might be able to slip in there, because you'll have over 50 people in the plan as of January 1, 1989, let's say. And if you take an interpretation that there's one prior benefit structure, that prior benefit structure covers everything and you're okay. I agree with you that this is a separate benefit structure. If you take that point of view, then there's a problem. Again, it should not be a prior benefit structure. You have a further problem because of the new 411(c)(2) regulations on employee contributions with our magic interest rates; how do they apply to a plan that stopped contributions in 1980?

MS. CLARK: That's a good question.

MR. KENNEY: Do you think Don, that you could view this as a defined contribution plan within a defined benefit plan. And since it's a prior benefit structure and defined contributions don't have prior benefit structures, you could get around it that way?

MR. SEGAL: I think that's a great interpretation.

FROM THE FLOOR: I have a question that's related to 410(b). I was curious about employees with 500 or more hours, but less than a 1,000 hours that terminate in a year and are considered counted in the test. If you have a small plan with three people, you can see what can happen.

MR. SEGAL: I think you've got a real problem there. Although the regulations say that you've got to do this test on various dates, the most logical time to do the test is the end of the year. If you've got someone who terminated during the year with more than 500 hours, they have to be counted in that test. But they may well not have any benefit, particularly if they were not vested. The smaller the plan the bigger the problem, except small plans generally do not have splits in coverage within the employee population. My experience in the small plan area is that basically all the employees are eligible to be covered under all of the plans if they meet the 1,000-hour requirement to get in. The companies that did not have that kind of arrangement are forced out of existence by 401(a)(26). So I don't think it's likely to be a problem in the small plan area. I do think it could be a problem in the large plan area when you come to do your tests at the end of the year if you have a sizeable turnover in your work force, for instance among the hourly employees.