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NONDISCRIMINATION RULES (BASIC)

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Recorder: JAMES A. KENNEY

The panel will present the basics of nondiscrimination in pension plans.

- 401(a)(4)
- 410(b)
- 401(l)
- 401(a)(26)
- Any final regulations
- Has the fog lifted?

MR. JAMES A. KENNEY: Our speakers are Sherrie Desmond, the president of Hooker & Holcombe, Inc., Scott Galloway, a partner in Johnson & Gibbs, and I'm president of Coates Kenney, Inc.

As you probably already know, discrimination under U.S. pension law refers to provisions of the tax code designed to prevent benefits and contributions from being steered primarily to the higher paid participants in a plan. The reason that this is forbidden is that a very sizable portion of the deductions allowed under the tax code has to do with employee benefits and particularly with pension plans. If the tax code did not prevent discrimination in favor of the higher paid, then the sponsors of these plans might be tempted to design plans that would cover primarily the higher paid. The purpose of the U.S. tax code deduction for pension contributions is primarily to ensure broad coverage of workers to relieve pressure on the Social Security System. If the tax code did not prevent discrimination in favor of the higher paid, the purpose of the deduction would be defeated, and ultimately probably the deduction would be removed. This is the reason that the nondiscrimination requirements in the U.S. code are there.

There's a very clear watermark now in the tax code between who the nonhighly compensated are and who the highly compensated are. If the plan does not cover any of the highly compensated, the employer can mostly do whatever it wants, within restricted limits of other sections of the U.S. law. Under pension law, for instance, there would be nothing to prevent an employer from covering the workers at one plant and not at another plant or from covering only those people who made $20,000-40,000 as long as it did not cover anyone who is a highly compensated employee. The employer can more or less pick and choose in the plan who it does and who it does not cover under pension law. So, the key thing is that discrimination in general speech has a meaning that it does not have for the purpose of this session. For the purpose of this session we are only concerned about the discrimination in favor of the highly paid employee.

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These techniques of discrimination take three major aspects. One involves coverage under plans. One involves the amounts of benefits or contributions made on behalf of the higher paid, and one involves the various rights and features that plans have. I think Mr. Galloway will be talking about rights and features. An example of this would be allowing the high paid to take lump sums because they know how to manage money and not allowing the low paid to take lump sums because they would spend it. This is no longer permitted under the U.S. tax code, and there are tests that must be passed to demonstrate that, in fact, these rights and features are available to a nondiscriminatory classification of employees.

Naturally, since this is a tax code, there are a lot of exceptions to things. One of the most important exceptions under the discrimination testing is the ability to use what is now referred to as permitted disparity. Those of you who have been around in the pension field for a while may know this as integration. This is a concept whereby the benefits delivered through the United States Social Security System are allowed to be considered in one form or another. They may be considered alongside the benefits or contributions that are made to the privately sponsored plan in determining whether or not that plan is discriminatory in favor of the higher paid. There's been a great deal of restriction on the ability to recognize the contributions and benefits under the Social Security system when testing for nondiscrimination as part of the Tax Reform Act of 1986, and Sherrie Desmond will be talking about that.

I'd like to talk about the statutory basis for the nondiscrimination rule. The primary statutory basis is 401(a)(4). This is a very short section of the tax code that says in a very abbreviated form you may not discriminate in favor of the higher paid. The next section of the tax code that is of key importance is Section 414(q). This section defines who the highly compensated employees are. Obviously, if you are going to have to demonstrate that the plan does not discriminate in favor of highly paid employees, you must be able to identify these individuals in order to make your determination. The rules for determining who is highly compensated are quite complicated, in some cases extremely complicated. Those are the two basic sections of the code that set forth the statutory basis for nondiscrimination. There are other sections of the code that implement these, and probably the major section of the code that implements this is 410(b).

Section 410(b) of the U.S. Tax Code concerns coverage requirements under various plans. There are mathematical tests now that plans must meet in order to demonstrate that they are covering a sufficient number of low paid workers. These tests are mathematical in nature, and they basically boil down to two separate tests. In the ratio test you take the percentage of the nonhighly compensated who are covered by the plan and divide it by the percentage of highly compensated covered by the plan. If the result is 70% or larger, then the plan has passed the ratio test. If it is less than 70%, the plan has failed the ratio test. It's a very straightforward test, and you must consider all employees of the employer and the affiliated group including leased employees under 414(n), (m) and (o).

The second test under 410(b) is the average benefits percentage test. Under this test the first step is to compute the overall average of the benefits being delivered to the low paid employees and compare it to the overall average of the benefits being delivered to the high paid employees. If the low paid receive on the average at least

70% of the benefits being received by the high paid on the average, then the plan has passed the first step in the average benefits percentage test. The second step in that test is a watered-down version of the ratio test. Under this test the ratio is reduced to as low as 20% in some cases. It will never be lower than 20%. If a particular plan covers a percentage of lower paid employees that is less than 20% of the percentage of high paid employees, then it will fail the coverage requirements of 410(b) no matter how you analyze the plan. There are some other strategies that may be used to cure this, and we will get to that later.

Another important element in the statutory basis for the nondiscrimination testing is Internal Revenue Code, Section 401(l). This is the section that concerns permitted disparity that I referred to earlier. That section recognizes the existence of the U.S. Social Security system, and Sherrie Desmond will be going into that in greater detail. Another modest loophole in the tax code is the 401(k)/401(m) tests. I'm sure most of you are very familiar with 401(k) plans. Under these plans the amount of deferrals made by employees are tested in the two groups -- one's the high paid group, the other's the low paid group -- and a measure of favoritism is allowed in this test. If the average of the high paid contributions does not exceed a certain ratio of the low paid average contribution, then this test is considered to be passed.

Finally, another section of the tax code that is important to consider when you're analyzing nondiscrimination is Section 401(a)(26). This requires that a certain portion of the employees be covered by the plan. Regardless of how many plans there are or how many employees there are, at least 40% of the employees, or 50 employees, whichever is less, must be covered. For a very large employer, this means 50 employees. That's not hard to achieve, but for a very small employer, then it's 40% of the employees, and this can be more difficult. One problem comes when an employer has acquired a smaller entity that has fewer than 50 individuals in it. If that entity has a stand-alone plan, then that plan will not pass the 401(a)(26) requirements. What is often done in that situation is merging the plan into the acquiring entity's plan.

This element of the tax code in my view is largely a device to eliminate what was perceived to be widespread abuse by highly paid professional practitioners who would establish a defined-benefit plan for themselves, and establish a defined-contribution plan for their rank-and-file workers. Through the Revenue Ruling 81-202 they would demonstrate that these plans were of equal worth, and they would be allowed to make very large contributions on behalf of the professional employees into the defined-benefit plan and modest contributions into the defined-contribution plan on behalf of the other workers. The result was that the government, the Treasury in particular, proposed this section that now prevents this type of structure. A large number of plans were set up on this basis, and they have pretty much all been shut down as a result.

Obviously, if you're going to talk about discrimination, it's important to know who is in which group. As I mentioned, Section 414(q) gives the basic definition of highly paid which includes owners, certain officers, and employees earning more than $75,000, or $50,000, depending on the demographics of the population. That figure is adjusted annually for changes in inflation. A very complex portion of 414(q) requires that family members of the top 10 highly compensated employees be treated as the same person as the highly compensated employee. This applies primarily for 401(k) plans, and it does not really apply to most other types of plans except in unusual circumstances or where permitted disparity is being used under Section 401(l).

The basic strategy under the tax code for preventing discrimination is fourfold. The first method is to require that plans covering people in the prohibited group now cover a significant portion of low paid workers. The second is to require that any benefits given to the high paid be matched by equal benefits given to the low paid workers. The third is to require that any rights and features or special prerequisites given to the high paid also be available to the low-paid workers. The fourth element of this strategy is to tax the benefits that have been accrued by or on behalf of the high-paid workers if these tests are not passed. Since these plans often accumulate very sizable benefits, this can be a very powerful deterrent. The U.S. tax code was modified in 1986 to provide that only the benefits of the high paid workers be subject to this tax. It used to be that the benefits of all workers were subject to this tax. Obviously, this was a disincentive to the Revenue Service to go ahead and apply this sanction. Now that disincentive has been removed. It's considerably easier for the Revenue Service to take this position because, presumably, the high paid deserve it.

I'd like to illustrate nondiscrimination in U.S. pension law with some commonplace examples. In particular I'd like you to imagine that the sponsor of the plan has designed a business lunch program under which the employer is paying for the business lunches of the employees. If this were subject to the discrimination requirements of 410(b) and 401(a)(4), the first consequence would be that the plan would have to prevent the high paid from going to one restaurant while the low paid went to another restaurant. The reason for this is, presumably, that the high paid are going to a better restaurant. Second, if you were to test such a program, you would make sure that none of the low-paid employees received an entree that is less expensive than any of the entrees received by the highly paid employees. If one of the highly paid employees ordered a steak that cost $8, all of the low paid would also have to order an entree that cost at least $8. You may make this test on the basis of a percent of pay. Third, if the high paid were permitted to order an appetizer or a dessert, then the low paid must also be able to order the same appetizer or dessert. You're not allowed to set up the business lunch program in such a way where the high paid get to order desserts from one list and the low paid have to order desserts from a different list; and this has nothing to do with the cost of the dessert. Finally, if these rules were not passed, then every business lunch ever eaten by any of the high-paid employees would be reported as income in that year, even if the lunch was eaten 10 years ago.

The tax code has some loopholes. As I've mentioned before there are the rules regarding permitted disparity. There are also rules regarding restructuring and aggregating of plans. You are allowed to combine plans and take plans apart, and you are allowed to subdivide plans into tiers and levels. There's an enormous variety of ways in which you can put plans together and take them apart again, that are essential for passing these tests. Another loophole is the ability to average contributions under 401(k) plans and test the averages. Finally, another very important loophole, in my view, is the ability to convert from one form to another. You can take a defined-benefit plan and hypothetically convert it into a defined-contribution plan, or you can take a defined-contribution plan and turn it into a defined-benefit plan. To some extent this involves changing apples into oranges and then testing the oranges.

If we go back to the business lunch program for an analogy to the permitted disparity, suppose the government sponsors a luncheon program to which all employers are required to contribute. The employer would be allowed to combine the cost of the lunches available under the government-sponsored plan with the price of the entrees ordered by the employees before doing the testing. Since the price of the entrees is measured as a percentage of pay and the lunches offered under the government-sponsored lunch program are not proportional to pay, combining would ease the burden of testing the entrees.

For an example of another planning technique, suppose one of the low paid is on a diet and orders cottage cheese. Does this mean all the high paid have to order cottage cheese in order to pass this test? No. What you can do is divide everybody into eating groups based on the entrees that they're ordering. Everyone who orders cottage cheese, gets put together in one group. Everyone who orders hamburgers, gets put together in one group. Everyone who orders filet mignons, gets put in a group. And then you test each one of these groups, and if the population in each group has the right ratios, then the plan passes the test. This is known as restructuring.

For an analogy of the 401(k) test, suppose the lunches are paid for by the sponsor, but employees have to buy their own drinks. We would average the cost of all the high paids' drinks and the cost of the low paids' drinks. As long as the high paid average drink price was not more than 25% above the average drink price of the low paid, then that test would be passed.

Finally, to illustrate converting benefits into contributions and vice versa, suppose instead of testing the cost of the entrees we were to test based on the number of calories in each entree. We would compute the number of calories in each entree, and then we would test on that basis. If a high-paid person ordered filet mignon, and a low-paid person ordered hamburger, when you convert them into calories, if they are of a similar level of calories, then the test is passed. So, this is a garden variety analogy that you might think of when you're trying to get a handle on some of these regulations that are pretty complicated.

Now for the real meat of these regulations we're going to go to Scott Galloway who will give us the lawyer's point of view.

MR. J. SCOTT GALLOWAY: It might be helpful at the onset just to give you a flavor of the statutory provision that spawned these many pages of regulations that were published in September 1991. Section 401(a) generally sets forth what a plan must provide to constitute a qualified plan. Section 401(a)(4) provides, ". . . if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees within the meaning of section 414(q). For purposes of this paragraph, there shall be excluded from consideration employees described in Section 410(b)(3) (A) and (C)." It's less than 50 words, and about half those words are just cross-referencing you to an exclusion. The Federal Register package that went to the

United States Printing Office in September was 317 pages long. So, you can see that the IRS takes very seriously its charge of explaining to you what those nondiscrimination rules mean. The rules are very long. They're very complicated. They're interrelated. They also, in general, are more readable than most government packages I've encountered since 1978 when I started practicing employee benefits law. I would give you one word of advice while dealing with these regulations. It is probable that if you practice in the employee benefits area, you do not on a daily basis encounter every aspect of employee benefits that would be covered by these regulations. There may, in fact, be certain things discussed in the regulations with which you are not familiar. While the regulations are readable, they can be overwhelming. When you encounter an area you're not accustomed to, read the general or overview material that usually is found at the start of that section. Then perhaps go to the examples. Read a few of them, and get a flavor for the nature of the beast that that section addresses, and then go back, and re-read the preamble portion and the regulation. I think you'll find it more understandable. At least I did when I went through it.

The 401(a)(4) regulations provide the method for determining whether the plan is either discriminatory or not discriminatory. Your intent or the employer's intent is irrelevant. The plan must satisfy these provisions in fact. In addition, these rules are exclusive. They are not a safe harbor. There's no alternative method, although there are alternatives within the regulations. As James mentioned, the employer must satisfy regulatory requirements with respect to the amount of contributions under the plan or the amount of benefits under the plan and, in addition, must satisfy other rules regarding availability of optional forms of benefits and other rights and features and ancillary benefits under the plan. Plan amendments must meet certain nondiscrimination rules. The plans must meet certain nondiscrimination rules upon plan termination. You test these plans for the active employee population, but you must also separately test them, and they must separately pass, for the former employee population. You can use permitted disparity, as James mentioned, which is the Social Security integration aspect of it. You can do that whether or not the plan satisfies 401(l) in form and qualifies for a design-based safe harbor, but it can't be used by plans that are not allowed to use permitted disparity such as 401(k) plans.

Certain plans automatically pass under these regulations; for example, collectively bargained plans, whether a governmental collectively bargained plan or a private sector collectively bargained plan. You might note that despite the importance of employee stock ownership plans (ESOPs), currently, rules regarding ESOPs are still reserved in this regulation package. The test is based on the plan year; however, the rules contain new and very important retroactive amendment rules that I will discuss later.

Regarding defined-contribution plans, the general test is found in Section 1.401(a)(4)-2 of the regulations but 401(k) plans and 401(m) plans must separately pass the discrimination rules in 401(k) and 401(m). They must also pass the benefits rights and features test, the plan amendments and plan termination test of this regulation package, but with respect to the amount of contributions under the plan, the 401(k) and 401(m) regulations are the exclusive method of passing the test. What you're testing under the general test of Section 1.401(a)(4)-2 is employer contributions, not employee contributions. There are several safe harbors. In order to use the safe harbor there must be a uniform normal retirement age and a uniform allocation formula, and all employees must be subject to the same vesting schedule and the same definition of years of service. In addition, the plan design must either be a uniform allocation formula as a percent of compensation or dollar amount, or a uniform points plan.

The regulation contains a definition and examples of a uniform points plan. A plan can have certain nondisqualifying provisions, that is, certain provisions which, while you might as a lay person consider them to result in the plan not being uniform, will not result in the plan failing to qualify for the design-based safe harbor, as long as they apply to all employees. One is, of course, permitted disparity. Another is certain allocation requirements such as the employee must be in service on the last day of the year or the employee must have at least one thousand hours of service during the year. There can also be a ceiling on the dollar amount of allocations or benefits under the plan as long as it applies just to the highly compensated employees. Of course, the 415 limits can continue to apply. There can be multiple definitions of service for different purposes such as a definition of year-of-service for eligibility which differs from the definition of year-of-service for vesting, as long as they're uniformly applied. Uniformity here means applicable to all employees on an equal basis. A plan will not fail to have the safe harbor available merely because it provides for certain preemployment service. It can also have certain multiple allocation formulas providing they meet the rules that are detailed in the regulations.

If the plan doesn't satisfy one of the safe harbors, it is under the general rule for defined-contribution plans. Now, keep in mind a defined-benefit plan can also satisfy 401(a)(4) under this rule, under the cross-testing provisions where benefits are converted to contributions. This rule is satisfied if each rate group satisfies Section 410(b). As James discussed, 410(b) provides for a ratio percentage test or, alternatively, an average benefits test.

What is a rate group? A rate group is a group consisting of employees with the same allocation rate. There's a different rate group for each highly compensated employee and each other employee in the plan with an equal or greater allocation rate. We're not talking about benefits here. We're talking about an allocation rate. So, if there are 10 highly compensated employees under the plan, you're going to have to create 10 different rate groups. Although if they all have the same allocation rate, they will merge into one rate group.

An allocation rate is equal to the contributions for the year expressed either as a percent of compensation or a dollar amount. Contributions for this purpose mean actual contributions and forfeitures but do not mean earnings, expenses, investment gains or investment losses. You can also group allocation rates. You can group around a midpoint rate within a permitted range, and the range is expressed in the regulations, if the nonhighly compensated employees are dispersed in a reasonably comparable manner through that range. The regulations don't say what a "reasonably comparable manner" is. For passing Section 410(b) with this rate group the full 410(b) rules apply, including the average benefits percentage test, except as modified in the regulations. You cannot aggregate plans for the purpose of testing a particular rate group, except for mandatory aggregation as provided in Section 410(b). One of the modifications of the 410(b) test as applied to these groups is that the reasonable classification portion of the nondiscriminatory classification test is deemed to be satisfied. In addition, the facts and circumstances test of the nondiscriminatory classification test will be deemed to be satisfied if the plan passes a ratio percentage-type test. This isn't the same ratio percentage test as in 410(b), but is modified to be more liberal in this case. In general, for purposes of applying 410(b) to the allocation rate group, the rate group will satisfy the average benefits percentage test if the overall plan passes the average benefits percentage test. That's a down-and-dirty overview of Section 1.401(a)(4)-2. Obviously you need to study it. You need to develop checklists for approaching it with clients, but that's the general overview.

Section 1.401(a)(4)-3 of the regulations refers to testing benefits under defined-benefit plans or testing benefits under defined-contribution plans if converting contributions into benefits under the cross-testing rules. Again, there is a general test or there are safe harbors. There are four design-based safe harbors that do not require determination of amounts or comparison of benefits. You can restructure or cross-test under these rules. To use the safe harbor the plan must first satisfy the uniformity requirements that are similar to the uniformity requirements applicable to defined-contribution plans: uniform normal retirement age; uniform vesting service credit; no employee contributions; uniform postnormal retirement benefits and uniform subsidies.

There's a safe harbor for unit credit plans. These plans must meet the 133&1/3 rule of Section 411(b) of the code. The accrued benefit is determined by applying benefit formula to years of service and, if applicable, compensation, both determined as of the year for which you're testing. The end goal here is that employees with the same amount of service will have the same benefit as a percentage of pay. There's also a safe harbor for a unit credit plan using a fractional accrual method.

There are two different safe harbors for flat benefit plans, and there's a safe harbor for 412(i) insurance contract plans, a type of plan that is not exceedingly common these days, but it's a plan for which the IRS feels comfortable giving a safe harbor. Note that, as is the case with defined-contribution plans, the safe harbors can still be used if there are certain additional provisions in the plan that might result in some differential treatment of employees, such as permitted disparity, multiple entry dates, credit for prior vesting schedules to satisfy 410(a) of the code, certain ceilings on accruals, and certain offsets for other defined-benefit plans. This is one change from the proposed regulations. I believe you can now design plans to provide for certain offsets for defined benefits under other defined-benefit plans and, nevertheless, qualify for a safe harbor.

The general test is passed if each rate group satisfies 410(b). There's an alternative for a plan that determines the qualified joint-and-survivor annuity at each age as a uniform percentage of normal retirement benefit and meets certain other requirements. James and Sherrie might have some observations about whether that alternative is helpful. In satisfying 410(b) under the general test, the reasonable classification test is deemed passed. The facts-and-circumstances test does not apply. Section 1.401(a)(4)-3 regulations are extremely long, and I've just given you an overview. You simply have to read it, look at the examples and get comfortable with them. We could spend the whole day discussing exactly what's in there.

Once one gets past the benefits and contributions, one hasn't passed the hurdle. As James mentioned, the plan has to satisfy rules regarding nondiscriminatory benefits, rights, and features. The general rule is that the availability, not the utilization, of benefit rights and features must not discriminate in favor of highly compensated employees. Optional forms of benefits, ancillary benefits and other rights and features are each subject to the availability test, regardless of whether there may be actuarial equivalents available. It is not enough to give highly compensated employees one optional form of benefit and to give the nonhighly compensated employees a different form of benefit and simply claim they're actuarially equivalent. So, there must be equality in fact.

This rule is implemented by a current availability test and an effective availability test. The current availability test provides that the benefits, rights or features must be available to a group that satisfies the 410(b) ratio percentage test or the 410(b) nondiscriminatory classification test. However, in the latter case you don't pay any attention to the average benefits percentage test. Availability to an employee is based on the facts and circumstances regarding that employee, and I realize that isn't horribly helpful, but that's as helpful as the IRS is going to be. The IRS does give us certain examples regarding facts and circumstances. One looks to the current compensation to determine whether or not something is currently available to the employee. So we look at current compensation, the current accrued benefit of the employee, the current position, and this is my favorite, the current net worth. Now, I don't know how many of the employers you advise know the net worth of each of their employees or exactly what questions they would use in determining the net worth of employees. Perhaps the value of the car they're driving and whether it's leased or purchased determines net worth. Does the size of the home determine net worth? I'm not sure exactly how one could be held to a standard that a particular feature wasn't reasonably available because the net worths of the employees were not compared. Nevertheless, it is mentioned in the regulations as one of the factors that you have to consider. The potential for future availability is not enough.

You can disregard any age or service conditions for optional forms of benefits or Social Security supplements. For instance, one optional form of benefit is an early retirement benefit at age 55 with 10 years of service. You don't have to conclude that the plan is discriminatory merely because the percentage of highly compensated employees who are 55 with 10 years of service is greater than the percentage of nonhighly compensated employees. You can ignore those restrictions. However, that's true only as long as there is not a limited period of time to satisfy those. This exception where you can disregard the age and service for an optional form of benefit does not necessarily apply if the plan provides that employees age 55 with 10 years of service can get the normal retirement benefits as long as they satisfy that by January 15, 1992. In addition, the exception does not apply to ancillary benefits other than Social Security supplements or to the other rights and features. By the way, optional benefits, ancillary benefits, and other rights and features are all defined terms, and we'll go over those soon.

Also ignored are conditions requiring termination of employment, death, disability, hardship, marital status, default on plan loans secured by an account balance, minimum accrued benefit up to $1,000 in order to qualify for a plan loan, and executions of covenants not to compete. It doesn't state, by the way, that the covenant "not to compete" has to be enforceable under state law, and those provisions tend to vary from state to state.

Also, if the plan has a mandatory cashout provision, you can exclude employees who are below that amount in testing for whether or not a certain feature or optional form of benefit is available to those individuals. Elimination of optional benefits will not necessarily result in that benefit not being available for purposes of the 401(a)(4) regulations as long as it's done prospectively and there's no change to the optional form of benefit or other right or feature.

The plan also must satisfy effective availability in order to have nondiscriminatory availability of rights, ancillary benefits and features. Effective availability is a facts-and-circumstances test. Effective availability is satisfied if the group to which a feature is available does not substantially favor highly compensated employees. *Substantially* is a difficult word to have any certainty about. However, there are some examples that help. Also note that effective availability is in addition to current availability. There can be a benefit right or feature that is currently available, but if it's not effectively available, the plan still will not satisfy the regulations. Example 1 in that portion of the regulations points out a feature that probably would have passed the current availability test but does not pass the effective availability test.

There are special rules for merger and acquisition. We're not going to cover them in detail. But if you have a client in that situation, you need to be aware of them. You should know that they are there. The plan must satisfy these rules for frozen participants as well, but the regulation gives certain liberal rules for passing the availability of benefits rights and features for frozen participants.

There are special early retirement window rules. You can aggregate benefits, rights and features, including sequential aggregation, in order to pass these rules. Thus, the employee can offer highly compensated employees a benefit separate from the nonhighly compensated employees if it can be aggregated with the benefits, rights and features of greater value offered to a 410(b) group. It's a complicated little rule, but it might give some assistance in quirky plans that offer certain benefits to highly compensated employees that aren't actuarially greater in value than the benefits offered to all the other employees but are particularly useful for that group and wouldn't particularly be useful for the remainder of the work force. There are also special spousal benefit rules.

There are important definitions under this section, including optional forms of benefit. Distribution alternatives, including the normal form of benefit for any 411(d)(6) optional form of benefit or an early retirement benefit or retirement-type subsidy protected under 411(d)(6). Whether there are one or two benefits depends on whether they're payable substantially in the same terms. The relevant terms here are all terms that affect the value of the benefit. You look as to whether, for instance, a benefit's payable in cash or kind, what the payment schedule might be, the timing, the election rights, when it commences. Ancillary benefits are Social Security supplements other than qualified Social Security supplements which is a defined term under this package: certain disability benefits, ancillary life and health insurance benefits, death benefits under defined-contribution plan, preretirement death benefits under a defined-benefit plan, plant shutdown benefits that aren't protected by

411(d)(6), for instance, plant shutdown benefits that don't extend past the normal retirement age, and other similar benefits. That's quoted from the statute. I don't know what "other similar benefits" necessarily are. Other rights or features are defined as any other right or feature of more than insignificant value under the plan, such as plan loans, right to direct investment, right to a particular form of investment, right to class or type of employer securities, right to make each rate of elective contributions or each rate of 401(m) contributions, and the right to each rate of matching contribution.

I'm going to skip the plan amendment and termination rules and go right to the *retroactive correction rule because I think it's one of the more important things in this* package. In the past, if the plan did not pass 401(a)(4) for a year, the whole plan was potentially disqualified. The IRS now has more liberal statutory authority to tax benefits only of highly compensated employees, and thus not disqualifying the entire plan. This may seem like a benefit except that this probably will get the IRS to invoke the sanctions more frequently. Before, it sometimes was hesitant to impose the penalty on everyone. In certain cases it will now allow you to retroactively correct a plan that does not satisfy 401(a)(4) after the plan year is over. It makes a point of telling you that you can use the retroactive correction mechanism even without proof that the plan did not pass 401(a)(4). So if an employer wishes to sweeten benefits after the close of the year, it can do so pursuant to this rule even if the plan failed to violate 401(a)(4). However, note that the retroactive correction will solve all 401(a) problems, 401(a)(4) included, but you will not necessarily solve for 404, which is the deductions provision, or 412, minimum funding. Thus, the employer will not necessarily get a deduction for that amount of sweetened benefits unless it separately satisfies the 404 rules regarding deductions.

There are some liberal rules for making contributions after the end of the year, but they would need to be looked at. You can't conclude that you will necessarily be able to get a deduction for the year for which you're increasing benefits just because you've done so within the 401(a)(4) retroactive correction period. After the year you can increase benefits or accruals of the benefitting employees and/or grant accruals or benefits to nonbenefitting employees, that is employees who were not benefitting under the plan as of the close of that year.

The retroactive correction generally does not apply to benefits, rights and features except when directly related to a grant of accrual or benefit. Thus, this retroactive correction method is a way of fixing the amount of contributions, or the amount of benefits. If the employee went through the plan year without having the appropriate benefits, rights or features, and that's the sole reason that the plan violated 401(a)(4), the employer doesn't get any help under the retroactive correction.

A discriminatory plan amendment can be retroactively corrected as well. The amendments don't apply to 401(k) or 401(m) amounts or to eligibility under those plans. So, if there is a problem with those plans, there will be trouble. A couple of rules apply. The employer can't reduce benefits; it can only increase benefits. The amendment has to be effective as of the first day of the year. It has to be adopted and implemented by the 15th day of the 10th month after the close of the plan year. The increased benefit accruals must separately satisfy 410(b) and 401(a)(4) unless the increases are done for the purpose of qualifying for one of the safe harbors.

MS. SHERRIE B. DESMOND: My part is how the numbers work. And my first thing to say to you is I suggest you go home and get out your spreadsheet programs and try some of this. For me, at least, in preparing for this, light bulbs went off when I sat down with the numbers, and I suggest that the same thing is going to happen to you, too. When you see how it works, lots of things fall into place that in all those pages and pages of text can get lost.

Chart 1 illustrates the new formulas. Calculating the accrual rates is a key element that you'll need for lots of parts of 401(a)(4), and here's how the arithmetic goes. For defined-contribution plans we are use taxable wage base, which is a single number for the year. For defined-benefit plans, on the other hand, we use covered compensation, which is a table for the year, not the same number for everyone, unless there are very young employees. Also, the permitted disparity rate on defined-contribution plans is the 5.7% that's currently in there, and that'll be around for a little bit, but that also will move. For defined-benefit plans, the permitted disparity rate is that 0.75% graded down as employees' Social Security ages rise, and that little table is in the regulation. You are, however, permitted to use 0.65% for everyone in the plan, and that makes your spreadsheet a little simpler to do. It does not necessarily make the results better for you, but we'll look at that in a little bit.

CHART 1

Actuarial Aspects of 401(a)(4)

Adjusting for Permitted Disparity Under New Regulation

Defined-Contribution Plans

- Employees under taxable wage base (TWB)

  Lesser of 2 x unadjusted allocation rate

  or

  unadjusted allocation rate + permitted disparity rate

- Employees over taxable wage base

  Lesser of allocations/(compensation – 1/2 TWB)

  or

$$\frac{\text{allocations} + \text{permitted disparity factor} \times \text{TWB}}{\text{compensation}}$$

Defined-Benefit Plans

- Employees under covered compensation

  Lesser of 2 x unadjusted accrual rate

  or

  unadjusted accrual rate + permitted disparity rate

- Employees over covered compensation

  Lesser of accrual/(compensation – 1/2 covered compensation)

  or

$$\frac{\text{accrual} + \text{permitted disparity factor} \times \text{covered compensation}}{\text{compensation}}$$

So, note the different things here. Those are key in making sure you're using the right elements and will become very important as you're doing some cross-testing. We'll refer back to those formulas quite a lot.

The basic data for my examples is the example that was in the proposed regulation. Table 1 is an example from the proposed regulation, except that the proposed regulation did not make clear how many years of service were involved in each of these things, and I have made an assumption that there are 10 and 11 years of service at the two dates we're looking at.

TABLE 1
Basic Data for Examples

	12-31-93	12-31-94
Employee C		
Accrued Benefit	$ 2,000	$ 2,310
Testing Compensation	20,000	21,000
Testing Service	10	11
Employee D		
Accrued Benefit	$ 16,000	$ 18,500
Testing Compensation	100,000	106,000
Testing Service	10	11
Covered Compensation		$ 25,000
Social Security Retirement Age		65

And now we get into the good stuff. The first thing that you do for each employee that you're looking at is calculate unadjusted accrual rates (Table 2), and these are the key elements, the raw data, if you will, for each plan.

TABLE 2
Unadjusted Accrual Rates

Method	Employee C	Employee D
Proposed Annual	1% 2,310/21,000-2,000/20,000	1.45% 18,500/106,000-16,000/100,000
Final Annual	1.48% (310/21,000)	2.36% (2,500/106,000)
Accrued to Date	1% (2,310/11 years/21,000)	1.59% (18,500/11 years/106,000)

Under the proposed annual method, which we don't get to use anymore, we essentially calculate the accrual rate at the beginning of the year and the accrual rate at the end and subtract the two, and, again, this is right in the example in the proposed regulation. In the final regulation there is a different calculation with results that you see here that are actually not so good for us. A lot of what we thought we had in that annual method has gone away. This plan was essentially a 1% times year-of-service plan with some sort of integration. Under the method in the final regulation we take the dollar amount of benefit accrued during the year, and divide it by the salary for the year, and we see some very different results here. Now, let me call a few things to your attention. In calculating these numbers we base our numbers on accrued benefits. It doesn't matter what your formula is, how it got there, whether or not you have a safe harbor formula, the tests are based on the accrued benefits under the plan. That's the element. There are no differences for different types of plans or different types of formulas. You simply calculate the accrued benefits according to the plan. We know how to do that, at least in general cases.

There are a couple of things to look for. There is a term called *testing compensation* that is, in most cases, the same final average compensation that you use in calculating the accrued benefit, which is kind of handy for most plans. There is also *testing service*, which again is usually the service that you use in calculating the accrued benefit. But do look at those definitions very carefully and make sure that when using testing compensation and testing service you use the same things in calculating accrued benefits.

So, now we have an annual method that probably doesn't look as good for us. Both James and I discovered independently and discussed earlier that because of the changes here if you move to the accrued-to-date method, you probably will get better results for the plan.

You see in Table 2 that the results look very much more like what the old annual method gave to us. This is simply the accrued benefit at the end divided by testing service, divided by testing compensation, and you begin to get an accrual rate, and these unadjusted accrual rates become our building blocks.

Now we can impute disparity (See Table 3). So, we can now add back something into our unadjusted accrual rates so that we are allowing for the U.S. Social Security. Let's first look at the proposed annual method because, again, that was the example in the regulation. Under Employee C who comes up with an answer of 1.75%, you go through the formula of two times the accrual rate or the unadjusted accrual rate plus the permitted disparity factor, and it's the lesser of those two in every one of the cases here.

Now, under the proposed annual method, Employee C, who is our highly compensated employee, actually has here an adjusted accrual percentage that's lower than our low paid employee. That's very helpful. If we go to the new annual method that's in the final regulation, going through the same formulas but for employees who have salary over covered compensation, we now have a situation where the higher-paid employee has an accrual percentage, even after the permitted disparity, that's better than the nonhighly compensated employee. It doesn't look so good for us. So, again, rush to that accrued-to-date method, and, lo and behold, with just the tiniest little bit of grouping, the rates are the same for both the highly compensated and the nonhighly compensated.

TABLE 3
Accrual Rates -- Adjusted for Disparity

Method	Employee C	Employee D
Proposed Annual	1.75% 2 × 1% or 1% + 0.75%	1.63% $\frac{1.45\% \times 106{,}000 + 0.75\% \times 25{,}000}{106{,}000}$ or $\frac{1.45\% \times 106{,}000}{106{,}000 - 1/2 \times 25{,}000}$
Final Annual	2.23% 2 × 1.48% or 1.48% + 0.75%	2.54% $\frac{2{,}500 + 0.75\% \times 25{,}000}{106{,}000}$ or $\frac{2{,}500}{106{,}000 - 1/2 \times 25{,}000}$
Accrued to Date	1.75% 2 × 1% or 1% + 0.75%	1.76% $\frac{18{,}500/11 + 0.75\% \times 25{,}000}{106{,}000}$ or $\frac{18{,}500/11}{106{,}000 - 1/2 \times 25{,}000}$

Now, at this point let's stop and consider what can happen. The employer has generally decided that it will go with the accrued-to-date method at the present time to do its general testing. However, we may find that we get through this on the accrued-to-date method and it doesn't work. We're going to take a step back and ask, gee, what's the issue here? Are there things that have tilted the accrued-to-date method that make it not so useful? Now, as it turns out, if the highly compensated employees get higher raises than the lower compensated employees, which is what we have here -- the highly compensated got a 6% raise, the lower compensated got a 5% raise -- the annual method does worse than the accrued-to-date method.

However, there may be some employee groups in this economic environment we're in, where the highly compensated decide they're going to take the hit and give big salary increases to the nonhighly compensated, and they will take no increases or very low increases. The opposite result can happen. In that case you might want to immediately rush back to the annual method. So, there isn't a clear, right answer on what's going to be best. A lot happens with who gets the raises here. It is not something that you would immediately discover on reading the regulation. It also makes it a little harder to set up programs that you're going to use in your firms, and I would suggest that you experiment with spreadsheet before your programmer sets up permanent things for you to use; unless they're comprehensive enough to do all the testing on all the methods, then choose the best one. Notice on Table 3, I do not have the projected method. I did not put this in here because when cross-testing you can't use the projected method. I've left it out for our examples here, but in some of the other places you would go through the arithmetic in this same sort of way.

There are other things that will be very helpful in using the accrued-to-date method that you would lose under the annual method. There are several things in an annual method that give you some strange results for people. One, of course, is a plan amendment. The plan amendment is not there at the end of the prior year. It's there at the end of the year, and as you're doing a comparison, you may get some strange-looking results. Another thing to look out for is an employee group with a sizable number of people with 35 or more years of service. You get some funny results using the annual method because that extra part of the formula on permitted disparity goes to zero, for everybody who has more than 35 years of service. Of course, if the highly compensated are the ones with over 35 years, you may get some results that are useful, but here again you just may have to try lots of things to find out what gives you the results you're looking for. If anything, all of this is going to enhance the actuary's reputation of you-give-me-the-answer, and I'll-tell-you-how-to-get-there. We have a lot of room for playing, even with this very large regulation.

Table 4 shows a defined-contribution plan with four employees in it. This happens to be a very simple 5.7% plan, 5.7% on all wages, plus 5.7% in excess of the taxable wage base. It's a fully integrated defined-contribution plan, the results are as you see. Employee A gets 9.88% of pay, and all the people who have less than the taxable wage base get 5.7% of theirs. Those are the unadjusted accrual rates. We can impute disparity, go through the same formulas from Chart 1, and with those, getting the lesser again, of each of those formulas, each employee in the group comes up with an adjusted accrual rate of 11.4%. There is a dead-even plan top to bottom, and I'll leave that arithmetic for you to go through. It's very simple using the formulas on Chart 1. The nonhighly compensated use the two-times rule, the highly compensated use the second one of those two rules, and each person comes out at 11.4%.

TABLE 4
Defined-Contribution Conversion

Employee	Age	Compensation	Allocation	Allocation%*	Equivalent Annual Benefit†	Equivalent Accrual Rate with Disparity
A	50	$200,000	$19,756	9.88%	$8,450	4.37%
B	40	30,000	1,710	5.70	1,654	6.21
C	35	20,000	1,140	5.70	1,658	8.94
D	30	15,000	855	5.70	1,869	13.11

* Allocation/Compensation

† $\dfrac{\text{Allocation} \times (1.085)^{65 - \text{Age}}}{7.9486}$

Now, that's very nice all by itself, but let's say there is in this particular group a defined-benefit plan that on its own doesn't make it, or just barely makes it; or you're very nervous about the group, and there is a defined-contribution plan with this kind of tilt in the demographics, that on the surface comes out to be deadeven top to bottom with the imputed permitted disparity.

Now, we can use the cross-testing here to really help us. The cross-testing, although the formulas look awful, really turns out to be pretty simple. The formula's in the lower left-hand corner of Table 4 and in this case, changes the defined contribution to a defined-benefit permitted disparity factor. Simply take the allocation, the dollar amount that each person got, and run it out to retirement with interest only – there is no preretirement mortality here. You should use between 7.5-8.5%, and we'll talk a little bit about that later. When you get that number accumulated to retirement, divide it by a single life annuity at the retirement age, that probably again ought to be between 7.5-8.5%, using one of the mortality tables that's in the regulation. The regulation gives the ones that you're most likely to use anyway. So, it's not really very restrictive. But the arithmetic again gets very easy.

You can see that this would be very easy to set up on a spreadsheet. The rates are unisex. So, everybody gets divided by the same factor down there at the bottom. And what you come up with is an equivalent annual benefit that's in the next-to-the-right-hand column. We go from there to the last column by again going through the same kind of arithmetic we did on the defined-benefit plan. Those become the annual benefits. You divide that by salary to get some rates. So, you take each one of those numbers, equivalent annual benefits, and divide by compensation. Those become your unadjusted rates. Impute your disparity, and you come up with the percents that are in the right-hand column, and look at that. Employee A dropped to the lowest, by far. If there is a defined-benefit plan where there are some rates, we can now add those defined-benefit rates to these numbers in the right-hand column, and even though the plan was okay on its own, we now have worked some leverage into it, that, when we combine it with other plans, may be helpful to us. These are very, very different tilts. Now, I caution you, however. As James said, we've got apples and oranges, and then we're going to compare oranges. This works in this case because Employee A was 50, and everyone else was younger. If the particular plan that you're looking at is started by a young entrepreneur who has hired many senior citizens, the results will be very bad, and in that case you may want to convert some defined-benefit plans to defined-contribution plans. A lot depends on the facts and circumstances that are in the real case that you're looking at.

Now, another thing that I did here in using this is I used the 0.75% graded down to 0.65% for this particular group which also helped me here. The youngest employee has 0.65%. The oldest employee has the 0.75%, and they grade up through there. So, that can help you or not help you. You may want to use the 0.65% for everybody. You may want to use the actual ones, whatever seems to work.

Table 5 looks like Table 4 except it has a formula that's clearly one at which the IRS would raise its eyebrows. This defined-contribution formula says 15% of pay goes to the owners. Everybody else gets 5%. I've gone through the same arithmetic, the same set-up you just saw, but, gee, this doesn't look too bad out there on the right, does it? The complete test will depend on what the whole employee group does and how you're looking at things, and whether you're combining it with others. But, still, this badly tilted plan, if the demographics are right, may not be too bad by the time you change the defined-contribution rate to a defined-benefit rate.

Now, the same sort of arithmetic works backwards. This formula that just flipped and worked the other way converts the defined-contribution rate factors back to defined-benefit factors, and, again, that's a very nice little exercise to go through. Also, with a defined-contribution plan we can use an accrued-to-date method, and the regulation says that if you use the accrued-to-date method on defined-benefit plans, you must also use it on defined-contribution plans, or you must use the annual one on both of them.

TABLE 5
Testing Results for Questionable Plans
Allocation Formula: Owner 15%, All Others 5%

Employee	Age	Compensation	Allocation	Allocation %*	Equivalent Annual Benefit†	Equivalent Accrual Rate with Disparity
A	50	$20,000	$30,000	15%	$12,831	6.56%
B	40	30,000	1,500	5	1,451	5.54
C	35	20,000	1,000	5	1,454	7.92
D	30	15,000	750	5	1,640	11.58

* Allocation/Compensation

† $\frac{\text{Allocation} \times (1.085)^{65 - \text{Age}}}{7.9486}$

Now, to use an accrued-to-date method for a defined-contribution plan, instead of looking at the allocation in the year, take the account balance in the year, and then divide by service and salary to come up with the unadjusted allocation rate. The one little glitch is that if the plan has distributions, you must add back in the distributions with appropriate interest on those distributions, and to make things simpler, you can forget that on the nonhighly compensated, and just add back the distributions for the highly compensated people. So, there is, if you will an accrued-to-date method for defined-contribution plans, and remember that you must have matching methods in the defined-benefit and defined-contribution plans as you're combining and doing that cross-testing.

MR. KENNEY: One of the things that was very interesting to me was that the proposed regulations provided safe harbors on your actuarial assumptions. In the interest rate case that was 7.5-8.5%, and in the mortality table the regulations gave a list of mortality tables. The final regulations, instead of providing us with safe harbor assumptions, have said essentially to use any recognized rate and any recognized table. I've been using the safe harbor rates from the proposed regulations to do my analysis on various plans, and I'm wondering how safe that is when the other interest rates we use, for instance, for valuations, are now being restricted by the IRS. Look at the small plan audit program and so on. If the 30-year Treasury rate changes significantly, do you feel comfortable sticking with the 8.5% that you used to convert Employee A?

MS. DESMOND: I don't know the answer to that. If, for instance, rates rise to 12% or drop to 6% for Treasuries, I'm not sure that we've got something that's reasonable here, and I'm not sure 8.5% is correct. Because of the small plan audit program where the IRS has gone back after several years, looking at 1987 and 1988, it makes that a little more difficult if we get to the point where our Treasuries are significantly different from the 7.5-8.5% range. I think we'd better concern ourselves with that and at least do a trial run at a different interest rate and see if it makes a difference.

MR. KENNEY: How are you going to get a plan design that's stable if the rates change?

MS. DESMOND: I don't think there's an answer to that one, and I think that's very much a problem for us here.

MR. KENNEY: I'm wondering about you, Scott. How comfortable are you with a plan that does not have a safe harbor on which the client is seeking your advice? Should you tell the client that, yes, you meet this test, and if the demographics don't change too much, you'll probably meet it next year?

MR. GALLOWAY: I think actuaries and lawyers are both at the lower end of a new learning curve, similar to what happened when ERISA was passed, and I think for a period of time we're all going to be asking more questions than we used to ask. We're going to be asking more questions of the clients. We're going to be asked more questions from the clients. And we're going to ask the professional on the other side of the table more questions. And whether one relies on a specific actuary's recommendation is going to depend on a lot of different factors, but in general one is going to be less likely to take anyone's word for anything these days.

MR. KENNEY: Are we basically stuck with safe harbors because of the expense of testing?

MS. DESMOND: I would suggest that that's not so, and I think it's going to be difficult to convince some of our clients of that. But if you've been going to meetings for the last couple of years, you have seen that those people in research departments who got into this and the proposed regulation very early on were easily able to show that, for instance, offset plans in most every instance could pass. If you have a client who's very happy with his or her Social Security offset plan, the general tests are not going to be that difficult to do. The arithmetic is not tough, and, in fact, the plans are going to be able to pass. Now, the problem will be convincing clients to pay your bills to do that. It may be worth the price, I think.

MR. KENNEY: It may also depend on what information-gathering procedures the client would have to implement in order to help you perform the tests. If the client already keeps the sort of records from which you can do the test, then avoiding a design-based safe harbor and implementing the exact plan design desired by the client is more feasible than if the client doesn't currently keep the sort of information you need.

MS. DESMOND: Another thing to consider is the whole human resources side of the business which we as actuaries often forget. If the human resources department has just put out a glossy booklet illustrating the Social Security offset plan and has been promoting that and has done slide shows and has invested thousands of dollars in doing that, then maybe your fees don't look so bad.

MR. KENNEY: Unless the plan has a safe harbor design, and probably the easiest situation in which you'll have a safe harbor design is where your clients sponsor a plan that covers everyone and doesn't have special features for special divisions, one of the things that's important to communicate to the clients once they are no longer in a safe harbor, is that they're at the mercy of the demographics of their population. If the demographics of the population change considerably from one year to the next, then the results of this testing will change, and what was safe last year may well be a disaster this year. This means that you may want to warn your clients that in order to help them you need advance notice of things that will make marked changes in their demographics; plant closures, huge layoffs, early retirement windows. These things should perhaps be examined through your 410(b) and 401(a)(4) computer models for their effects prior to announcements being made to the population involved. There's nothing like having the employer go ahead and make the decision to close the facility or make the decision to institute an early retirement window, then you do the testing and conclude that under the early retirement window provisions of the (a)(4) tests they do not meet the ratio requirements and that that program is basically illegitimate under the U.S. Nondiscrimination rules.

MS. DESMOND: What if the employer is planning to close a plant and you can show that if it closes Plant A, the plan fails, and by closing Plant B, the plan passes? Is that enough information? It may be that the one you're recommending closing has all the older employees in it. Have you recommended then something to the employer that is discriminatory in a different way rather than 401(a)(4)? We really need a dialogue with our clients here.

FROM THE FLOOR: Isn't it a matter of just timely amending the plan once you find you're in trouble?

MR. KENNEY: That is not always the case. In some cases that's correct; if the client goes ahead and announces an early retirement window which covers a certain category of employees. You hear this announcement, go to your computer, look at that category of employees, and conclude the plan does not pass this test; but if this requirement was modified, then it would pass the test. You notify the client that that requirement can be modified, but they've got egg on their face. That's one problem.

Another problem is that if it is an amounts issue, you can always cure the amounts issue by throwing money at it, assuming that the plan sponsor's willing to do that, but if it is a rights and features issue, then you can't. There's no solution. Take a situation in which there are two 401(k) plans, and the people who are administering this are testing each plan separately, and they both pass the test. If you don't meet the 410(b) coverage requirements for each one of those plans separately, then you're going to have to aggregate them. If it turns out that, in one plan there were different investment opportunities, or there were different levels of contribution that could be made, it's too late to go back. The employee can't go back and give the low paid the opportunity to make contributions to be invested in employer stock. That window is closed. The employer had the chance last year, and you didn't tell them about it, is really what it boils down to. If the plan design allowed the highly-compensated to have segregated accounts but none of the nonhighly compensated could, and the stock market went crazy, there's nothing you can do about this situation. The plan is dead.