## NONDISCRIMINATION ISSUES (BASIC)

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|---|---|
| Moderator: | MICHAEL I. WIESNER |
| Panelists: | STEPHEN A. ALPERT |
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An overview of the status of rules and regulations on nondiscrimination, including IRC Sections:
- 401(a)(4)
- 401(l)
- 401(a)(26)
- 410(b)

MR. MICHAEL WIESNER: This session is an overview of the nondiscrimination rules, discussing how 401(l) integration and 401(a)(26) relate to the basic coverage and nondiscrimination rules.

MR. STEPHEN A. ALPERT: The IRS has set up the nondiscrimination rules in the proposed regulations in two big tests that must be passed (Chart 1). The first is 410(b), which shows the plan covers a nondiscriminatory group of employees. If it doesn't, then aggregate with some other plans and then show that the aggregated plan covers a nondiscriminatory group. Then show under 401(a)(4) that the benefits provided to that group of employees are provided on a nondiscriminatory basis. There is also the concept of restructuring under 401(a)(4) by breaking up the original plan and into smaller pieces. Each one of those smaller pieces, through 410(b), has to show that it covers a nondiscriminatory group. I think of 410(b) as the engine that drives all of the nondiscrimination rules and, as you can tell by the flow chart, you have to work hard to go around and around before you get out to the "pass" end.

In general, to have a nondiscriminatory group, review the group that is covered, divided by some universe of employees; in the covered group you may not unduly favor the highly compensated employees. Because pensions get such a huge tax subsidy, Congress wants to make sure that all employees are benefiting under the plan. Avoid favoring the highly compensated employees either on a number count weighted basis or on a benefits-provided weighted basis.
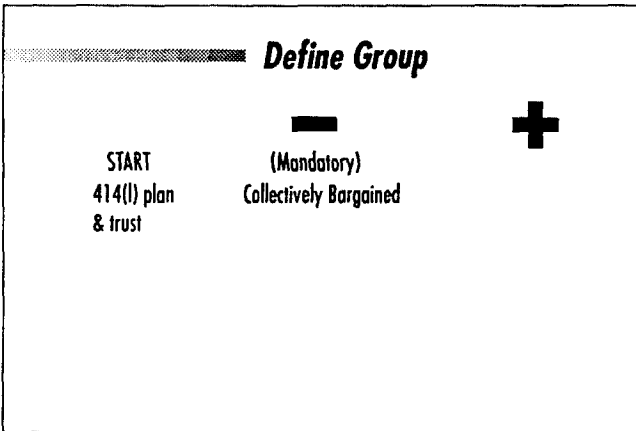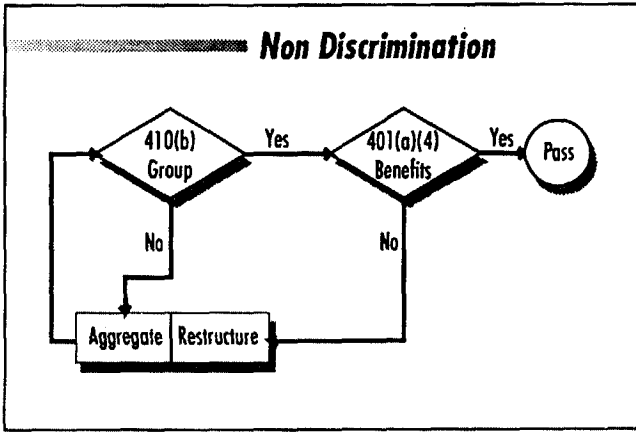
Define a test group using the basic 414(l) definition of plan (Chart 2). One trust equals one plan and things like that. There is an automatic exclusion for collectively bargained employees. These employees are presumed to be protected by the collective bargaining process. There are some exceptions to that, for example if your collective bargaining group covers more than 2% of professional employees.

In addition, after excluding the collective bargaining people, any part of a plan that's an Employee Stock Ownership Plan gets pulled out (Chart 3). It's not automatically excluded. It's separately tested, as are the parts of the plan that have 401(k) or 401(m) contributions.

Employees in a separate line of business can frequently be excluded (Chart 4). The rules are a whole separate topic. In some cases you get to test the separate line
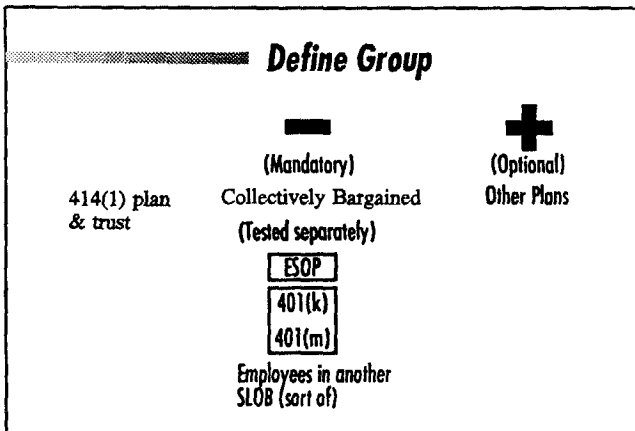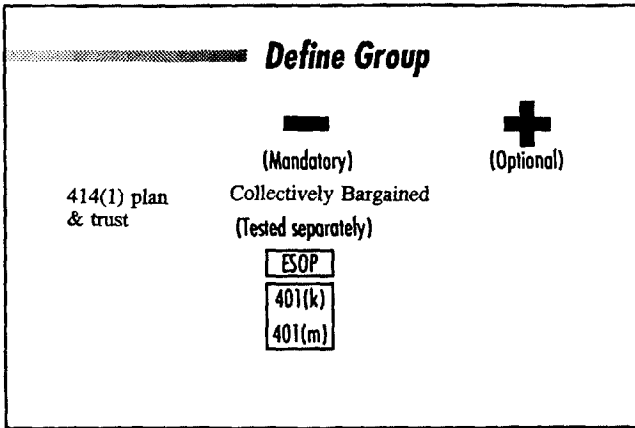
*Non Discrimination*



*Define Group*

| START | (Mandatory) |
| 414(l) plan | Collectively Bargained |
| & trust | |

## Define Group

**—** (Mandatory)          **+** (Optional)

414(1) plan & trust

Collectively Bargained

(Tested separately)

| ESOP |
| 401(k) |
| 401(m) |

## Define Group

**—** (Mandatory)          **+** (Optional)

414(1) plan & trust

Collectively Bargained

(Tested separately)

Other Plans

| ESOP |
| 401(k) |
| 401(m) |

Employees in another
SLOB (sort of)

of business separately; in at least part of the separate line of business rules you still have to look to the whole controlled group.

After all the disaggregations, include other plans optionally so that two plans aggregated together are a nondiscriminatory group if one doesn't pass. But you cannot optionally aggregate anything that's in the minus column, because all of the disaggregations in the minus columns are mandatory. So you can't add anything back in that you've already been forced to pull out.

In defining our group, we start with our 410(b) group, my big amoeba blob on the left (Chart 5). Applying ginsu knives in 401(a)(4), slice, and produce a number of little groups. Use 410(b) to do the same testing all over again. Group means both on a plan basis and on a restructured basis after going through 401(a)(4), and they are used interchangeably.

After defining the group, what is the universe that we're comparing to? Remember, coverage is defined in terms of how many people are covered by the group relative to the universe.

Start with the controlled group. Add in the affiliated service group, leased employees, and subtract collectively bargained employees, again because they get the free ride, nonresident aliens with no U.S. income, and, for at least most of the separate line of business testing, employees who are being tested as part of a separate line of business. For a part of the separate line of business, we need to consider all of the controlled group employees.

With an optional exclusion for employees who don't meet the statutory minimum age and service requirements -- basically age 21 and one year of service -- you can break that into pieces. For example, consider all the people who don't have a year of service but are 21. Exclude them from testing if you don't provide any plan at all to them or if you provide nondiscriminatory coverage to that group only. This is the intent of the regulations. Whether to exclude depends on your plan design. If you have a plan or plans where you're not covering very many of those people, then you prefer to exclude them from testing, If, on the other hand, you're a generous employer and you're covering most of those people, most of them are nonhighly compensated and it probably works to your advantage to include them.

After you define the group, define the universe, the third step, is to define the types of employees and classify them as to highly compensated or nonhighly compensated. In my example here I have the New York Actuaries Baseball Team in which the ballplayers, as we all know, are quite highly compensated (Chart 6). The requirements are listed. Everyone else, represented by the grounds keepers, I'm calling nonhighly compensated. There must be at least one highly compensated employee in the controlled group and in the universe.
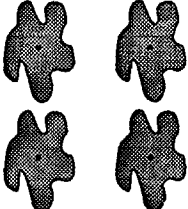
We defined the plan or the group. We defined our testing universe. Now we've classified employees. Now we're ready to start testing.

The first test, which is the numbers weighted approach to showing that you cover a nondiscriminatory group, is called the ratio percentage test. Look at the percentage of

## Define Group

410(b)

Component Plan [401(a)(4)]

## Two Kinds Of Employees

HCE     5% owner
Officers & Comp > 54,482
Comp > 90,803
Comp > 60,535 and top 1/5

NHC     Everyone else

nonhighly compensated people who are covered by the particular plan or group relative to all the nonhighly compensated people in the universe (Chart 7). You do the same thing for the highly compensated people – the number of people covered (that is, actually earning benefits under the plan) divided by all of the highly compensated employees in the universe. If the ratio of those two percentages is at least 70%, or 0.7, then the ratio percentage test is passed and for that group of employees 410(b) is passed.

Chart 8 shows the New York Actuaries Baseball Team, which is a very large team. (There is a big minor league franchise.)

As well as a salaried and hourly plan, there are some union employees who are covered by their own plan. They get the free ride. One hundred highly compensated people are all in the salaried plan, 1,000 nonhighly compensated people are in the salaried plan, 900 are in the hourly plan, and my testing universe is the total of all my employees. Obviously the hourly plan covers a nondiscriminatory group of employees. It covers only nonhighly compensated employees, so that one passes right off the bat (Chart 9). In my salaried plan, I have 1,000 in the plan, 1,900 in the universe; 100 highly compensated who are covered and 100 in the universe. The ratio of those two percentages is less than 70%, so it fails the ratio test, apparently (Chart 10).
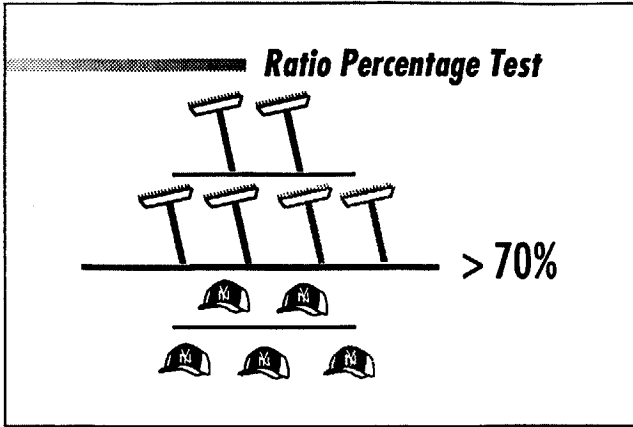
But there are two ways to get through this test. On a benefits weighted basis, use an average benefit percentage test. This is a two-part test, one of which is called the average benefits test (Chart 11). If the average benefits provided to your nonhighly compensated people are at least 70% of the average benefits provided to your highly compensated people, then the 410(b) test permits a lower ratio percentage. The lower ratio percentage is called a nondiscriminatory classification test -- different name, but the same mathematics.

To calculate these benefit percentages, you have to calculate a benefit percentage for each employee in your universe. You have to include all plans – defined benefit and defined contribution. You're looking at the employer-provided benefit as a percentage of compensation. You can include the permitted disparity under 401(l). Larry will describe the employer-provided benefit later. You may define this benefit either as a defined-benefit plan, accrual rate (1% of pay, payable at age 65), or as a defined-contribution plan allocation rate (10% of pay, or something like that). You are allowed to convert from defined benefit to defined contribution or whatever using 401(a)(4) type rules.

A couple of points here. You only have to do this test once for the employer. You do it once for the universe and that entitles you to use these lower ratio percentages, the nondiscriminatory classification, for all of your nondiscrimination testing. The lower ratio percentages become valuable primarily in the situation of our example where we had a salaried plan that failed the ratio percentage test. It will also become valuable much later on when we talk about restructuring, because each of those restructured groups under 401(a)(4) must be tested under 410(b). Satisfying the lower ratio percentage is much easier than the 70%. There is a special rule that allows you to test only defined-benefit plans or only defined-contribution plans if you test them on a defined-benefit or defined-contribution basis, respectively.

## Ratio Percentage Test

> 70%

## Ratio Percentage Test

| EXAMPLE | | | Total |
|---|---|---|---|
| Salaried | 100 | 1000 | 1100 |
| Hourly | 0 | 900 | 900 |
| Testing Universe | 100 | 1900 | 2000 |

## Ratio Percentage Test

EXAMPLE

|  | | | Total |
|---|---|---|---|
| Salaried | 100 | 1000 | 1100 |
| Hourly | 0 | 900 | 900 |
| Testing Universe | 100 | 1900 | 2000 |

$$\text{Salaried Plan R.P.} = \frac{\frac{1000}{1900}}{\frac{100}{100}}$$

## Ratio Percentage Test

EXAMPLE

|  | | | Total |
|---|---|---|---|
| Salaried | 100 | 1000 | 1100 |
| Hourly | 0 | 900 | 900 |
| Testing Universe | 100 | 1900 | 2000 |

$$\text{Salaried Plan R.P.} = \frac{\frac{1000}{1900}}{\frac{100}{100}} \quad < 70\%$$

*Escape Hatch*

AVERAGE BENEFIT PERCENTAGE TEST

If $\dfrac{\text{Average Benefit \% -}}{\text{Average Benefit \% -}}$ > 70%

☞ Lower ratio percentage threshold
("Non-discriminatory classification")

Watch out for 401(k) plans. If you take your typical 401(k) plan where your highly compensated deferral rate is probably right at the maximum, for example, 3.3% with nonhighly compensated people deferring at 1.7%. In this example, I have assumed no match or other employer-provided benefit. Although, you meet the 401(k) test, but on a contributions basis you've got 1.7 over 3.3 in terms of average benefit rates and you're going to fail the average benefits test on a contributions basis. Now, you may not fail if you aggregate it with defined-benefit plans and turn those contributions into defined benefits if the highly compensated people are enough older than the nonhighly compensated people. In one of my plans that was not the case, so we basically kept the 401(k) plan separate.

If you have noncovered employees in your testing universe, you have to count them in as zero when calculating your average benefit percentages. Generally calculate each employee's benefit percentage, add them up, and divide by the total number of employees to get the average benefit percentage for the highly compensated and for the nonhighly compensated group. Don't try to avoid this test, it's really not so bad and actually makes a lot of things a lot easier. If you go through the nondiscrimination rules you almost always end up with the average benefits test anyway.

Chart 12 shows the 410(b) status. In the first chart, we had to get through 410(b) and 401(a)(4) so I exploded my 410(b) diamond. Start with the ratio percentage test (70%). If you pass that, fine. If you do not pass that, then do the average benefits test. If you get through average benefits, then do the nondiscriminatory classification, which is the ratio percentage test with a lower threshold. So there are two paths. One is only one test and one is two tests. In practice, many people find that they compute the ratio percentage, find that they fail that test, and then the first thing that they check is "do I pass the classification test?" If yes, they will go back and see if they can do the average benefits test.

The classification test works like this (Chart 13). First, calculate another ratio called the "concentration percentage," which is the percentage of nonhighly compensated employees in the universe as a percentage of all the employees in the universe – highly plus nonhighly. In the example, that would be 50%. I have three nonhighly compensated people (they could be in different plans). Six employees altogether in the universe. Depending on your concentration percentage you have a different ratio percentage needed to pass the test. The ratio percentage is the vertical scale here. The concentration percentage goes from 0-99%. (Actually the zero probably should be 1%.)

In Chart 14, the boat is a safe harbor. If your ratio percentage is in the safe harbor, then you automatically pass. In the black is the pirate's flag, which is the unsafe harbor and automatically fails. In between is the gray area of facts and circumstances aimed at determining whether this is really a bona fide group. Even at a very low concentration percentage only a 50% ratio percentage is needed to get through, having shown that you're not unduly favoring the highly compensated employees through the average benefits test. A very large employer with a lot of nonhighly compensated employees, can get into the safe harbor at around 21% or 22% and get into the facts and circumstances at 20%. This is a real big help, particularly with the 401(a)(4) rules.
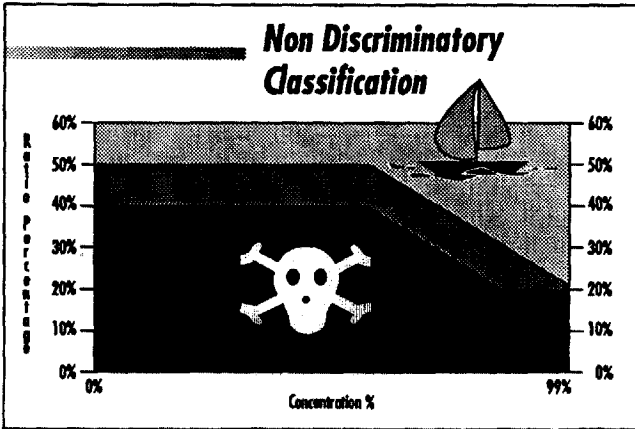
**410(b)**



**Non Discriminatory Classification**

CONCENTRATION %

Non Discriminatory Classification
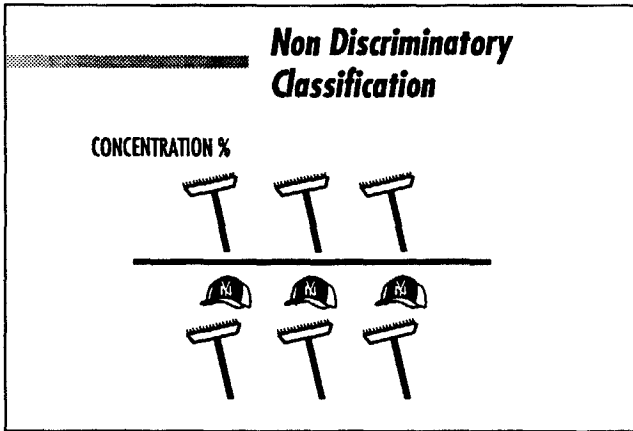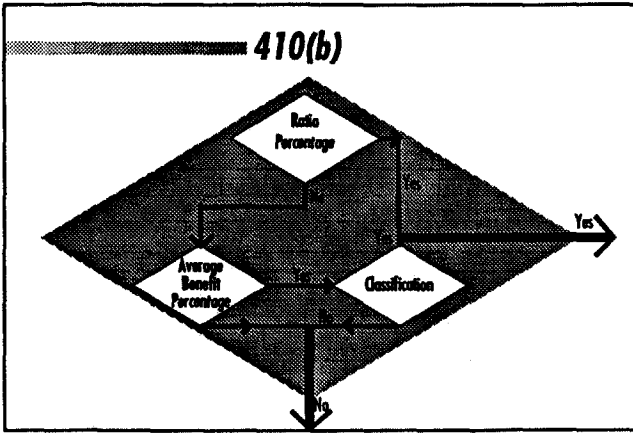
The Chart 15 example is the same plan, the same group of employees, except that my salaried plan has a benefit of 1.5% of pay and my hourly has a benefit of 1.0% of pay. Assume for now that this includes the permitted disparity under 401(l). The average benefit for the highly compensated employees is 1.5% of pay. Computation for the nonhighly compensated: 1,000 are getting 1.5% of pay and 900 are getting 1.0% and that averages out to 1.26%. Verify that 1.26 over 1.5, the ratio of my accrual rates, is greater than 70%; so I've passed the average benefits part of this test and that allows me to use the nondiscriminatory classification.

The concentration percent is 1,900 nonhighly compensated employees divided by 2,000 total, so it's 95%. The ratio percentage is 1,000 over 1,900, divided by 100 over 100, or 52.6% (Chart 16).

In the safe harbor graph, the New York Actuaries Baseball Team is well into the safe harbor and so we pass there (Chart 17). That's the real power of this average benefits test, as it really makes getting through 410(b) much easier, once you get past the computational part of doing the average benefits. Programmed once, redo it every year as part of the valuation.

The nondiscriminatory classification test does have a couple of stand-alone uses where you would use the safe and the unsafe harbors without having to resort to the average benefits test. The first principal use is testing optional forms under 401(a)(4). To show that there is a nondiscriminatory availability of benefits, you get to use the nondiscriminatory classification. Don't go through the average benefits test just for that piece. The other principal use is as a gateway to the separate line of business rules. Basically for every plan, group, subgroup, whatever, that you want to test on a separate line of business basis, you must first show on an employer-wide basis that you meet the nondiscriminatory classification test.

MR. LAWRENCE J. SHER: The overlap between Steve and my comments is intentional because some of this material has to be reinforced.

In going through the 401(a)(4) regulations is the so-called general test. It allows you to test for nondiscrimination by using demographics and an annual test rather than adopting a safe harbor benefit formula; that is, a formula that would pass nondiscrimination by the very design of the plan formula. The general test will frequently allow you to avoid having to adopt a safe harbor so long as you can prove that the numbers work out appropriately.

Determine where a general test makes sense, how it works and how to assure that you continue to comply with it. Who a highly compensated employee is and who a nonhighly compensated employee is, is not only important in 410(b), but it has significance in 401(a)(4). View the combination of 410(b) and 401(a)(4). Within the section 401(a)(4) regulations watch the amount of benefits or contributions that a plan or an aggregated plan for testing purposes provides, and also watch other features of the plan that could potentially be nondiscriminatory.

Again, Steve talked about what the plan is for testing purposes. In some cases, do some aggregation and in other cases take a plan or an aggregated plan and break it

**Average Benefits**
**Non Discriminatory Classification**

EXAMPLE Cont'd

| PLAN | BENEFIT | | | TOTAL |
|------|---------|---|---|-------|
| Salaried | 1.5% | 100 | 1000 | 1100 |
| Hourly | 1.0% | 0 | 900 | 900 |

Avg. Benefit - HCE = 1.5%

$$- NHC = \frac{1.5\% \times 1000 + 1.0\% \times 900}{1900} = 1.26\%$$

1.26 / 1.5 > 70%

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**Average Benefits**
**Non Discriminatory Classification**

EXAMPLE Cont'd

| PLAN | BENEFIT | | | TOTAL | RATIO % |
|------|---------|---|---|-------|---------|
| Salaried | 1.5% | 100 | 1000 | 1100 | $\frac{1000}{1900}$ =52.6% |
| Hourly | 1.0% | 0 | 900 | 900 | 100% |

Concentration % $= \frac{1900}{2000}$ =95%

Salaried Plan easily passes safe harbor

## CHART 17
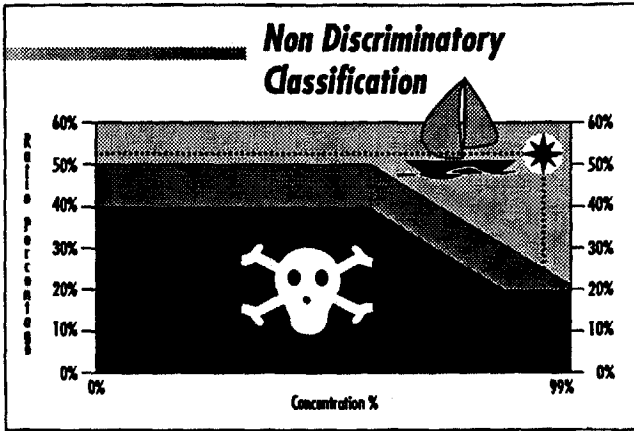


Non Discriminatory Classification

into components and then go back to 410(b). There are certain situations where you can't aggregate or you must disaggregate. The regulations are, at this state, in a proposed format. They are not likely to change significantly from where they are currently, although we do expect to get some additional guidance on how to run some of these tests. The final regulations will probably be out sometime during the summer.

There are basically three major parts to the 401(a)(4) regulations. One is testing the amount of either benefits or contributions, which may not discriminate in favor of highly compensated employees. The second section deals with making sure there are no discriminatory rights, benefits, and features in your plan. The third is just labelled "effect of special circumstances." There is a totally free ride for plans or sections of plans that cover exclusively collectively bargained employees.

Regarding changes in the final regulations, the IRS and Treasury know that restructuring needs clarification.

In other areas of the regulations, you can't discriminate with respect to optional forms of benefits and ancillary benefits. Ancillary benefit might be, for example, a Social Security supplemental benefit, disability benefit, certain death benefits. Also don't discriminate on other rights and features which primarily apply in defined-contribution plans; for example, availability of loans or the ability to elect various investment options.

If you're testing a plan where the same choices and options are generally available, there would not be a problem. On the other hand, you may be aggregating plans with different options. Make sure the people who have the special option constitute a group that would pass the 410(b) coverage rules. There's also an effective availability test, which is a facts and circumstances test. There are some limited exceptions for acquisitions and mergers; so if you acquire a company and their plan had some special provisions that cover a group that would not satisfy 410(b) when you look at it for the plan being tested, include the acquiring company, you get a free ride for that reason, so long as you don't extend the provisions to any additional people.

The other tier in the regulations deals with plan amendments, grants of past service, and special termination rules. This relates to facts and circumstances. Having either no plan or an insignificant plan, and then just after all the nonhighly compensated employees terminate and just before all the highly compensated employees retire, you cannot significantly improve benefits. So, this is a smell test and there are no bright line rules.

In the amounts part, there are two courses you can take. One is to adopt a safe harbor. If you're going to do that, then you're off the hook in doing the annual testing, which seems very appealing. Many companies had already adopted formulas after the 401(l) regulations came out with the hope and expectation that those plans would, in fact, pass 401(a)(4) as well. If you're going to pass the safe harbor, the permitted disparity rules in 401(l), which tend to be very restrictive, must be met. You can't pass a safe harbor if you have a primary insurance amount offset plan. Many plans either have to change the nature of their formulas or try the general test.

The safe harbor has another disadvantage in that to comply with one you may have to make significant changes to your plan, which would either mean a significant increase in cost to raise the level of benefits for lower-paid employees or, to maintain the same level of cost, you're going to have to reduce, to some extent, the level of benefits for highly compensated employees. Neither of those alternatives is particularly appealing to most companies, unless they had in mind doing something along those lines anyhow. Also under a safe harbor, you have to adopt a nondiscriminatory definition of compensation. For example, if you're using base pay, it may turn out that that is discriminatory, if more is paid in overtime relatively than in bonuses.

For safe harbors to work, you have to have a uniform formula that provides the same level of benefits for the current and all future years. It can be integrated with Social Security, but it has to meet the 401(l) rules. An example of the type of plan that might work is 1% of pay up to a $20,000 integration level and 1.5 above. All plan subsidies must be provided in a uniform matter; so if there is an early retirement subsidy, all are eligible. There must be the same normal retirement age for all. There's also an additional safe harbor that allows certain front-loaded benefit formulas to pass through. For example, you might have a formula that provides 50% of final average pay for 25 or more years of service at normal retirement and then prorates it for less than 25 years. That would meet a safe harbor. But you have to accrue benefits over a minimum of 25 years. If the same plan provided 50% of final average pay over 20 years and prorated it for less than that, that would not satisfy a safe harbor unless a special is satisfied.

There are special rules for contributory plans. Under a safe harbor, if you had a formula that doesn't meet the rules -- for example, it was integrated with Social Security and it doesn't meet the permitted disparity rules -- you can do one of three things. You can freeze the accruals under that and adopt a formula for future service only that meets the new rules. You can adopt a new formula that applies to all years of service. Then the minimum benefit is the accrued benefit under the prior formula. Or, you take the greater of the two. In September, a modification to the original regulations was introduced that permits indexation of the accrued benefit as of the end of 1988, for future pay increases, with certain conditions.

Safe harbors for defined-contribution plans must have the same contribution rate apply for all employees. You can integrate so long as you comply with the 401(l) disparity rules. In certain circumstances you can have a formula that is weighted by age or service, but in some cases, you may not be able to pass. I remind you that even though the amount tests for 401(k) and (m) are automatically satisfied if you pass the average deferral percentage and average contribution percentage tests, there is concern about the other 401(a)(4) provisions, particularly the benefits, rights, and features. A plan that has different benefits, rights, or features with respect to different groups of employees may be a problem.

The general test is used for plans that can't comply or if the employer does not want to amend to comply with 401(l). Currently others are plans that have transition provisions and cash balance plans. The only way a cash balance plan can clearly satisfy 401(a)(4) is through the general test. Even if a safe harbor is adopted in the final regulations for cash balance plans, it's doubtful that it would have any significant value in that it would probably be restricted to a plain vanilla type of future service

only cash balance plan. Many cash balance plans have been converted from traditional defined-benefit plans and have various transition provisions.

If you have multiple plans with different formulas and they are being aggregating, chances are the general test will be needed.

If the plan has a discriminatory definition of pay, the general test might help. For example, the use of back pay may be discriminatory under 414(s). You might be able, through the general test, to prove that the pay in combination with the benefits being provided are still nondiscriminatory.

Finally, in some cases, defined-contribution plans that cannot satisfy a safe harbor, can satisfy the general test.

The general test seems overwhelming when you first get involved with it; but once it is computerized, it should become a by-product of annual valuations or something close to that. It's an operational test, like 401(k).

The general test works for just employer-provided benefits. The first thing you want to do is calculate an accrual rate or a contribution rate with respect to each employee under the plan. You then want to adjust this rate by the imputation of permitted disparity that has the effect of increasing the rate that you originally calculated. The general test requires that no highly compensated employee can have an accrual rate that's higher than the accrual rate for any nonhighly compensated employee. This must generally hold for normal and most valuable rates. You may only have to test most valuable accrual rates and ignore normal rates if the plan, or the aggregated plan being tested, has a uniform formula. There's some question, even at this point, as to what constitutes a uniform formula. Test each component for compliance with 410(b).

The requirement that no highly compensated employee have a rate higher than any nonhighly compensated employee can rarely be met. If that's where the regulations stopped, you'd run into a brick wall and you might as well give up and adopt a safe harbor and go home. But the restructuring rules effectively change that. This will be illustrated when I get into a discussion of rate segment restructuring.

Calculating benefit accrual rates. There are three different methods -- annual, accrued to date, and projected. The same method must be used for all participants in the plan or aggregated plan being tested. The same method must be used for normal and most valuable rates.

The benefit accrual rate under the annual method is determined by taking the accrued benefit as of the end of the test year, divide it by compensation at that point, and subtract out another rate, which is the accrued benefit at the beginning of the year, divided by compensation at that point. Compensation here is generally an average compensation – in most cases it has to be an average over at least three years. You could have unusual accrual patterns and end up with a negative number. The regulations say that negative accrual rates are to be set equal to zero. Unusual answers depend on individual pay changes during a year and the benefit formula.

The other two methods tend to provide more stable results. Under the accrued-to-date method, you take the total accrued benefit at the end of the year divided by that average compensation at that point and then divide by the years of credited service. In all of these methods, note that what you're ending up with is the rate of benefit accrual that is attributable to the current year -- each method does the attribution in a different way. The projected method does the same thing, except it considers not only what's accrued to date, but projects future benefits under the current formula, assuming pay doesn't change -- and in all cases, incidentally, you don't count pay above the $200,000 section 401(a)(17) limit and you don't assume increases in that limit. You divide it by the average compensation and then divide by projected years of service. Again, you're getting a benefit attributable to one year of service.

The annual method can give unexpected results. The accrued-to-date method is usually the best one, although in some situations the projected method, depending on the particular formula, might turn out to be better. You can change the method from year to year. You can use different methods for different plans tested in the same year. In 401(a)(4) you can test a defined-benefit plan either using benefits or equivalent contributions. A defined-contribution plan can be tested using benefits by converting the contribution allocation for the year to a benefit. The conversion from one to the other can be advantageous, depending on the type of plan or plans that are being aggregated and the demographics of the group.

Chart 18-22 are examples that illustrate under the various methods the calculating of accrual rates. The accrued-to-date method results in 1.31% in Chart 19. Using the annual method produces a different rate for the same employee -- 1.16%. On a defined-contribution plan, converted to benefits, the result is a 4% accrual rate.

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CHART 18

Accrual Rate Examples

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| |
| --- |
| Defined-benefit plan formula: |
| --    2% × three-year average pay × years of service (max 25) |
| --    offset: 2% × Social Security benefit × years of service (max 25) |
| --    for service over 25 years: 1/2% × three-year-average pay × years of service |
| --    benefits unreduced at age 60 |
| Defined-contribution plan formula: |
| --    5% of pay |
| Employee: |
| --    age 40, with 15 years of service |
| --    1990 pay: $30,000 |
|       1989 pay: $29,000 |
|       1988 pay: $28,000 |
|       1987 pay: $27,000 |

## CHART 19
### Accrued-to-Date Method
### Defined-Benefit Plan

| Final average pay at 12/31/90 | $28,000 + $29,000 + $30,000/3 | $29,000 |
|---|---|---|
| Accrued benefit at 12/31/90 | 2% × $29,000 × 15 years | $8,700 |
| | 2% × $10,000 × 15 years | ($3,000) |
| | Total accrued benefit | $5,700 |
| Annual accrual | $5,700/15 years | $380 |
| Accrual rate | $380/$29,000 | 1.31% |

## CHART 20
### Annual Method -- Defined-Benefit Plan

| Accrued benefit at 12/31/90 | 2% × $29,000 × 15 years | $8,700 |
|---|---|---|
| | 2% × $10,000 × 15 years | ($3,000) |
| | total accrued benefit | $5,700 |
| Rate at 12/31/90 | $5,700/$29,000 | 19.66% |
| Accrued benefit at 12/31/89 | 2% × $28,000 × 14 years | $7,840 |
| | 2% × $9,500 × 14 years | ($2,660) |
| | total accrued benefit | $5,180 |
| Rate at 12/31/89 | $5,180/$28,000 | 18.50% |
| Accrual rate for year | 19.66% -- 18.50% | 1.16% |

## CHART 21
### Annual Method -- Defined-Contribution Plans

| Employer contribution | 5% × $30,000 | $1,500 |
|---|---|---|
| Equivalent age 65 amount (8% interest) | $1,500 × 6.85 | $10,275 |
| Equivalent age 65 annuity | $10,275/8.56 | $1,200 |
| Accrual rate | $1,200/$30,000 | 4.00% |

## CHART 22
### Projected Method -- Defined-Benefit Plans

| Projected benefit at age 65 | 2% × $30,000 × 25 years | $15,000 |
|---|---|---|
| | 0.5% × $30,000 × 15 years | $2,250 |
| | 2% × $10,000 × 25 years | ($5,000) |
| | total projected benefit | $12,250 |
| Annual accrual | $12,250/40 years | $306 |
| Accrual rate | $306/$30,000 | 1.02% |

What are most valuable accrual rates? Test two types of accrual rates -- normal and most valuable. For the normal accrual rate, to calculate the numerator of the fraction, take the normal retirement benefit as a straight life annuity and then divide it by

compensation. For the most valuable rate, review the possible ages at early retire-
ment and determine which is the most valuable. With subsidized early retirement, in
many cases it turns out to be the earliest age at which early retirement is available.
To the extent there is a subsidy inherent in options under the plan -- for example, the
qualified joint and survivor annuity, usually the most valuable option, the value of that
subsidy is to be included in the most valuable rate as well.

Chart 23 is an example of how to determine, under the accrued-to-date method, the
most valuable accrual rate. Note that to determine which is the most valuable age,
calculate all early retirement benefits and then take the inverse of early retirement
reduction factors, but that using actuarial assumptions which are considered reason-
able under the regulations. In effect, inflate or "normalize" these early retirement
benefits at each of the various ages to equivalent normal retirement benefits. Then
the most valuable benefit is the greatest of those amounts. The results are a most
valuable rate of 2.28% compared to a normal rate of 1.13%.

## CHART 23
### Accrued-to-Date Method – Most Valuable Benefit

| | |
|---|---:|
| Accrued benefit at 12/31/90 if payable at age 65 | $5,700 |
| Normal annual accrual: $5,700/15 years | $380 |
| Normal accrual rate: $380/$29,000 | 1.31% |
| Accrued benefit at 12/31/90 if payable at most valuable age (age 60): | $5,700 |
| Actuarially equivalent benefit payable at age 65 | $9,920 |
| Most valuable annual accrual: $9,920/15 years | $661 |
| Most valuable accrual rate: $661/$29,000 | 2.28% |

Next, impute disparity. The 401(a)(4) regulations provide the mechanics for mimick-
ing how much disparity is allowed under 401(l). The result is a rate that's higher than
the regular rate. The adjusted rate is analogous to the excess percentage in a step-up
plan or to the gross benefit in an offset plan allowed under 401(l). For a defined-
benefit plan, the permitted disparity factor varies depending on the individual Social
Security normal retirement age. It ranges from 0.65 for the older people up to 0.75
for the younger people. The amount of disparity imputed depends, in part, on
covered compensation and that, of course, varies by the individual's year of birth
(Table 1).

## TABLE 1
### Imputed Disparity

| Covered compensation depends on employee's age, for example: | |
|---|---|
| Age on 12/31/90 | 1991 Covered Compensation |
| 25 | $53,400 |
| 35 | 53,184 |
| 45 | 47,040 |
| 55 | 33,588 |
| 65 | 19,728 |

For the younger people, it's the current wage base, which is $53,400 in 1991, and for the people at age 65, it's $19,728. For an individual whose average compensation is below his covered compensation, the calculation is very simple (Chart 24). Use the lesser of the permitted disparity factor -- e.g., 0.65 -- and the actual rate calculated for the person before imputing disparity. The 1.31% is the rate calculated earlier before imputing disparity. Add in the 0.65 to the 2.28, the same 0.65 which was the most valuable rate. In the bottom left-hand corner, add in only 0.5. The regular rate, the employer provided benefit rate, was only 0.5, the upper limit.

CHART 24
Imputed Disparity

| | | |
|---|---|---|
| • If employee's compensation is less than covered compensation, permitted disparity is smaller of 0.65% or actual accrual rate<br>• Actual rate + imputed disparity = "adjusted accrual rate"<br>• Example | | |
| | Normal Rate | Most Valuable Rate |
| Actual rate | 1.31% | 2.28% |
| Imputed disparity | 0.65 | 0.65 |
| Adjusted rate | 1.96% | 2.93% |
| • Example: | | |
| | Normal Rate | Most Valuable Rate |
| Actual rate | 0.50% | 1.00% |
| Imputed disparity | 0.50 | 0.65 |
| Adjusted rate | 1.00% | 1.65% |

It's more complicated when the pay of the individual is over that person's covered compensation. Two formulas are designed to assure compliance with 401(l); not only the 0.65% maximum permitted disparity, but also the two-to-one rule (Charts 25 and 26). In this example the first formula produces 1.75% and the second one produces 1.99%. Take the lesser of the two, which is 1.75%. For this individual the addition is less than that person's 0.65%. In this example, the original accrual rate was 1.31, and only 0.44 was added. At the higher pay levels, the add-ons decrease.

CHART 25
Imputed Disparity

| | |
|---|---|
| If employee's compensation is more than covered compensation, adjustment is more complicated | |
| Imputed disparity is<br><br>Example | $\dfrac{\text{permitted disparity factor} \times \text{covered compensation}}{\text{compensation}}$<br><br>$\dfrac{0.65\% \times \$19,728}{\$29,000}$<br>$= 0.44\%$ |
| Adjusted accrual rate = 1.31% + 0.44% = 1.75% | |

## CHART 26
### Imputed Disparity

| Adjusted accrual rate can't exceed | $$\frac{\text{dollar amount of benefit accrual}}{\text{Compensation} - 1/2 \text{ of covered compensation}}$$ |
|---|---|
| Example | $$\frac{\$380}{\$29,000 - 1/2 \times \$19,728}$$ $$= \frac{\$380}{\$19,136}$$ $$= 1.99\%$$ |

Adjusted accrual rate:  smaller of 1.75%, 1.99% = 1.75%

Next test a plan that has a discriminatory definition of compensation. Run this test to determine the three or more year average in the denominator to determine the rates. For that purpose, use a nondiscriminatory definition of compensation. W-2 or a variation of that would work. In most cases, use at least a three-year average. The longer averages -- for example, five- or ten-year averages -- normally don't help because highly compensated employees tend to get higher increases as a percentage of their pay. For a longer periods, the rates are higher rates, relatively, for the higher compensated people. Try to avoid that.

It is important in the general test, whether you can use the employee data that are available for the annual actuarial valuations of a plan. The data collected in valuations tend to be fairly accurate; although, those data may not be accurate enough to do individual benefit calculations for employees actually retiring. The regulations don't seem to allow approximations except under some very limited conditions.

Some judgment is needed. Perhaps additional scrutiny may be required by employers of the data that they provide for the annual actuarial valuations. How much margin is in the test results? If the test passes easily, there is more confidence that minor data problems shouldn't be a cause for concern. On a close pass, there should be some concern that upon audit, there is a problem if the data are not very clean.

Restructuring is the procedure that helps get through the general test. Break the plan in certain ways into various components. The components have to add up to the total benefits. Then each one of those components has to pass coverage under 410(b). There are three basic types of restructuring. The most straightforward one is two groups of people in the plan -- hourly and salaried, for example. Then test the two separately.

Under total rates restructuring, set up a grid of ranges of rates and rank people -- consider how many highly compensated employees and nonhighly compensated employees are at various rate levels. Rate segments is a further variation. In restructuring, some grouping of rates is necessary to avoid thousands of component plans; so the IRS, in the regulations, allows some grouping. There still may be hundreds to deal with. Take all the people within a certain range and treat them as if they had a common rate at the midpoint of that range.

# PANEL DISCUSSION

Under the total rate method, all employees may have a normal rate between 1.5 and 1.8 and a most valuable rate between 1.5 and 2.4 (Chart 27). Nobody could have a rate in the black areas because a person's normal rate can't be higher than the most valuable rate. Just put the number of people in each bucket, separately by the number of highly compensated employees and the number of nonhighly compensated employees. Usually this method fails even if at the very low rates there are a lot of highly compensated employees and very few nonhighly compensated employees. There are various reasons why you might have a lot of highly compensated employees at the lower rates.

Rate segment restructuring is illustrated on Chart 28. Assume you have four employees -- A, B, C, and D -- that have the rates, and three component plans. In the first plan, everybody has a rate of at least 1.4; so all of the individuals -- A, B, C, and D -- are in that plan with the same 1% rate. In the second component plan, again, everybody has the same rate of 0.3; but only B, C, and D have the extra difference between the 1.7 and the 1.4. Finally in the last component plan, which is the additional component to get from the 1.7 to 1.8, only C and D are included. Here, no matter who's a highly compensated employee and who's a nonhighly compensated employee, all have the same rate in that particular component plan. Thus, no highly compensated employee has a rate higher than any nonhighly compensated employee.

Chart 29 shows segment restructuring graphically. You're looking at nonhighly compensated employees versus highly compensated employees. All are in Plan A and increasingly fewer are in each of the component Plans B, C, and D as we go up. The danger is that at the very top component, if there are no nonhighly compensated employees but some highly compensated employees, that would mean that the people who have the highest rates in the plan are highly compensated employees and you'd fail 410(b). The theory is you should fail. With enough nonhighly compensated employees who have those high rates in comparison to highly compensated employees, you'll pass.

Minimum participation standards must be tied back to 410(b). It is very important that if you can pass the average benefits test, in testing each of these component plans, rather than using 70% as the pass/fail threshold, you can end up using a rate that can be down in the 20s very often.

Hopefully there will be some changes in the final regulations coming out in the summer. Maybe the total rate method will be more useable. For example, with a lot of extra nonhighly compensated employees at the higher rates, you ought to be able to treat them as if they had lower rates. Then I think the whole process is simplified if it does not involve rate segments. When both normal and most valuable rates must be tested, the final regulations are expected to provide some clarification.

Monitor the situation in advance to avoid having the general test fail. One technique is to scale back to some degree on benefit accruals for highly compensated employees or increase them for nonhighly compensated employees. The benefit cut-back approach would be less costly and involve fewer people. Action must be taken during the year since benefits can't be cut back once they've accrued. The IRS and Treasury feel very strongly about this issue.

# Total Rates Restructuring

- total rates — every employee is in one component
- example: all employees have a normal rate between 1.5% and 1.8%
  all employees have a most valuable rate between 1.5% and 2.4%

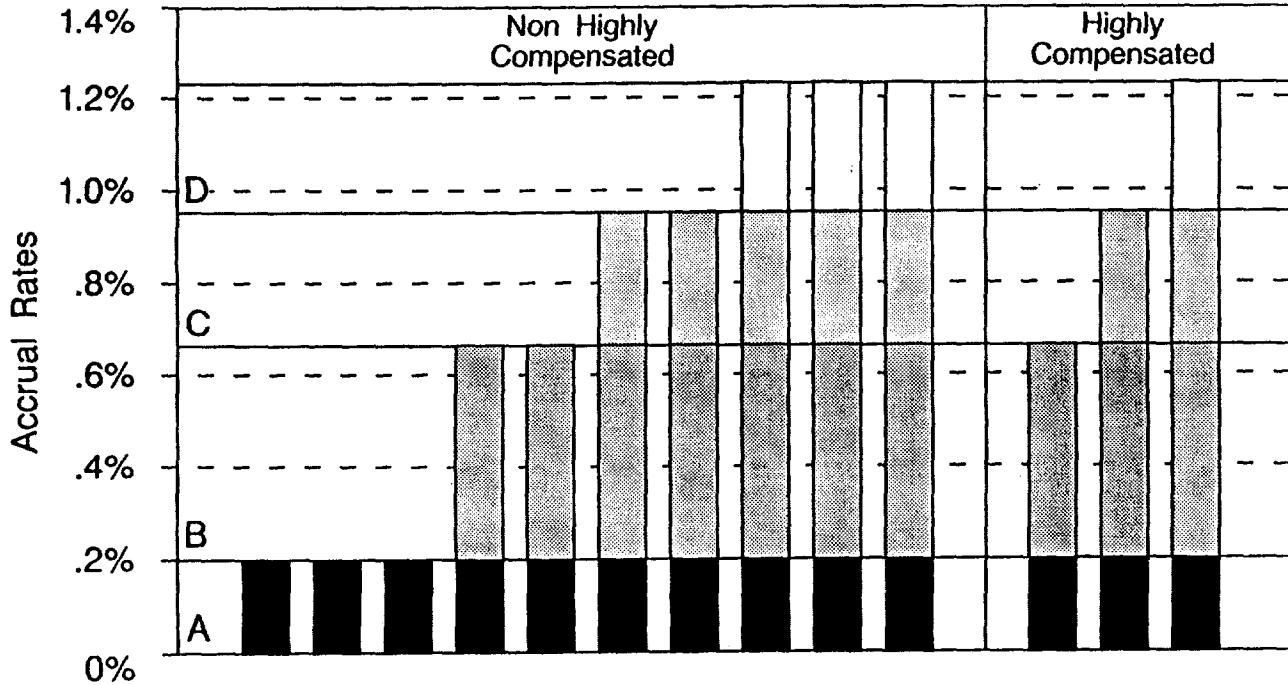| Most Valuable Rate | Normal Rate | | | |
|---|---|---|---|---|
| | 1.5% | 1.6% | 1.7% | 1.8% |
| 1.5% | | ■ | ■ | ■ |
| 1.6% | | | ■ | ■ |
| 1.7% | | | | ■ |
| 1.8% | | | | |
| 1.9% | | | | |
| 2.0% | | | | |
| 2.1% | | | | |
| 2.2% | | | | |
| 2.3% | | | | |
| 2.4% | | | | |

## CHART 28
### Rate Segment Restructuring

| | |
|---|---|
| ●     Rate segments — every benefit is divided into segments | |

| | |
|---|---|
| ●     Example: four employees: | A - 1.4% <br> B - 1.7 <br> C - 1.8 <br> D - 1.8 |
| Component | Members |
| 1.4% <br> 0.3 <br> 0.1 | A, B, C, D <br> B, C, D <br> C, D |

# Restructing By Rate Segments

Even under the benefit increase approach, if failure is foreseen, act in advance, because once the year is up there is a limited amount that can be done. There are various changes to plan in advance to assure that you pass the test. Run preliminary tests and see how the numbers work out. Measure the relative effect on costs of making an improvement as compared to just going all the way to a safe harbor. If making an improvement is almost as expensive as going to a safe harbor, then the safe harbor is preferred. Then all this testing is avoided.

When can you test the plan? As it stands right now, you can't do anything until the year is up. Of course, once the year is up it's too late to do anything, so you're sort of caught between a rock and a hard place. You can't even recognize retroactive improvements the way the regulations stand now once the year is up, to get the plan to pass. If as of the end of the year, you didn't have those improved benefits, you can't reflect them. This is an area where they're looking at giving us a window of several months after the end of the year during which retroactive improvements could be recognized. That's something we are expecting to see.

There are also some provisions in the regulations that allow testing other than on a plan year basis. In effect, test for the consistently applied year ending during the plan year being tested. One problem is duplicating data collection. We were hoping that the IRS would allow us to be off a year in the testing; the accrued benefits at the beginning of the year might be used, possible on some type of projected basis. But there seems to be sort of a paranoia about things like this -- the fear is that things might change dramatically during the year and plans that should fail would be passing.

Now, what do you do for 1989, 1990, and 1991? The regulations are not effective until 1992, so there is a reasonable compliance period with the law. What are companies doing? They have a variety of choices. They can comply on a reasonable basis by complying with the proposed regulations. There are other ways that companies are complying on an interim basis, for example, compliance with revenue ruling 81-202, which are the old law comparability rules, modified to reflect certain changes in the Tax Reform Act. Again, this is an interim measure which, before regulations are final, companies are looking to.

Now, when should benefit freezes be thawed? Many employers have frozen benefits temporarily for some or all employees; that was intended to buy them some time. Now that we have proposed regulations out and we think we know how most of the rules work, the question is, is it time to open up those benefit accruals? The answer is, it depends. It depends on how you think you're going to go forward. If the preliminary general test results look very favorable, I'm seeing companies unfreezing benefits.

MR. GERALD ANTHONY SCHILLACI: In a right-to-work state, the exclusion for collective bargaining employees is not affected by actual union participation, is it?

MR. ALPERT: Unfortunately, I've heard different people say different things. On the one hand, I've heard the position expressed that if you're not paying dues to the union, technically you're not covered by the collective bargaining agreement. That is probably more of a labor issue. I'm sorry, but I don't have a better answer for you.

MR. SCHILLACI: On the average benefits test, you had a notation that noncovered employees were counted as zero.

MR. ALPERT: That's correct.

FROM THE FLOOR: In that context, would noncovered employees include voluntary nonparticipants in a contributory pension plan?

MR. ALPERT: Yes.

MR. COLIN E. SOUTHCOTE-WANT: How would an integrated age-weighted profit-sharing plan work out under the general test?

MR. SHER: The interesting thing about the age-weighted profit-sharing plans is that there wasn't a way to cross-test a defined-contribution plan under the prior rules, where it was a defined-contribution plan. You couldn't test it as if it were a defined-benefit plan; in other words, test benefits. Now for a straight defined-contribution plan convert it to equivalent benefits. Then with an age-weighted defined-contribution plan that tends to weight contributions by compensation, because the younger paid people tend to be lower paid, when the contributions are converted to benefits and run through the general test, generally the result will pass. This mechanism will treat profit-sharing plans that weight benefits in various ways that would otherwise appear to be discriminatory. Whether or not they're integrated impute disparity under the defined-benefit rules once benefits are converted.

With less disparity, generally, under the defined-benefit rules as under the defined-contribution rules, depending on the age and pay composition of the group, the result should be an integrated age-weighted formula.

MR. ALPERT: To add to that, there has been some discussion in the actuarial community to actually design a profit-sharing plan such that your allocation meets the general test on defined-benefit rules.

MR. DONALD L. PETERSON: Under a plan that passes permitted disparity, do you still need to make the adjustment in the general test?

MR. SHER: You don't have to impute disparity, since in the general test it's optional, although in most situations it pays to do that. If you don't, there will be higher accrual rates for highly compensated employees than for nonhighly compensated employees. Impute the disparity, because that's the leveling device.

FROM THE FLOOR: In an acquisition situation the company that was being acquired, if they had a plan, wouldn't have to do any separate testing or somehow include that group in testing for the controlled group. Is there a grace period during which you didn't have to satisfy 410(b)?

MR. SHER: There are two issues here. One relates to the effect on 410(b) with an acquisition. You may have passed 410(b) immediately before the acquisition. In the prior employer's controlled group everything was fine and it passed 410(b) and 401(a)(4). If this group was pulled out of one controlled group and put into another

one, either one of the controlled group's compliance may be damaged. I think the regulations buy you a free ride for that case, provided that each controlled group passed immediately before, until the end of the plan year subsequent to the year the transaction occurred.

The second issue with respect to 411(d)(6) protected benefits, rights and features, under 401(c)(4) provides some other acquisition rules that are more liberal. For example, assume if a group is acquired that had a plan with a lump sum option but that none of the plans in the controlled group that they're going into has lump sum options. If the acquired plan has to be aggregated with one or more of the other plans to pass the general test or to pass 410(b), the discriminatory group may be eligible to the lump sum. In other words, there may be a large number of highly compensated employees, relatively, that have the lump sum available. The numbers in the new closed control group are okay and you can continue to provide that lump sum option in future years, provided that you don't extend it to any additional employees and that it covered a nondiscriminatory group immediately after the acquisition.