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RULINGS AND REGULATIONS UPDATE

Moderator:	PATRICIA L. SCAHILL
Panelists:	CRAIG HOFFMAN*
	JOHN A. RODGERS
Recorder:	PATRICIA L. SCAHILL

- o A review of IRS, Department of Labor (DOL), and PBGC rulings and regulations which have been issued in the last six months
- o A status report on what's out and what's due
- o How are practitioners handling the new guidance?

MS. PATRICIA L. SCAHILL: The person who will be speaking to you first is Craig Hoffman. Craig is a lawyer. He has his J.D. and Master's in Law from the University of Florida. And Craig works right now as the Assistant General Counsel of Corbel; he's been with that firm since 1985. Craig is going to talk about IRS non-401(a)(4) issues, the determination letter program, user fees, and other things that are going on besides 401(a)(4). The second speaker is Jack Rodgers, who's an FSA, a member of the Academy and an enrolled actuary. Jack works with Mercer in the Philadelphia office. Jack is going to talk on 401(a)(4) issues, and he's going to discuss some case studies.

MR. CRAIG HOFFMAN: Tax Reform Act 1986 (TRA) is now four years down the road. We are now just getting to the point of having to deal with updating our plan documents. Arguably, we've been operating them in accordance with those rules for the last four years. And only now we're getting around to updating them. I have prepared a rather comprehensive outline dealing with the TRA restatement process. And we could probably spend all a lot of time going through that outline line by line. And I know we've got some other, more important issues, also to get to on the (a)(4) side, as well. So I'm not even going to make an attempt to cover all of that outline.

What I'm going to focus on are those issues that relate to the determination letter program and, in effect, where we are going, what to expect from the IRS, and some of what we may see in the weeks and months ahead. I think, as I said, we started this task of TRA 1986 compliance back some four years ago. And Congress, at that time, had a grand plan as to how this would all work.

Having just come off the TEFRA/DEFRA/REA restatement period, and all of the problems and delays that caused, Congress thought we would try and do this a little more orderly this time. So in the Act itself, Congress provided that plan documents themselves would not have to be updated until the end of the 1989 plan year, provided that, in the meantime, the plan itself was operated in accordance with the changed law, and that when the document was updated, it was retroactively effective to each

* Mr. Hoffman, not a member of the Society, is Assistant General Counsel of Corbel & Company in Jacksonville, Florida.

separately stated effective date. And then the third prong of this grand plan was Congress also mandated that the IRS would release, no later than February 1, 1988, final regulations on all the core issues dealing with TRA 1986. Well, the IRS just missed it. We are now in the fall of 1990, and we have yet to see the first final regulation project. We haven't seen all the proposed regulations yet. I've often thought if there had been some kind of sanction or penalty levied against the Commissioner of the IRS, we may have had a little speedier response. But there were no sanctions and frankly, the IRS will tell you the people there are overworked and just don't have the resources to deal with all these issues.

So what we have seen from the IRS, instead, is a further delay in the time by which your documents could be updated, so as to deal with the lack of guidance that has been out there. There have been several delays. The one that we are now under came out of Revenue Procedure 89-65. And under that procedure, in effect, the time frame has now been moved back so that you have until the end of the 1991 plan year to update your documents, still all along mandating operational compliance, and separately stated effective date compliance within the document itself, when it is ultimately updated. One other thing that the IRS did in that same revenue procedure that was helpful is, they finally got around to giving you that same extension for new plans that were being put in during this interim period, or amendments to existing plans. Before that revenue procedure came out, you had the problem of putting in a new plan and having to submit it before the time the IRS was ready to review it for all of TRA 1986 to preserve your rights to correct any defects in that document. And it seemed rather foolish, but that's what we had to deal with until this procedure finally came out. This is particularly important in defined benefit plans since they still haven't opened up the program. New plans being put in, as well as amendments to existing plans and your TRA update compliance, are now tied in to the end of the 1991 plan year.

The delay has been given. Nevertheless, there are some very good reasons why practitioners might want to go forward at this point in time. I think chief among those is the lack of communication to the employee participants as to what has been changed in their documents. Long ago in this process, back in 1987, the IRS, quoting DOL officials, said that, "We're going to back off the mandate that under Title 1 of ERISA you must follow your written plan document." There was no amendment to Title 1 as part of TRA 1986. The IRS backed off that, but it said in the same breath, "There is still the obligation to communicate any material modifications to your plan that are in effect operationally." And we have a vehicle for that, the so-called summary of material modifications. The IRS's point was that if there were material changes, that summary should be distributed within, I believe, 210 days after the plan year in which the change is effective or adopted. Now, some people have focused on that word *adopted* as saying, you still have time to get out your updated summary of changes. I don't believe the DOL would agree with that philosophy. But the bottom line is, I think employers are anxious to get this information out to their employees. So, for that reason, the DOL wanted to go forward. Not to mention the fact, as I said, arguably employers are operationally complying with the document that has yet to be written. So, the sooner they get that document in writing, the better.

The one drawback was the fact that the IRS was not yet reviewing plan language. It was only in the spring of 1990 that it finally opened the program, at least a small bit. Revenue Procedure 90-20 was released this spring, and announced the opening of the determination letter program for TRA 1986, as well as the laundry list of other items that have now been wrapped up into this compliance project. The opening bell, however, was only sounded for defined contribution (DC) plans. So what we're looking at now is your 401(k), your money purchase, and your profit-sharing plans are open for submission, and the IRS is processing those plans. I know clients who are getting their determination and the IRS is processing those plans. I know clients who are getting their determination letters on those plans as we speak. However, there are certain requirements that have to be satisfied to be within this program at this time. Chief among them is inability to use the average benefits test to pass coverage. So you must be able to show you pass your coverage test using the ratio percentage test of Section 410(b). Additionally, you can't be utilizing the separate line of business rules and get a determination letter at this point in time. If you're an integrated plan, or perhaps more accurately, a plan utilizing permitted disparity, you too can only submit if you are in compliance with the proposed regulations under 401(l) as modified by Notice 89-70. Also, in the prepublication version of that revenue procedure, the IRS indicated that if an employer maintained a defined benefit (DB) plan as well as a DC plan, then that DC plan could not yet be submitted. That requirement was dropped from the procedure before it was officially published. And, to some degree, there's still a little confusion out there on that. In other words, then, the employers who have both a DB and a DC plan can submit their DC plans at this time, even though the DB program has not yet opened.

Under the Revenue Procedure 90-20, there are some new requirements. One being the employer has to include a certificate, signed by the employer, indicating that it is eligible to file now under the dictates of Revenue Procedure 90-20. You also must include a copy of the latest determination letter that the plan has received. Or, if you don't have a copy of it, include an explanation as to why you don't have a copy of it. And I think this is indicative of the IRS's attempt to compile an audit list of plans without determination letters. Because, not only are we seeing it on the 5300 series, but also I'm sure many of you who have done your 1989 5500s, have likewise seen the same question on that form as well. And, although I have not heard anything officially from somebody in the IRS, it seems to me that it would be a fairly easy process to coordinate that data, and it is the IRS's express desire to focus more energies on the audit program, and less on the determination letter program over time. So I think it's clear, the value of the determination letter, I think, is becoming greater in light of the IRS, perhaps for audit reasons, focusing on plans that have not received a determination letter.

Likewise also, you have to submit using the new 5300 series forms that are available. The 5300 and the 5301 have now been merged into a single 5300 form that will be used for both DB and DC plans. For master or prototype plans, or volume submitter individually designed plans, the 5307 form would be the appropriate form. You would also need to send in the appropriate user fee. You'll also note on the new 5300 series forms, which are dated January 1990 and later, the IRS has done away with the Schedule T, and it has also added some new questions where you are asked whether you want a determination as to whether the plan's separate benefit structures comply with 401(a)(26). Well, these forms came out before the 401(a)(4) monster regulation package where the

401(a)(26) regulations were reproposed, so consequently, that question, for all intents and purposes, has been mooted by those regulations. I think you could probably answer it either way and not suffer any kind of dire consequences. The forms also have questions as to whether you want a determination on your affiliated service group status, or leased employee status. And the only point to be made there is, you don't have to ask for such determination letters, or such reviews anyhow, in your determination letter because that's voluntary. If you know you've got an affiliated service group or you know you have leased employees, having the IRS tell you that is really not going to help you too much. And probably in those cases where you think it's a close call, the IRS is more likely to tell you something you don't want to hear anyhow. So, I'm not sure you want to look at that. Moreover, to get those latter two reviews, you must file the form 5300, so that you are talking about a higher user fee than would be the case if you are using a prototype plan, or a volume submitter plan, and you don't want that type of review.

The one thing the IRS hasn't done yet is open the program for DB plans. And obviously, that's a question on everybody's mind, when's that going to happen? Recently, there have been some commentators who requested that the listing of required modifications (LRM) language, which is the bible of the prototype program, the IRS specimen language, be held off as far as its updated issuance, in light of the 401(a)(4) regulations, so that the drafters of that language can perhaps take into account some of the comments that have been made on the 401(a)(4) regulations, and so they don't force people into safe harbors, perhaps, as the LRMs almost become, once they are issued. So there is some talk that the LRMs may be delayed. The fact is, it's unlikely that the determination letter program for DB submissions will open up any sooner than the end of 1990, and more likely than not, the beginning part of 1991. We are, obviously, here at the middle of October 1990; there's not much time left in the year for opening up the program. So I think it's more likely than not it will be next year before the DB plans will be opened for submission.

In that same regard, the separate line of business regulations should be out soon. I quote Elaine Church, when she describes how the IRS talks of time, they think of it in the geological sense, not in the normal sense of the word. So soon could be the next millennium or it could be the October-November 1990 thoughts that they originally had in mind. It is thought the separate line of business regulations would be out in November 1990, and that when the program opened up for DB plans, it would also open up for those employers wishing to utilize the separate line of business approach to passing coverage. You should also keep in mind that the IRS recently issued an announcement indicating that it is going to waive the mandate where you must give the IRS notice of your intent to use a separate line of business for the time being with the caveat that it may come back later and have you retroactively notify the IRS that you utilized it say for the 1989 or 1990 year. Likewise, in one of the debt bills last year, Congress eliminated the mandate of falling within the safe harbor for a separate line of business, or the guidelines that have yet to be released. For those of you familiar with these issues, this is the (c) section of 414(r). So, in effect, you're subject to a reasonable good faith, bona fide business reason for having a separate line of business. And that's about it. Hindsight is always 20/20, so how bona fide your business reason is is always subject to question. But it appears that there may be more flexibility in using a separate line of business, at least during this transitional period. It may be one benefit of not having the regulations out at this point in time.

As far as user fees, as you know, thanks to Omnibus Budget Reconciliation Act (OBRA) 1987, we've now been paying the IRS for the opportunity to have some reviewer nitpick our documents and tell us whether you should allow forfeitures to go to Subchapter S shareholders or not. I've always found that to be a key point in qualification. In any case, those user fees, as originally passed, were sunsetted, to be no longer applicable for submissions after September 30, 1990. The budget bill that is before Congress at this point will contain whatever reauthorization will be made for user fees. I asked Ken Yednoch at the IRS "Are user fees going to be reenacted, and will they be retroactive?" And he said, "Well, that's our thinking, but anything can happen in this budget process." In the meantime, what the IRS has done is issued Announcement 90-113. It essentially says, during this period of time, for submissions after September 29, 1990, actually, since I guess September 30 is a Sunday, and there were no filings on that date, plan sponsors should not include a user fee. You should submit your determination letter request, or any other request that calls for a user fee, without that necessary check being included. When legislation is passed, it may well be retroactive and, if so, the IRS will come back asking for the user fee at that point in time. It is not going to refund any user fees on submissions before October 1, 1990, so if you've already sent it in September, it's too late, you can't get your money back now. But at least during this interim time, you should not be including user fees. Now, given the need for funds in Washington, one would expect that if there's not some glaring error made, that user fees, when passed, will be retroactive. Nevertheless, I think at least now, there is a window where if you've got some user-fee-oriented requests that need to be filed, I would go ahead and file them. I would not go out and beat the bushes to try and get them all in, hoping that somehow they'll avoid the user fee. Nevertheless, anything can happen. We had one prototype client paying the national office user fees for getting its prototype approved, and its charge pre-October 1 was $1,000 per adoption agreement, going up to $3,000 per adoption agreement. The client seriously contemplated holding off and submitting on October 1, with the hope that instead of having to pay $6,000, it would pay nothing. But obviously it was risking instead having to pay $18,000, and I think the client wisely chose to go ahead and file its request on September 28.

As far as the user fees themselves, they are going up, assuming they are retroactively imposed. So that, assuming that we do have them reinstituted, the user fees are going up for prototypes, volume submitter documents, from $100 to $125. For individually designed plans of less than 100 participants, they're going up from $450 to $700. And for 100 or more participant individually designed plans, they're going up from $750 to $825. So, the distinction between prototypes and individually designed plans that are not volume submitter plans is being clearly drawn by the IRS. It's clear that the IRS is trying to move as many plans as possible into preapproved type of document formats, so as to facilitate its review process, and the carrot is the user fee. The lesser user fee, the better off the company would be.

Let me also add, quickly at this point, that there may also be one other exception to the 1991 plan year, as being the time by which documents have to be updated. And this relates to plans that are presently in a prototype format. If an employer sponsor has adopted a prototype, it will have the opportunity to adopt the replacement plan, the plan submitted by the insurance company, or bank, or brokerage house, at the later of either the end of the 1991 plan year or the end of the 12th month following the month in which that sponsoring organization gets its notification letter from the national office. We didn't think that rule was going to come up to be involved in this program, because many prototype sponsors have long ago submitted. But, with the morass over the 401(a)(4) regulations, and the fact that now the replacement plans do not yet have to be submitted until December 31, 1990, it is likely that a number of prototype sponsors will not get their notification letters until sometime in 1991. So for employers that have adopted the underlying prototype plan, they will have, perhaps, a longer period of time, stretching out into 1992, perhaps.

To close, let me just briefly talk a little bit about the different formats that are available for updating. Obviously, you've got the standby of old, the individually designed plan. Being very individually textured, it can meet the specific needs of the employer. It certainly will be a big part of the program. The user fee issue has caused a lot of problems for the employer sponsors, particularly the smaller plans. As a means of circumventing that problem, I guess, you've got the volume submitter program. I'm not going to go into detail on that. I think that's a good compromise between the prototype program and the individually designed, in that it is still an individually designed plan, but because its language has been preapproved by the key district, that key district will go ahead and grant it the same expedited review, the same lesser user fee.

In the prototype area, you do still have that same approach, we've got our traditional national office prototypes. We've also got regional prototypes, which are new players in the field. A regional prototype can be sponsored by an actuarial firm, a consulting firm, a law firm, or a CPA firm; these are the types of entities out in the field that, perhaps, could have a good use. There is some baggage that goes along with sponsoring a regional prototype as far as notification given to the national office of all the employers that have adopted it, and an obligation to annually report to those employers. You do get the lesser user fees. When first announced, the regional prototype program required that there be at least one common-law employee who was enrolled to practice before the IRS with regard to employee benefit matters, in order for that firm to be eligible to sponsor a regional prototype. The IRS decided that was a little too stiff a requirement, so the IRS made it a little bit easier. Instead the IRS has decided that you need to have somebody who can read who is a common-law employee. Because all that person needs to do is certify that he has read Section 14 of Revenue Procedure 89-13, and you can sponsor a regional prototype. You've also got to certify that you understood Section 14, which may be a more difficult certification. But in any case, the regional prototype, I think, is going to be a big player in the updating go-around.

The one last point I'll make, as just a trap for the unwary, when you are using prototype plans, or when you're using a standardized versus a nonstandardized adoption agreement. We know if you use a standardized adoption agreement, and the employer has never maintained another plan other than the one that it is currently putting into the standardized adoption agreement, that you can have reliance. Now, the one exception is if you can maintain another plan that is paired with that standardized adoption agreement, and still have that reliance. The reliance I'm talking about is the same reliance you would get by actually submitting to the IRS a determination letter request. So, in effect, by using a standardized adoption agreement, you can avoid any user fee. But that comes at a pretty big cost.

The one item I wanted to touch upon chiefly is the new coverage and participation test. As we know, beginning in 1990, if you've got somebody who's become a participant, you cannot exclude him or her from your coverage test unless the employee terminated employment during the year, and in the year in which he or she terminated, the employee failed to complete more than 500 hours of service. The standardized adoption agreements make you cover everybody else. So that means you can't have a last day employment requirement to share in an allocation in the DC plan. You can't have 1,000 hour requirement in a standardized plan. Now, it's possible in a nonstandardized plan to apply such requirements and still satisfy coverage and participation, so that might be available to you. But you may find the prototype standardized plan often went to the very small "mom and pop" type plan, and that's all well and good. The only concern is to make sure mom and pop understand that the part-time secretary may end up sharing in allocations for the future, where in the past that didn't have to happen.

MR. JOHN A. RODGERS: The topic that I was originally going to speak about, how are practitioners handling the new guidance, specifically deals with 401(a)(4). After some discussion, we decided maybe there are some people who don't have even a good overview of the 401(a)(4) regulations. So what we'd like to do is just briefly spend some time dealing with these nondiscrimination regulations, and then move into some case studies, which we hope you'll find interesting. Again, I'm going to keep this review brief, it's not meant to be all-inclusive. It's meant to touch on general ideas. And with that in mind, let's talk about this package that came out in May 1990. We're now provided with some objective standards to measure nondiscrimination. Specifically, contributions to a DC plan or the allocations under DB plans have to meet a new rule that no allocation or accrual for any highly compensated individual can be greater than any nonhighly compensated individual. On the face of it, this is a pretty harsh requirement. As we go through, we'll find that there is some flexibility in there. We do have some safe harbors; we do have some ways of splitting plans apart. The regulations also deal with other plan features besides contributions and benefits. These features may need to be tested under the minimum coverage requirements of 410(b).

Before moving in, though, to the regulation package, we have to ask ourselves a few questions. If we're going to test for nondiscrimination, who do we test? What's our testing universe? What's the entity that we're going to test, the plan? Sounds pretty easy, but when we get into the regulations, you'll see that it's not so easy. Also, in going through here, there's a mesh between the 410(b) regulations and the 401(a)(4) regulations. You can't really separate one from the other. We'll be bouncing back, we'll have a good 410(b) group, we'll go to see if we have a good nondiscrimination test. If we don't, we'll change our test, and then go back and see if we have a good 410(b) group. So we'll have a lot of movement in those two, and I think if you try to think of these regulations in that fashion, it'll be helpful.

In dealing with the testing universe now, I have to ask the question, who is the employer? Who are the employees? And who are these highly compensated individuals that I never had to deal with before? Well, the employer is basically determined on a controlled group basis -- parents, subsidiaries, brothers, sisters, affiliated service groups. We also have to take into consideration separate lines of business, because that may help us later on to pass the tests. The employees are who we think they are. They're common-law employees, they're leased employees. There are some other definitions of employees who are going to come into the regulations that we have to keep in mind. We have excludable employees, those who aren't eligible for the program that we're testing. There are people who are nonexcludable employees, who are, you guessed it, everybody who's not excluded. Among that nonexcludable group though, there's a group who are benefiting. Some people may be nonexcluded, but not benefiting under the program. So we have to differentiate between those groups, also. Last, we have highly compensated individuals. For those of you who deal with 401(k) plans, it's not a new issue for you. In the defined benefits sector though, it's definitely a new issue. Who are these people? We have to go to the 414(q) regulations: we have people making over $75,000, over $50,000 in the top 20% paid, etc., 5% owners. So, it's a new concept for many involved in the defined benefit area.

Some of these questions that we asked were easy for some employers. For other employers, especially those that are decentralized, for those that have U.S. parents and foreign subsidiaries, those questions are difficult. Once we've isolated our testing universe, though, the next thing is to try to get our hands around this entity, the plan that we're actually going to test. What is this thing that we're going to test? Well, as actuaries for defined benefit plans, we might think that if we have a single pool of assets, that that's the plan that we want to test. It may be, but it may not be. What we need to do is really get in and look at the definitions required under 410(b) of the Code.

Let's talk just a little bit about the groups that are going to make up the plans. First of all, if I go in with the attitude that I have a single asset base, I may run into some problems. If I have union employees in that plan, I have to disaggregate them, I have to take them out of the plan. It's one of my favorite terms in the regulations -- mandatory disaggregation. I also have to separate out elective contributions, 401(k) type, 401(m), matching contributions, those features of the programs have to be eliminated before I determine my 410(b) group. I have to split Employee Stock Ownership Plan (ESOP) and non-ESOP before doing my testing, also. Not only do I have mandatory disaggregation, but also I have some permissive disaggregation. This is where getting into the separate line of business may help me. And on the other side, if I have permissive disaggregation I, of course, have permissive aggregation, where I can take two plans that look and smell alike, and put them together and test them and call them one plan.

Now I've somehow gotten this plan together. How do I determine whether I have a good 410(b) group? Well, one of the things I do is I look at this ratio test. Well, what is the ratio test? It's a test for minimum coverage. And the way it works is I determine two additional ratios -- the ratio of nonhighly compensated employees benefiting under the plan to all nonhighly compensated employees. And when I say all, I mean that group of nonexcluded nonhighly compensated individuals.

Once I have those two percentages, I find the ratio of those two. And if I pass, if I get a number that's greater than or equal to 70%, I'm in good shape and I can move on. If I don't, if I fail this test, I still have some recourse. I can go back and look at what's called the average benefits test. The average benefits test itself has three pieces. You have to have a reasonable classification, a bona fide business classification. It has to be nondiscriminatory in terms of the safe and unsafe harbors as they appear in the 410(b) regulations. And there's a mathematical average benefits test, and that is what we're going to know and grow to love as the average benefit percentage test, or another acronym, our ABP test. That ABP test has a few pieces to it. We have to find the average benefit for all nonhighly compensated individuals, find that average benefit for all highly compensated individuals, and make sure that the benefits for the nonhighly compensated individuals are at least 70% of what they are for the highly compensated individuals. Again, this test includes all nonexcludable employees, it includes all plans of the employer. It does exclude separate lines of business so, again, that's something that may help us down the road.

Just to give us an idea of what can be excluded from this test when we're doing it, there are union, nonunion. We can separate out the union employees, separate line of business. ESOPs now will be included in this ABP test. An important thing to remember when doing this test, if you have an employee who's not in the plan, but who's not excluded, one of these nonexcludable employees who aren't benefitting, they're not in another plan, they're going into this test with a zero benefit, which can certainly hurt you. One other thing before we leave the average benefits test, we can do this test, we can split it and do it in a DB group, all our DB plans together, group all our DC plans together, and do them separately. We may find out that this is advantageous, and in fact, in one of the examples we'll go through we'll see how this applies.

Now we have found out what our testing universe is, we've found out what our plan is, and now we think we have a good plan. Question is, do we have a nondiscriminatory plan? What we'll do is look at some of the themes that we'll find in 401(a)(4). First of all, the tests are definitely much more objective than they were before. There's a zero tolerance, as I said before, if one highly compensated employee has an accrual or an allocation greater than any nonhighly compensated, you fail the test. There's a greater interdependence of plans. One plan can affect the other, especially as you can see through the average benefits percentage test. There's a greater focus on the controlled group employer here. As we get into these regulations, you'll also find that there's a substance over form. In other words, if a plan looks and smells like it's several plans hooked together and I could split them up, and they would still pass 410(b), then they're going to let us test that plan in that fashion. On the same token, if I have two plans that I want to put together, and together they look and smell like one plan, well that's okay also. So I can aggregate and I can restructure, a word that we'll talk about a little later on. There's again an interdependence of 410(b) and 401(a)(4), as we had talked about. Last but not least, one of the important things to remember here, there are two ways in order for us to comply with these regulations. We have some plan design options that if we design our plan in this manner, we'll automatically be deemed to be nondiscriminatory. If not, we have to get into some general testing, which means testing each individual and his benefit accrual amounts.

Where am I going to look for this type of discrimination? I'm going to look for it first in the amount of contributions to a plan. Elective contributions, 401(a), 401(k), 401(m), are tested under separate requirements, the ABP tests. These regulations are really dealing now with nonelective contributions, and in the regulations we have some safe harbors. If we, again, meet these safe harbors, we automatically are deemed to be nondiscriminatory. Otherwise, we drop down to the general test. It means testing each individual, looking at all the rates, and proving that the company doesn't have a discriminatory plan. The allocation rates are contributions and forfeitures divided by 414(s) compensation. And that's going to come up, it's something we shouldn't let slide. This is an important aspect that came out in the package in May 1990, redefining this Section 414(s) compensation. It appears in all aspects of the 401(a)(4) regulations. In order to determine my accruals or my allocations, I always am using a good definition of compensation, as defined in 414(s).

I can use permitted disparity either explicitly in my formulas or, if I'm using the general test, I can impute this permitted disparity to help me pass those tests. When I look at the various allocations that I get, the amounts allocated under a DC benefit plan can be grouped together. I may restructure them so that I can look at various groups within that program and test separately on those groups. For example, if I had a DC plan with different contribution rates of 8, 9, and 10%. I could look at everyone who's getting 8%, treat it as one plan; everybody who is getting 9%, treat it as another, and so forth. Again, if I took any particular piece of that, let's say I take the 9% piece, that piece will clearly be nondiscriminatory, but the question now is, do I have a good minimum coverage? So now I'm back to 410(b) to do my testing there. I also have to test benefits if I have a DB program. If I have employer contributions and employee contributions, I test those separately.

For DB plans, there are four safe harbors, and there are two general tests. Again, I have permitted disparity. And again I can group my rates and restructure my program if it helps me pass 401(a)(4), remembering all the time that once I pass 401(a)(4), I have to go back to 410(b) and make sure I have a good group. What else do I need to test? I need to test benefits, rights, and features under the plan. Benefits, rights, and features include optional forms of benefits, such as early retirement benefits, and ancillary benefits, such as social security supplements, disability benefits, plant shutdown provisions. I also have other rights and features, which may include loans, investment options, amount of employer matches under a 401(k) plan, those types of things. What I need to do here is to check to make sure that these benefits, rights, and features are currently available. And I do that by going back to good old 410(b) again and looking to make sure that I have a reasonable group, a bona fide classification, and it's nondiscriminatory. Nondiscriminatory again using the safe and unsafe harbors as they appear in that regulation. What I don't need to do is the average benefits percentage test. So I only need to look at this on a demographic basis. I don't have to do any numeric testing, and I can just look at it and decide whether these benefits, rights, and features are indeed available to a nondiscriminatory group. The effective availability is a facts and circumstances test. What this is saying is if it's currently available to everybody, but only highly compensateds can really take advantage of it, then I really probably do have a discriminatory feature.

Last but not least, 401(a)(4) deals with special circumstances. Plan amendments may not discriminate in favor of highly compensated individuals. Unfortunately, there is no objective standard for that, other than the determination process, if and when we get it open. Past service credits, if I provide service at the establishment of the plan or if I provide service prior to the effective date of the program, I'm going to have to show that that's nondiscriminatory. There is a little safe harbor under this one. If I don't give any more than five years of past service, I can automatically treat it as being nondiscriminatory. Finally, under a plan termination basis, I need to look at the top 25 rules differently now. This group used to be frozen at the time the plan came into existence, and after 10 years, it all went away. Now, the top 25 are highly compensated individuals. They can change from year to year, and I have to keep track of them, not only from the origination of the plan, but also from any changes that I make in the program.

As I promised, that was a relatively brief overview. What I'd like to do now is to look at a couple case studies. If I have a particular kind of program, can I continue that program into the future? The three that I'd like to look at are plans that determine benefits using base pay. Can I keep that kind of a program? If I have a Social Security offset program, a Primary Insurance Amount (PIA) offset program, can I keep that? And for many of our clients that have separate plans for separate employee groups, am I going to be able to continue to do that in the future? Our approach here will be to look at the options in each case, choose an approach, and then determine again whether I have a good 410(b) group. If I have a good 410(b) group, do I meet 401(a)(4)? If I don't, I'm going to make some changes to the program so I meet 401(a)(4), and then I'm going to go back and look and make sure that I still have a good 410(b) group to deal with. So we'll see that all through these case studies.

With our base pay plan, as part of the regulation package, additional information, as I said before, was given on what is a good definition of compensation. Base pay is not something that falls into that category. In our example, we're going to have a plan, be it DB or DC, a generic plan which determines benefits using base pay. And the plan covers all employees, so we don't have a 410(b) problem. So all we need do now is see if I have a 401(a)(4) problem. Am I discriminating somehow in favor of my highly compensated individuals? This is important because the use of the safe harbor under 401(a)(4), any of the safe harbors for DC or DB plans, require that the definition of compensation used in determining benefits and contributions must be a good 414(s) definition of compensation. Base pay is not. Well, if base pay is not, what is? Let's determine that. Well, there are three by name, and probably about 10 in operation that we can come up with that are good 414(s) definitions of compensation. There's our good old Section 415 compensation and the modified version of that. What's new is Federal Insurance Contributions Act (FICA) wages, wages that I would withhold FICA taxes on, ignoring the taxable wage base. And wages that are subject to federal tax withholding. These are all good definitions of 414(s) compensation. All of these can be reduced by a laundry list of things, such as expense reimbursement, fringe benefits, moving expenses, deferred compensation, etc. I can't pick and choose, though. If I take that whole laundry list, I can take it out from any of these definitions, and I still have a good definition. I can also add something in. I can add in all deferrals under Section 125, Section 401(k), Tax Sheltered Annuity (TSA), etc. And that would also be a good definition of compensation. What is clearly standing out by its absence is W-2 pay. W-2 pay is not a good definition of compensation and must be tested. Although I would imagine in most cases, W-2 is going to be certainly nondiscriminatory, it must be tested in a manner that we're going to talk about.

Let's assume here that we want to keep our base pay plan. We like it, we don't want to make any changes to it. So what do we do, because we don't meet a safe harbor? Well, we have to decide whether our definition is reasonable. And base pay is not unreasonable. In some discussions with the IRS, as long as we're in some method reflecting the actual pay that someone gets, whether it's base pay, base plus overtime, etc., that's going to be a reasonable definition of compensation. What's not reasonable is a rate of pay. So if you have any plans out there that base their benefits on a rate of pay at a specific date, that is probably going to cause you a problem, and not going to be a reasonable definition. This means that you're going to have to change that definition in order to proceed. The definition cannot favor highly compensated individuals, and it must pass a nondiscrimination test, of course. We have tests all over the place here.

What is the nondiscrimination test that I have to look at to determine whether my 414(s) compensation is nondiscriminatory? Well, first of all, I have to find out what the average percentage of total compensation is for highly compensated individuals, and determine the average for nonhighly compensated individuals. And the average for the highly compensated can't be any larger than the average for nonhighly compensated individuals. This test can be done in two ways. It can be done on an individual basis, and then averaged. Or it can be done in the aggregate, as long as it's reasonable in both cases. The total compensation in the denominator in each of these averages must be one of the 414(s) definitions of compensation. The employees to be tested, again in numerator, are either those benefitting under the program or those who are not excluded from the program. A de minimis variance may be allowed. That's going to be a facts and circumstances case. Is 1% not enough, is 5% too much? I think 5% is too much, I think we're probably looking for something around 1% or less as falling into that de minimis category.

Let's look at our particular plan. Right now, when we do the test, we break it up by base pay. We add in overtime and bonuses, the only pieces that we have in our 414(s) we're going to assume. When I add those in for the highly compensated individuals, I get 87% of their pay included in the benefit formula. For the nonhighly compensated, I get 90.9%. Hooray, I pass the test. Now, what happens? I pass the test, I'm good for this year. What does that mean for next year? Well, let's assume that I have a bad year next year, and I don't pay any bonuses to my highly compensated employees. And my nonhighly compensateds do need to work a little overtime in there. Well, what happens now is the percent of pay that's included for highly compensated individuals has jumped up to 100%, for nonhighly compensated it's less than 100%, and I fail the test. Alright, well maybe I had a bad year. What happens if I have a good year? If I have a good year, I could have the same problem. My sales are going through the roof, all my nonhighly compensated individuals are working lots and lots of overtime. But, there's some delay in the cash flow that's getting through to be distributed to the highly compensated individuals, and while they get bonuses, they are not as great as may be indicated by the sales that are going on. And lo and behold, when I do this test, even in a good year, I get a percentage for the highly compensated individuals that could be higher than for nonhighly compensated individuals. So at best, a base pay plan is going to cause you problems, perhaps at some point in the future. If it's a de minimis problem, so be it. If it gets to be a string of years in which it happens, I think clearly you're going to be in jeopardy of being accused of having a discriminatory definition of compensation.

What happens if I fail this test? Unfortunately, I have to jump to the general test. Jumping into the general test is okay; I can use any definition of compensation I want in the general test, except that, again, the IRS is apparently frowning on rate of pay. If I have a rate of pay plan, I probably will not be able to pass the nondiscrimination test even from the general test.

Our next plan that we'd like to look at is the Social Security offset plan. It's the typical old offset plan, 50% less 50% accrued over 30 years. Again, we don't have a coverage problem. Everyone's covered under the program. The problem is we don't have a safe harbor in 401(a)(4) to handle this plan. And, like many other organizations out there, this sponsor has decided to wait until the 401(a)(4) regulations came out before making its final decision. Now the sponsor has found that it doesn't have a safe harbor. It has this general test it has go through. What do I do now? I can redesign the program to meet one of the safe harbors. Or I can retain the program and try to test it on a general basis. Assuming I want the plan to remain integrated, or to use the new nomenclature, use permitted disparity, I'm going to redefine the program to be an excess program, a step rate, .85%/1.5% over 30 years. Again, remember that the changes in the permitted disparity rules were intended to reduce the spread between the highly compensated and nonhighly compensated, and therefore if I go in with a goal of trying to obtain the same costs, what I'm going to see is some type of benefit shifting here from the higher paid individuals down to lower paid individuals. And we'll see that as we go through. Having made this decision, there are a few transition considerations that have to be reviewed. First of all, how do I want to handle transition? If I have a final pay plan, which I have here, I somehow want to update the benefits that have accrued to date. I can look at the new benefit going forward in the future only. I can look at it over all years of service. Or I could look at it in those two combinations and choose the larger of the two.

What we're going to do here is look at two particular situations. First, where I've frozen the minimum benefit. This means that I'm going to have my new DB plan apply for all years of service, and at any point in time, the benefit will not be any smaller than the benefit that's been accrued to date. We'll also look at another alternative here, which is to use the new transition rules provided under the 401(l) regulations. Which is taking the accrued benefit at the end of 1988, and updating it to reflect increases in compensation. We add to that then, the new formula going forward from December 31, 1988, beginning with the 1989 plan year for those plan years that aren't calendar year, to give me my new formula. Those are the choices that we've looked at for this particular client. I'll just point out that there are some 88-131 issues here that are not necessarily that easy. You're going to have to deal with those. Before doing this update, I might have to adjust my accrued benefit under my offset plan. I have to make sure that the accrued benefit that I'm going to adjust is not reduced by more than 50% when I take the offset. So if I have a benefit before taking the offset at $2,900, it says that my accrued benefit can't be less than $1,450. If it is, and it is in this example, then I have to recalculate that accrued benefit, and that has to be my starting point.

Well, what happens now? To get this inflation protection, I look at an employee. Let's assume that over his 10-year period, the pay has increased by 70%. My benefit 10 years from now will be calculated by taking this 70% increase, applying it to my accrued benefit at the end of the 1988 plan year, and adding my new formula going forward. And there are three ways to do this update, which I think for time purposes we're not going to go into. Again, there are a few different choices in transitioning that benefit, and increasing it over that 10 year period.

We have four sample employees. And what we have is the frozen benefit compared to what happens if I use this new transition formula. The percentage change in the benefits at age 65 shifts. If I use the frozen benefit approach, I have a shift from highly compensated to nonhighly compensated, which is what we anticipated early on. With using this transition formula, because I could get more integration under the old formula, I was able to alleviate that shift somewhat, but the shift nonetheless occurs. My second option was not to use the safe harbor, but to prove compliance each year. Again, I'm going to use the same plan for everyone. I don't have a coverage issue, but I have a benefit issue. Why would I do this? Because from employee relations, I like the plan that I have, I don't have to recommunicate the program. And it meets my corporate philosophy.

What do I need to do? I have to go in and calculate individual rates for everyone. And I'm going to impute permitted disparity in this program because I know that my higher paid individuals are getting a bigger benefit from the program, so I'm going to have to impute permitted disparity in order to somehow close that gap. And I do that by taking my benefit accrual and setting it to some hypothetical permitted disparity formula, taking into account the maximum permitted disparity that each individual would be entitled to. And this theoretical rate is the rate that's going to go into my test. When I do this, when I find these rates, I see that I get a spread of rates from .88% to 1.89% and, unfortunately, all my highly compensateds are not at .88%. So I have at least one who's higher than a nonhighly compensated and I fail the test.

Alright, what do I do next? Well, I restructure my program. And now I'm going to separate it into 10 separate groups within the same plan. Each of them has the same formula in there. Each of them is deemed to have the same accrual rate. If I know that my benefits are nondiscriminatory within each of my 10 groups, I need to make sure I cover a good 410(b) group. Well, when I do that I see that, for the bottom percentages I do. When I get up to the top four, I fail the ratio test. But that doesn't necessarily wipe me out. I could still drop into the average benefits test. But when I go up to the top two, I see that the percentage of nonhighly compensated individuals is less than even what would be required under a nonsafe harbor under 410(b) and, again, I fail the test. What do I do at this point? What I'd like to do is increase the benefits for lower paid individuals and increase them in the least amount possible in order to help me pass the test. So I'm going to put a minimum benefit formula in. And now, I'm going to restructure the program. I have a formula that meets 401(a)(4). I'm going to have to make sure that I get good coverage. So I restructure and lo and behold, when I go back in here, I have a plan that, for each of these groups, 13 groups pass the ratio test. When looking at this though, don't get too happy. Remember that a chain is only as strong as its weakest link. And we have one there that is close to not passing that 70% test. So we have a stability issue. So even though we pass for this year, we may not pass in the future.

I'd like to briefly discuss the situation where I have separate plans for separate groups of employees. I have a DB plan and a 401(k) plan for my salaried group. I have a DB plan for my hourly employees. The benefits look good. Each plan all by itself has no nondiscriminatory benefits provided. Unfortunately, I have a coverage problem here. And that's what I have to deal with. My hourly DB plan clearly passes the ratio test. The salaried 401(k), the salaried DB plan, does not pass the ratio test, does not pass the safe harbor test under 410(b), but it does pass an unsafe harbor. So what I need to do now is two things. Are my classifications reasonable? I think hourly and salaried split is a reasonable classification. And then I have to go on to the average benefits test and see if I can prove somehow that I'm nondiscriminatory in providing these benefits.

Let's assume that because of the level of benefits for the salaried plan that I fail the ABP test. Again, this test can be done on a contribution basis or it can be done on a benefits basis. In any case, I fail in both instances. What are my design options? I can pump up the benefits for the nonhighly compensated individuals and go back in and try to test again. I can lower the benefits for the highly compensated individuals. Or I might try to extend coverage in the 401(k) plan to the hourly people and see what happens. Let's take that tact, and we'll expand the coverage. Now, expanding the coverage to hourly employees obviously hurts my ABP test, if they don't contribute under the program. So I'm going to be losing something there. And not only that, although I've taken care of the coverage problem in the 401(k) plan, I still have a problem in my salaried DB plan. Let's look at that problem. I'll go back and I see that the DB plan looks pretty good. When I combine the DB plans under the ABP test, it looks pretty good. I pass that ratio test. The 401(k) plan doesn't pass, and the combined plans don't pass. Well, the question now is, the DB looks good. What can I do? Well, I can test my DB and DC plans separately. That's one of the options that we are allowed to do up front. So now I'm going to say that my DB plans pass the ABP test. Now let's go over and test the DC plans. Well, our only DC plan in this case happened to be a 401(k) plan. It also happens to cover everyone. So it already passes the 70% ratio test, and there's no need for me to continue to do the ABP test here. I automatically pass it because I cover a good 410(b) group there, the ratio test. Again, this may help in some instances, rather than cutting back additionally on benefits under the 401(k) plan.

Last but not least, the hearings concerning the 401(a) regulations occurred in September 1990. And briefly, there's not really too much news coming out of there. Some of the main questions or requests that were brought up were changing the effective date so that it's a year after the final regulations are issued; eliminating testing based on the current year; and using a prior year or having some kind of fail safe. Because right now, even though we talked about all these general tests up here, if we fail that general test, there's no recourse for us. We have a disqualified plan. There's no way to go back and change it. So hopefully we're going to see something coming out, allowing us to do that. Restructuring is an issue, especially with 401(k) plans. People are still looking for PIA offset safe harbors, although probably they are not going to happen. Also people are looking for cash balance safe harbors, which may or may not happen. But there are still other issues out there that we need to know about for cash balance plans, whether they in themselves are going to be a viable animal in the future.

MR. MITCHELL I. SEROTA: I have a question for Craig. Last year, the State of Florida, or the Attorney General's Office of the State of Florida issued some sort of statement that actuaries and benefits consultants and insurance salesmen, I don't want to lump them all together, but Florida did, were not allowed to practice employee benefit law, whatever that might mean. And that was supposed to have had a significant effect in preventing those groups from, say, calling up Corbel and saying, "Can you give us a plan document?" Has there been any further developments in that regard?

MR. HOFFMAN: What you're referring to was in the State of Florida; the Florida Bar Association has a committee whose job is to propose advisory opinions as to what is or is not the practice of law in the State of Florida. And it proffered those proposed opinions to the Florida Supreme Court, which can choose to adopt that opinion verbatim, can change it, or can choose to issue no opinion. The whole goal is to give guidance for all those laymen out there as to what is or is not the practice of law. The opinion that you described was proffered by the Florida Bar's Committee to the Supreme Court. That was about six or seven months ago. The Supreme Court heard arguments on what it should do in regard to that opinion, and it has yet to do anything further on it. So, for the time being, the proposals are in abeyance. And what the Supreme Court ultimately may do is still subject to speculation.

MR. STEVEN D. BRYSON: I'd like to ask two questions, one of each speaker. With regard to the 401(a)(4) regulations, if a plan only covers nonhighly compensated employees, can it be de facto assumed that it satisfies the nondiscrimination requirements?

MR. HOFFMAN: Yes.

MR. BRYSON: Let's reverse that. What if it only covers highly compensated employees and still meets the coverage test? Would the same conclusion also apply?

MR. HOFFMAN: The only way it could pass the coverage test is if the employer has no nonhighly compensated employees. And in that case, yes, it could pass as well. The only caveat to your first question is you said it covers only nonhighly compensated individuals, and I presume it is not being aggregated with a plan that covers highly compensated employees. That allows that plan to pass.

MR. BRYSON: No, it's a plan that, by its definition of the eligible class, does not include any who fall in that definition of highly compensated. There's no other plan.

MR. HOFFMAN: Then yes, that would, on its face pass.

MR. BRYSON: Follow up to that then. This plan has a formula which satisfies Revenue Ruling 71-446 integration. I don't need to comply with 401(l), do I?

MR. RODGERS: No, I don't believe so. If you have only nonhighly compensated individuals in there, you can't be discriminating in favor of any highly compensated. And therefore you don't need to fall back on 401(l) in order to assure that you're nondiscriminatory.

MR. BRYSON: My other question was about terminating plans. We're helping another organization file a 5310. We did no work on the plan while it was in existence. And the IRS reviewer is now requiring that this terminated plan be amended to comply with all of the respects of TRA-1986, but has not given us any list of changes to be made. We don't have our prototypes approved by the IRS yet, otherwise we'd just give them one of those to use. Can I go back to the reviewer and say, "Fine, tell us which provisions of the plan to change?"

MR. HOFFMAN: You could tell him that, but I doubt you're going to get much response from him. I mean, the fact is it's not his obligation to point out to you every nit-picky point that needs to be covered. What he might do is simply send you a copy of the LRMs as they were first drafted. The bottom line is Notice 87-57 early on in the process indicated that a terminating plan would not have the ability to delay its updates since it wouldn't be around, and that you would have to update that document. And I can only say that people have been using our services to update terminating DB plans, and have been very successful in getting their approvals on the 5310. So, if you don't have a prototype available, which there aren't any approved available, your only choice is to go the individually designed route. Prior to the 1989 plan year, even perhaps during the 1989 year, you could have availed yourself of some of the model amendment approaches. But I'm afraid that approach has now gone by the wayside, now that we're well into the 1990 year. And you don't have available any of the opportunities to avoid 1989 effective date compliance.

MR. BRYSON: Okay, you mentioned LRMs. I haven't seen any LRMs yet.

MR. HOFFMAN: There were LRMs issued at the same time as the DC LRMs on DB plans.

MR. BRYSON: This is a DC plan. But I haven't seen LRMs, and we subscribe to Commerce Clearing House (CCH) and Bureau of National Affairs (BNA) and I've seen no such animal.

MR. HOFFMAN: This is a DC plan?

MR. BRYSON: Yes.

MR. HOFFMAN: They're out and in final form.

MR. BRYSON: So we probably can get a copy of them.

MR. HOFFMAN: Oh, absolutely. I know the BNA weekly pension reporter, in BNA's services LRMs are included. I'm almost sure CCH includes them, too.

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MR. BRYSON: I've been looking at every BNA that came out over the past six or seven years. And I haven't seen those LRMs published in there yet.

MR. HOFFMAN: Get with me after the program and give me your card and we'll find them.

MR. FRANK W. SCHLAGETER: There are a lot of plans that I have seen that have the age 65 and 10 years participation requirement. And obviously to go to 65 and five and accrue benefits fully over that shortened period of time would be quite a burden on many plans. Have you or any of the actuaries in the room seen any solution to that problem?

MR. HOFFMAN: I'm afraid I'll have to pass on that one. There are a lot of open questions on it, where the 65 and five rule falls, and it's really more of a funding and an actuarial issue. And I've got to confess, I rely on you folks to give me further guidance in the ultimate, where it's all going to come down. There was a technical correction made, and my understanding is there's still a need for further technical correction to the technical correction, which is not unusual. I don't know, Jack, if you know where that stands at this point in time?

MR. RODGERS: No, I really don't, Craig. I would say that your problem is that your plan is requiring 10 years of participation? My feeling is that those programs probably need to be changed.

MR. HOFFMAN: With regard to plans that are making loans, keep in mind, the DOL is the only group that didn't want to play along the same field. If you've got plans that are making loans, the DOL final plan loan regulations, which were finalized last fall, require that for loans made after the beginning of the 1990 plan year, the document has to be up to date with those final DOL regulations. So you don't have the opportunity to delay until 1991. If you're not making any loans between now and the time you update, that's fine. But if you have got a nonfinal loan regulation updated document, you need to update that document before you make any loans after the beginning of the 1990 plan year.