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Qualified Plans still offer benefits, but rules governing them are increasingly complex

Recent tax acts have modified the participation, distribution, and vesting requirements for defined benefit plans. This article reviews these areas and provides examples to illustrate how plans may respond to these changes and retain their qualified status

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RECENT TAX legislation has made comprehensive changes to the rules governing plan qualification and imposed new penalties and restrictions to ensure that tax-deferred amounts are used for retirement and not as tax shelters. For instance, changes in TRA '86 affect minimum coverage and vesting rules, Social Security integration, and distributions from qualified plans. TAMRA includes nondiscrimination rules for integrated plans, minimum coverage requirements, and minimum participation rules, as well as rules respecting the taxation of pension plan distributions.

Coverage rules

Effective for plan years beginning after 1988, a pension plan must meet one of three coverage tests. Under Section 410(b)(1), a qualified pension plan must:

1. Cover at least 70% of all nonhighly compensated employees.

2. Cover a percentage of nonhighly compensated employees which is at least 70% of the percentage of highly compensated employees covered.

3. Satisfy the average benefit test, which requires that benefits be provided employer-wide (or in the line of business, if applicable) such that the average benefit percentage for nonhighly compensated employees is at least 70% of the average benefit percentage for highly compensated employees.

Example. An employer has 50 employees, of which ten are highly compensated employees (HCE) and 40 are nonhighly compensated employees (non-HCE). Eight of the ten HCEs are benefiting (80%) and 30 of the 40 non-HCEs are benefiting (75%). Under the second of the above tests, at least 56% of the non-HCEs must benefit (70% X 80%). Since 75% of the nonHCEs are benefiting, the plan passes.

Thus, an employer's workforce needs to be divided into those employees who are highly compensated and those who are nonhighly compensated. Under Section 414(q), highly compensated employees generally include officers, owners, and those who are highly paid, which generally are employees earning more than $50,000. Identification of highly compensated employees is performed employer-wide, including all members of the controlled groups and affiliated service groups, including management organizations. Section 414(q)(10) prohibits line of business distinctions except for the determination of 5% owners. Only those employees earning more than $50,000 and who are in the top-paid group are considered highly compensated. For purposes of determining the top-paid group, Temp. Reg. 1.414(q)-1T provides that all employees who receive compensation during the year in question generally must be included even if they are not employed at year-end or for the entire year.

Exclusions from top-paid. Section 414(q)(11) permits the exclusion from the top-paid group, highly paid nonresident aliens with no U.S. earned income in a qualified pension plan, a provision of particular importance to the growing number of U.S. companies that are subsidiaries of foreign parents.

Temporary Regulation 1.414(q)-1T, A-9(b)(1)(iii), provides that union employees generally must be included unless at least 90% of the employer's employees are

covered by collective bargaining agreements, in which case the exclusion applies but only in determining the size of the top-paid group. In fact, few employers will qualify for the union exclusion.

Exclusions from coverage tests. Under Section 410(b), nonresident aliens and certain union employees are excluded in applying the three coverage tests. Also excluded are employees who do not meet the plan's minimum age and service requirements, if all such employees are excluded. An employer with only highly compensated employees in its workforce, which can be determined after permissible exclusions for age, service, collective bargaining, etc., satisfies the general coverage test.

Sanctions. Failure to satisfy the coverage test results in disqualification of the plan. Sanctions include:

1. Disallowance of employer deductions (to the extent a deduction is otherwise not allowed under Section 404(a)(5)).

2. Taxation of income earned by the trust.

3. Current inclusion in income by participants of employer contributions that are vested when made.

Coverage of separate business lines. Under Section 414(r), all three coverage tests may be applied separately to employees in a separate line of business of the employer, including the entire controlled group or affiliated service group. The employer must operate separate lines of businesses or maintain an operating unit in a separate geographic location for bona fide business reasons.

Factors considered in defining a separate line or operating unit include the services provided, products produced, and how the employer organizes itself. Job classifications, such as hourly and salaried, may not be tested in separate lines, nor may support personnel, such as secretaries and nurses. The separate line or operating unit must generally employ 50 people, meet a cross-section of employees test, and either receive IRS approval or meet a statutory safe harbor.

Minimum participation

Under Section 401(a)(26), for plan years beginning after 1988, plans must benefit the lesser of 50 employees or 40% of all employees of the employer on a controlled and affiliated group basis. Proposed Regulation 1.401(a)(26) separates plans into benefit structures, thus effectively treating them as separate plans by defining any separate benefit structure, separate trust or any other separate assignment as a separate plan which must meet this new rule.[1] This rule applies directly to each current benefit structure existing in a plan. A single current benefit structure exists within a plan for each part of a benefit formula to the extent that subsidies, optional forms of benefits, and rights and features, such as Social Security supplements, ancillary benefits, loans, and investment options are presented on a uniform basis to all employees eligible to participate under the benefit formula.

Example. A profit-sharing plan covers two divisions of the employer. Under Prop. Reg. 1.401(a)(26)2(d)(12)(i), two current benefit situations exist, and thus need to meet this rule separately, if contributions for each division's employees are based on profits of that division even if all other provisions are uniform. Under a target benefit plan that uses a uniform method to derive the contribution to be allocated on behalf of participants, a single benefit structure exists even though the allocations are not actually made as a uniform percentage of compensation.

The minimum participation requirements prevent discrimination in favor of highly compensated employees through aggregation of small plans in a manner difficult to detect in a complex comparability study. The IRS felt that it lacked sufficient resources to monitor compliance with the nondiscrimination standard by small aggregated plans so it required that a minimum number of participants be covered by all plans on an individual basis.

Disparity of plan contributions and benefits. A plan is not discriminatory merely because the contributions and benefits of or on behalf of employees favor highly compensated employees if the plan meets certain disparity limits relating to the integration of contributions or benefits. A plan's integration level is a threshold level of compensation, above which the rate of benefits increases. A defined benefit plan does not exceed the disparity limits if the increase of benefits at such a threshold is no more than the maximum excess allowance described in Section 401(1)(4). Also, optional benefits provided on the same basis both to employees above the level and employees below it will satisfy the disparity limits, as will benefits uniformly based on average annual compensation.

Defined benefit offset plan. A defined benefit offset plan (1) does not provide greater benefits above an integration level, and (2) reduces a participant's employer-provided benefit by an amount that is a specified percentage or amount of the participant's final average compensation. The maximum offset may not be greater than 0.75% of the participant's final average compensation. Section 401(1)(3)(B) also provides that a participant's accrued benefit from the employer's contributions may not be reduced by reason of offset by more than 50% of the benefit that would have accrued without the reduction.[2]

Example. A defined benefit plan maintained by employer X contains no provision that would require a reduction in the factor for the maximum offset allowance. All participants have a Social Security retirement age of 65. Under the benefit formula contained in the plan, for each year of credited service for X, a participant receives a normal retirement benefit of 2% of the participant's average annual compensation, reduced by three-fourths of 1% of the participant's final average compensation (up to covered compensation). The plan provides that not more than 35 years of credited service may be taken into account in determining benefits under the plan. Adam retires at his Social Security retirement age with 40 years of service. At the time of his retirement, Adam has average annual compensation of $16,000 and final average compensation (up to covered compensation) of $14,000. Under the plan benefit formula, Adam is entitled to receive a normal retirement benefit of $7,525 ($11,200 (70% X $16,000) less $3,675 (3/4 of 1% X 35 years X $14,000)).

Adam's maximum offset allowance is not exceeded because the offset under the plan (1) does not exceed three-fourths of 1% of his final average compensation (up to covered compensation) for any year of credited service, (2) does not exceed the maximum cumulative offset allowance of 26.25% (3/4 of 1% X 35) of Adam's final average compensation, and (3) does not exceed 50% of the normal retirement benefit Adam would have been entitled to receive under the plan with respect to his average annual compensation not in excess of his final average compensation up to covered compensation if no offset had been applied.

Vesting

Under Section 411(a), a plan is not a qualified plan, except for a multiemployer plan, unless a participant's employer provided benefit vests at least as rapidly as under either (1) a five-year vesting schedule in which upon the completion of five years of service a participant has a nonforfeitable right to all of his accrued benefit derived from employer contributions, or (2) a three-to-seven-year vesting schedule in which upon the completion of three years of service a participant has a nonforfeitable right to 20¡10 of said benefit plus 20¡10 each year thereafter until the completion of seven years for lOO~o. Top-heavy plans must vest more rapidly.

Example. In 1989 a participant in a pension plan has four years of service with his employer. The plan has a three-to-seven-year vesting schedule and the present value of the participant's accrued benefit is $20,000. He has a vested right to $8,000 of such benefit (40% X $20,000). Another participant in the plan has 1½ years of service with the employer. This participant is not vested in any portion of his accrued benefit.

A plan may not condition eligibility to participate in the plan on more than two years of service and may provide for two years of service eligibility only if it provides for full and immediate vesting after two years of service. The accelerated minimum vesting requirements are effective for plan years beginning after 1988, except for certain collectively bargained plans. These rules, however, do not apply to any participant who does not perform at least one hour of service in any plan year to which these rules are applicable.

Benefit limitations. The limits on annual benefits (ie., the lesser of 100% of compensation or $90,000) have not changed. However, the normal retirement age under employee benefit plans must now be the same as the Social Security retirement age. If retirement benefits under a defined benefit pension plan begin before Social Security retirement age, Section 415(b)(2) requires that the $90,000 limit be reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at the Social Security retirement age, which is currently age 65.[3] The retirement age is being raised to age 67 over a 20-year period. For those employees who want to retire at or after age 62, the $90,000 limit is reduced in the same manner as the reduction for early retirement benefits under Social Security.

The $90,000 limit on defined benefit plan benefits is reduced by 10% for each year the employee's participation is less than ten years, effective for years beginning after 1986.

For example, if a participant has three years of actual plan participation, the participant's accrued benefit could not exceed three-tenths of the dollar maximum then in effect. Benefits, however, may not be reduced below $9,000 (one-tenth of the $90,000 limit, as indexed). Service with the employer prior to becoming a participant is disregarded in determining the dollar limit on benefits payable under the plan.

For purposes of applying the combined plan limitations, the dollar limit on pension plan benefits is to be phased in over ten years of service rather than ten years of participation. However, under Section 415(b) (5), there is a special $10,000 *de minimis* benefit based on years of service.

Includable compensation. Under Section 404(l), the $200,000 limit on compensation that may be taken into account by top-heavy plans applies to all qualified plans, effective for tax years beginning after 1988. The limit applies for, among other things, purposes of determining

allowable Federal income tax deductions.

Nondeductible contributions. Employer contributions in excess of the deductible limits are subject to a 10% annual nondeductible excise tax until the excess is eliminated. Excess contributions liable for the tax include those retained from preceding years. Amounts returned to the employer during the year are not included. Under Section 4972, the excess contributions for a year are determined as of the close of the employer's taxable year.

Excess distributions. Excess distributions made from qualified retirement plans are subject to a new 15% excise tax. The individual to whom the excess distributions are made is liable for the tax. Under Section 4980A, excess distributions are generally distributions in excess of the greater of $112,500 (as indexed - $122,580 for 1989) or $150,000. A higher ceiling applies for purposes of calculating excess distributions for any calendar year in which an individual receives a lump-sum distribution that is taxed under forward income averaging rules.[4]

Early withdrawals. The 10% excise tax imposed by Section 72(t) on early withdrawals from an IRA now covers early withdrawals made by a participant from any qualified plan. Exceptions apply to premature distributions payable (1) for medical expenses, (2) upon the participant's death, (3) in a series of substantially equal periodic payments, and (4) after separating from service after age 55. TAMRA eliminated the prior law requirement that the participant satisfy the requirements for early retirement under the distributing plan. TAMRA thus opened a window of opportunity for retirement between ages 55 and 59½ and avoids the need for complicated plan amendments to provide for early retirement.

Spousal consent. Under Section 417(a), a plan loan must provide that none of the participant's accrued benefit may be used as security for any loan unless the participant's spouse consents in writing. The election period for spousal consent is the 90-day period before execution of the security agreement. If use of a participant's accrued benefit as security for a loan meets these requirements, the survivor benefit requirements do not preclude any distribution required by reason of a failure to comply with the terms of the loan.

Maximum age limitations

Post-retirement accruals. Employers must continue benefit accruals in an employee benefit plan for employees who work beyond normal retirement age. Proposed Regulation 1.410(a)-4A(b) indicates that no maximum age participation limitation may be applied after 1987 to an employee with at least an hour of service in the year. Hours and years of service before 1988 are taken into account under 29 CFR part 2530.

Effective for plan years beginning after 1987, plans may no longer exclude an employee who begins working within five years of the normal retirement age. Service before the 1988 plan year does not have to be taken into account for benefit accrual purposes. However, hours of service and years of service credited to employees before the 1988 plan year must be taken into account in applying the plan's eligibility and vesting provisions.

Example. Xanadu Corp. has a plan with a June 30th year-end. The plan provides that employees are eligible to participate on the first entry date after completing one year of service. The plan has two entry dates, July 1 and January 1. The plan contains a provision that excludes from participation employees hired within five years of the plan's normal retirement age of 65. Bill was hired on 8/1/86 at age 62 and completed a year of service by 8/1/87. If Bill performs at least one hour of service for Xanadu during 1988, and is still employed on 7/1/88, he must become a participant on that entry date.

Under Section 410(a)(2), benefit accruals under a defined benefit plan may not be reduced or discontinued because of the attainment of any age. Benefit accruals and allocations are not reduced or discontinued solely because of a correlation between increased age and a reduction or discontinuance in accruals or allocation. For example, a plan may reduce or discontinue benefit accruals or allocations for participants who have completed 30 years of credited service even though those employees who have completed 30 years of service will be older employees.

Benefit accruals or allocations may be frozen or reduced if the reason for the reduction or discontinuance is not directly or indirectly related to the participant's attainment of a specified age. For example, a defined benefit plan that is amended to reduce future accruals for all participants does not violate these benefit accrual rules.

When an employee continues to work past normal retirement age, a plan may (1) make benefit payments, (2) suspend benefit payments during this period of employment and then actuarially increase benefit payments that commence when the employee stops working to reflect the delay in benefit payments, or (3) permanently suspend benefit payments during this period of employment provided certain notice requirements are satisfied.

Contributions

Full funding. Employer contributions to a defined benefit

pension plan are deductible only up to the full funding limitation. For plan years beginning after 1987, the full funding limitation is determined by reference to the lesser of (1) accrued liability, or (2) 150% of current liability. Current liability does not include projected benefit increases. This rule is intended to raise revenues by substantially reducing deductions for qualified plan contributions. Many large and most small plans will be affected, causing pension contributions to become much more volatile.

Quarterly contributions. OBRA'87 requires employers sponsoring defined benefit plans to make quarterly plan contributions. Contributions are generally made before filing the employer's Federal income tax return (including extensions) to qualify for a deduction.

Failure to make contributions. If the full amount of a required contribution installment is not made on a timely basis, (1) interest must be paid to the pension trust in respect of any underpayment, and (2) the employer is required to notify each participant, beneficiary, and alternate payee (under a qualified domestic relations order) of the failure to make a quarterly payment. This notification is required only if the quarterly payment is not made within 60 days of the applicable due date of the payment. In other words, there is a grace period regarding notification.- OBRA '87 increased the nondeductible excise tax to 10%, which is imposed on an employer if the annual contribution is not made within 8½ months after the end of the plan year for plan years beginning after 1989. If the required contribution is not made within 90 days after the IRS advises the employer to make a contribution, a 100% nondeductible excise tax is imposed.

Funding waivers. For plan years beginning after 1987, funding waivers will be granted only if application is made within 2½ months after the close of the plan year and if a temporary substantial business hardship exists. If the employer is a member of a controlled group, the hardship must exist for the entire group. In addition, no more than three waivers will be granted in any 15 consecutive years.

PBGC premiums. OBRA '87 significantly increased the premiums for insuring a single-employer defined benefit pension plan by changing the PBGC premium structure from a flat rate per participant to a combination of a flat-rate and a variable-rate premium based on the funded status of the plan. Effective for plan years beginning after 1987, the annual pension benefit guarantee premium equals the sum of a flat-rate premium of $16 per participant plus an additional premium of $6 per $1,000 of the unfunded actuarial value of vested benefits in the plan. The additional premium, however, is limited to $34 per participant. Thus, PBGC premiums for some plans will be $16 per participant, while other plans may have premiums as high as $50 per participant.

Joint and several liability for PBGC premiums extends to the plan administrator, the contributing sponsor, and all members of the contributing sponsor's controlled group. Failure to timely pay the premiums may result in a penalty up to 100% of the payment due.

Plan terminations and reductions

Under the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA), effective for filings of notices of intent to terminate after 1985, an employer can voluntarily terminate a defined benefit plan only by (1) a standard termination for adequately funded plans, or (2) a distress termination for underfunded plans. The prior termination insurance system, in some cases, had encouraged employers to terminate pension plans, evade their obligations to pay benefits, and shift unfunded pension liabilities onto the termination insurance system. SEPPAA modifies the termination insurance system to increase the likelihood that participants will receive full benefits, to limit termination claims to cases of severe hardship, and to maintain premium costs at a reasonable level.

Notification of reduced accruals. SEPPAA requires that plan administrators provide written notice of plan amendments that significantly reduce future benefit accruals. The notice must be provided after the adoption of the plan amendment but at least 15 days before its effective date. Thus, the freezing of contributions under a pension plan by amending the benefit formula triggers this requirement. If the notice is not provided on a timely basis, participants and former participants may argue that the amendment reducing accruals does not apply in determining the amount of their benefits. Thus, in the absence of this statutory notice, a plan's liabilities may be significantly increased beyond an amount funded by the employer.

Distress terminations. For plans that issue notices of intent to terminate to the PBGC after 1987, distress terminations are available only if the entire controlled group has entered into bankruptcy proceedings before the proposed termination date. Further, terminations are allowed only if the controlled group would not otherwise be able to pay all its debts and would be unable to continue business without a reorganization.

Insufficient assets on termination. For plan years beginning after 1987, if a single-employer defined benefit plan terminates without sufficient assets to meet all accrued benefit obligations, the contributing plan sponsor and each member of the controlled group are jointly and

severally liable to the plan participants and to the PBGC for the excise tax and payment of any contribution of required installment due from any group member. If upon the plan termination, any controlled group is liable for unfunded benefit obligations and does not pay the amount of such unfunded liability, the PBGC may impose a lien against all real and personal property up to 30% of the net worth of the controlled group until satisfaction of this liability.

For plans terminating after 1987, any amendment providing for a reversion of assets to an employer upon termination will not be effective before the fifth calendar year after the adoption of the amendment except for plans in existence less than five years.

Bills have been introduced to effectively curtail an employer's ability to recover excess assets from a terminated defined benefit plan.

CITATIONS

[1] See Ellias and Hira, *Proposed minimum participation Regulations contain some fiexibility as well as harshness*, 42 TA 270 (May 1989).
[2] Prop. Reg. 1.401(1)-l(b)(4); Notice 89-70, IRB 1989-25, 10.
[3] Notice 89-45, IRB 1989-16, 15: See also Watson and Feutz, *Integrating qualified plan benefits with Social Security remains complex*, 41 TA 78 (August 1988).
[4] See Kirschbaum and Kravitz, *Minimizing taxes on excess retirement distributions and accumulations*, 41 TA 312 (November 1988).