REPORT #667

TAX SECTION

New York State Bar Association

Report on Proposed Regulations
Relating to
Qualified Plan Nondiscrimination Requirements

September 28, 1990

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REPORT # 667

TAX SECTION

New York State Bar Association

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The Honorable Kenneth w. Gideon
Assistant Secretary of the Treasury
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3120 Main Treasury
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Washington, O.C. 2022

Re: Proposed Regulations Relating to Qualified Plan Nondiscrimination Requirements

Dear Sirs:

Enclosed is a report on proposed regulations relating to qualified plan nondiscrimination requirements prepared by our Committee on Employee Benefits.

The report considers the provisions of the proposed regulations issued on May 14, 1990 relating principally to Section 401(a)(4) of the Code. Among other things, the report recommends significant changes in the "safe harbor" provisions of the nondiscrimination rules, general nondiscrimination tests, testing of other benefit rights and features, treatment of mergers and acquisitions and the treatment of the effect of plan amendments. The report also addresses the authority of the Service and Treasury to impose the sanctions prescribed by Code Section 402(b)(2) on employers and plans failing to meet the 401(a)(4) requirements.

We hope this report will prove helpful in developing nondiscrimination regulations which, while furthering the policy goals associated with qualified plans, also minimize burdensome administrative and compliance requirements for employers.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

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Tax Report #667

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON EMPLOYEE BENEFITS

Report on Proposed Regulations Relating to Qualified Plan Nondiscrimination Requirements

September 28, 1990

I.

Introduction

This Report of the Committee on Employee Benefits (the "Committee") of the Tax Section of the New York State Bar Association[1] comments on a package of proposed and ' temporary regulations published in the Federal Register by the Internal Revenue Service (the "Service") and the Department of the Treasury (the "Treasury") on May 14, 1990 (the "Proposed Regulations").[2] The central set of proposed rules relates to the nondiscrimination requirements of Section 401(a)(4)[3] and the average benefit percentage test of Section 410(b)(2). The package also includes proposed regulations under Sections 401(a)(26) (minimum participation requirements), 401(a)(17) (limitation on includable compensation), and 401(1) (permitted disparity), as well as proposed and temporary regulations under Sections 414(s) and A 415(c)(3) (compensation definitions).[4]

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[1] This Report was prepared by a subcommittee of the Committee on Employee Benefits consisting of Stuart N. Alperin and Kenneth C. Edgar, Jr., co-chairmen of the Committee on Employee Benefits, and Loran T. Thompson, subcommittee chairman, who were the principal editors of the Report; Karen A. Ackermann, Mark D. Arian, Stanley Bauro, Matthew J. Bozek, Carol I. Buckmann, Albert Feuer, Stephen H. Frankel, Laurie Gorelick, Terrence A. Greiner, George R. Ince, Jr., Stephen T. Lindo, Michael Macris, Therese Ann Michaels, Lawrence Nirenstein, Irwin N. Rubin, Clarin Schwartz, and John J. Sweeney, Jr.

[2] The Proposed Regulations were subsequently amended on September 12, after this Report was substantially complete. These amendments addressed some of the concerns of the Committee; however, in the interests of time this Report has not been altered to reflect the amendments. If appropriate, the Committee will make further submissions reflecting its comments on the amendments to the Proposed Regulations.

[3] Except as otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to proposed, temporary, or final regulations thereunder.

[4] Regulations under Sections 401(a)(5), 401(k), 401(m), 410(b), and 411(d)(6) would also be modified by the proposals.

In preparing this Report, the Committee has not attempted to address all portions of the Proposed Regulations, and has generally refrained from commenting on issues that are principally actuarial in nature.

Executive Summary

This Report is generally supportive of the goals of the Proposed Regulations, particularly with regard to simplification. The Committee feels, however, that the Proposed Regulations would be significantly improved if they were changed in the following ways:

1. Expand the design-based safe harbors to cover as many types of plans as possible, including specifically PIA offset plans and career average plans.

2. Alter the general nondiscrimination test by:

   a. Returning to the longstanding approach of testing discrimination by reference to average benefits or allocations for the highly and nonhighly compensated groups;

   b. Permitting appropriate use of statistical sampling;

   c. Allowing for de minimis variations in average benefits or allocations for the highly and nonhighly compensated groups; and

   d. Permitting limited retroactive correction of failures to satisfy the Section 401(a)(4) retirements.

3. Eliminate double testing under Section 1.401(a)(4)-3. Test normal accrual rates under Section 1.401(a)(4)-3, but determine nondiscrimination in respect of retirement subsidies by reference to the current and effective availability rules of Section 1.401(a)(4)-4;

4. Liberalize the plan restructuring rules by, inter alia, permitting separate restructuring for testing the normal and most valuable accrual rates;[5]

5. Substantially revise the testing of other benefits, rights, and features under Section 1.401(a)(4)-4. Utilize, where appropriate, the rules of Section 1.401(a)-4, but eliminate effective availability testing for most benefits, rights, and features not protected under Section 411(d)(6). Identify rights and features regulated elsewhere in the Code and expand the category of insignificant benefits — neither of these types of benefits, rights and features would be subject to any Section 401(a)(4) testing.

6. In the area of mergers and acquisitions:

    a. Promote consistency of treatment by rationalizing the Section 401(a)(4) rules with the merger and acquisition relief afforded under Sections 410(b) and 401(a)(26)(F);

    b. Afford protection both to the buyer and the seller, and extend the protection to ancillary benefits; and

    c. Liberalize the special rule in the Proposed Regulations to permit certain post-transaction changes to benefits, rights and features without the loss of protection under the special rule.

7. Eliminate Section 1.401(a)(4)-5(a) and (b). These provisions promote complexity, are conceptually flawed, and do not appreciably advance the purposes of Section 401(a)(4).

8. Eliminate the concept of core benefits in Section l.401(a)(4)-9 and extend the special availability rules of Section 1.401(a)(4)-9(c)(3) to all benefits, rights, and features that are otherwise subject to testing under

[5] Obviously, this is only required if the Committee's suggestion in (3) above is rejected.

Section 1.401(a)(4)-4.

9. Provide one or more additional safe harbors under Section 1.401(a)(4)-10 to permit increases in benefits to former employees.

10. In view of other protective provisions (e.g., top-heavy rules and liberalized minimum vesting requirements), eliminate independent testing of vesting for Section 401(a)(4) purposes in most circumstances.

11. Eliminate the applicability of Section 402(b)(2) to violations of Section 401(a)(4).

12. Postpone the effective date of the Proposed Regulations.

13. Make certain technical and clarifying changes to the Proposed Regulations under Section 401(a)(26) and the Proposed and Temporary Regulations under Sections 414(s) and 415.

General Comments

The Proposed Regulations reflect an approach to drafting that the Committee hopes will serve as a model for future pension and tax regulations. The Committee particularly applauds the Proposed Regulations' structure and clarity of articulation, and strongly endorses their stated objective of enabling large numbers of qualified plans to satisfy nondiscrimination requirements on the basis of design-based criteria rather than by means of annual employee data analysis. The Committee believes, however, that the Proposed Regulations fall seriously wide of the mark in achieving this objective, and accordingly recommends in this Report various changes that the Committee believes would help close the gap between the Proposed Regulations' stated goals and their likely effect in actual operation.

The safe harbor rules on nondiscrimination in contributions and benefits form the cornerstone of the Proposed Regulations' design-based approach, and plans that fall outside the safe harbors will automatically require annual testing. The Committee anticipates that large numbers of plans will be unable to take advantage of the safe harbors as currently formulated, and that even where the safe harbors are available, annual monitoring of plans may be required to ensure compliance with the rules on nondiscriminatory availability of benefits, rights, and features.[6] Plan sponsors are likely to respond to these added compliance burdens in one of three ways.

First, a segment of affected employers can be expected to submit to the economic and administrative costs of complex annual testing.[7] To the extent this occurs, the Proposed Regulations will have the unintended effect of undermining the Commissioner's announced goal of reducing the pension law's complexity, and will impose further strains on the government's ability to administer the tax system.

Second, the significant costs of annual testing may prompt some employers to substantially alter their current plan designs in favor of very simplified structures so as to fall within the safe harbor rules. The Committee believes that the incentive created by the Proposed Regulations to standardize plans by molding them into one of the safe harbors is misplaced. Valid business reasons may lead a plan sponsor to incorporate structural variations within its retirement plans, and in many situations it is inappropriate for businesses to adopt a single benefit structure for all employees.[8] This is particularly true in the merger and acquisition

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[6] Some annual testing will also be required in the case of plans relying on the safe harbor for defined contribution plans with a uniform allocation formula weighted for age or service.

[7] Because it is impossible for an employer with thousands of employees to maintain a flawless system of data collection, however, no expenditure of resources will prevent the possibility of an inadvertent violation of the exacting nondiscrimination standards embodied in the Proposed Regulations.

[8] Although the separate line of business rules may permit certain employers to preserve differences within plans, these rules will be unavailable in many situations where, for legitimate business reasons, separate benefit

context — an area which, in the Committee's view, is inadequately addressed by the Proposed Regulations generally, and with respect to which this Report makes various recommendations.

Finally, the Committee is concerned that many plan sponsors will terminate plans altogether (and that new companies will forego the adoption of qualified retirement plans, particularly defined benefit plans) rather than incur additional costs or redesign their plans. This result will force the social security system and private savings to assume more of the burden of replacing income from active employment.[9]

These likely effects of the Proposed Regulations represent heavy economic and social costs that, in the Committee's view, must be weighed against the benefits to be derived from the regulations' complexity in application. In striking this balance, weight should be given to the other legislative measures already in place that erect barriers to the abuse of qualified plans in favor of the highly paid.[10]

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structures are offered to different groups of employees within the same line of business.

[9] See Joint Committee on Taxation Staff Description of Present-Law Tax Rules Relating to Qualified Pension Plans, JCS-9-90 (March 23, 1990) at p. 62. The various tax acts, beginning with the Tax Equity and Fiscal Responsibility Act of 1982, have already caused the termination of a large number of defined benefit plans maintained by smaller employers.

[10] Relevant statutory changes enacted since 1982 include the reduced dollar limitations on contributions and benefits under Section 415; the additional Section 415 restrictions introduced by the Tax Reform Act of 1986; the limitation on includible compensation under Section 401(a)(17); the new plan funding limitations imposed by 412(c)(7); the minimum participation rules of Section 401(a)(26); more rapid vesting requirements under Section 411; the permitted disparity rules of Section 401(1); the Section.416 top-heavy rules; the Section 402(g) dollar limitation on elective deferrals; the actual deferral percentage and actual contribution percentage limits of Sections 401(k) and 401(m); the Section 410 minimum coverage requirements; the Section 4972 excise tax on nondeductible contributions; the Section 4979 excise tax on excess contributions; and the Section 4980A excise tax on excess distributions and excess accumulations.

The effectiveness of these rules in limiting qualified pension benefits to the highly compensated is evidenced by the proliferation of nonqualified supplementary retirement arrangements for executives. In a recent survey of major corporations, nearly 80 percent of survey respondents sponsored nonqualified supplemental retirement plans for executives, consisting principally of so-called excess benefit plans, which provide

These existing safeguards reduce the marginal benefit — extracted at enormous cost — of the Proposed Regulations' elevated degree of conceptual purity that prohibits even minor variations within a plan that might incrementally benefit a highly compensated employee more than the nonhighly compensated. From this perspective, the Committee recommends changes to the Proposed Regulations that it believes would substantially simplify compliance and thereby lessen burdens on plan sponsors without compromising the goals of the regulations.

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benefits that cannot be provided under qualified plans by reason of the limitations of Sections 401(a)(17) and 415.

II.
Sections 1.401(a)(4)-2 and -3:
Nondiscrimination Safe Harbor Rules

Although the Treasury and the Service would apparently prefer that employers use the safe harbors in the Proposed Regulations, their assumption that most plans as currently constituted will qualify to use the safe harbors appears to be unduly optimistic. As discussed below, the safe harbors do not appear broad enough to accommodate plan designs that are in common use by plans. As to smaller plans in particular, the Committee believes that the safe harbors and testing approaches should not further discourage or eliminate the incentives for small employers to establish and continue to maintain qualified plans for their employees. However, as presently designed, many small plans will be unable to meet the rigid safe harbors, and it is questionable at best whether small employers will be willing to redesign their plans to meet the safe harbors or be willing to incur the additional costs necessary to monitor compliance with the Proposed Regulations. Thus to avoid driving small employers to curtail retirement plans, and to spare large employers significant increases in administrative costs, the Committee believes the safe harbors should be expanded and clarified in certain respects.

Breadth of Safe Harbors

PIA Offset Plans. The most glaring omission from the safe harbors for defined benefit plans is the absence of a safe harbor for plans which offset the participant's benefit with part or all of the anticipated social security benefit ("PIA offset plans"). These types of plans are popular among large and small employers which sponsor defined benefit plans.[11] Although some PIA offset plans may pass Section 401(a)(4) through testing, the fact that

[11] According to data published by the Bureau of Labor Statistics, in 1988 there were 7.64 million participants in PIA offset plans offered by medium and large employers. See "Employee Benefits in Medium and Large Firms," United States Department of Labor, Bureau of Labor Statistics (1989).

there is no design-based safe harbor for such plans means that many existing plans will not pass the safe harbor in their present form. If the Proposed Regulations included a limited PIA offset plan safe harbor — perhaps limiting the amount of offset permitted to a specified level — substantially more existing plans would be able to utilize a safe harbor.

The Preamble to the Proposed Regulations indicates that the Treasury and the Service considered a PIA offset safe harbor, but eventually rejected it on the ground that such a safe harbor would add "complexity" to the proposed regulations. Given the immense complexity of restructuring a PIA offset plan under Proposed Regulation Section 1.401(a)(4)-9(d)(2)(i)(B) and (C) and then testing the restructured plan on a normal accrual and most valuable accrual basis under Proposed Regulation Section 1.401(a)(4)- 3(c), it is hard to imagine that a safe harbor could not be designed that would be less onerous to employers than the currently proposed testing approach. Were a design-based PIA offset safe harbor to be provided, many employers which currently sponsor such plans would be able to preserve these plans and avoid the annual expense of testing without radically altering their retirement plans.

Prior to the issuance of the Proposed Regulations, officials of the Service had informally indicated that such a safe harbor would not be objectionable on policy grounds. The Committee urges that a PIA offset safe harbor be created.

Career Average Plans. The Proposed Regulations may be read not to provide a safe harbor for career average defined benefit plans. To meet the unit credit safe harbor, the definition of compensation used under the plan must satisfy Section 1.401(a)(4)-3(f)(2), which requires that a formula base benefits on compensation over a period of at least three years or, if shorter, the employee's period of employment. Since this language could be read to require that compensation be averaged over a period of at least three years, a career average plan, which bases the current accrual only on the current year's pay, may not qualify for this safe harbor.[12]

The Committee recommends that the Treasury and the Service specifically incorporate a design-based career average safe harbor in the Section 401(a)(4) regulations or modify the existing unit

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[12] Even if averaging were required, certain career average plans could nevertheless be viewed as falling within the unit credit safe harbor. A career average plan with a benefit formula of the sum of 1% of annual compensation in each year of service, for example, could be viewed as meeting the unit credit safe harbor because the formula is mathematically identical to a formula of 1% of average compensation calculated over the employee's total years of service. The latter formula is essentially identical to the formula described in the Example under Section 1.401(a)(4)-3(f)(2)(ii) of the Proposed Regulations, modified by substituting 50 years (or some other period exceeding the maximum length of service of any employee) for five years. It would seem to follow that this type of career average plan could qualify under the unit credit safe harbor rules if reformulated in this manner.

On the other hand, an integrated career average plan apparently could not qualify under the unit credit safe harbor because it could not be reformulated in the manner described above.

credit safe harbor to expressly permit career average plans to meet that safe harbor.

There is also no safe harbor for a popular form of career average defined benefit plan, the "cash balance plan." Although officials at the Service have publicly stated that cash balance plans can use the safe harbors to the extent the safe harbors are available, it does not seem likely that a cash balance plan would be able to meet the requirements of any of the design-based safe harbors for defined benefit plans. The language of the Proposed Regulations limits the use of the defined contribution safe harbors to defined contribution plans and thus precludes a cash balance plan from taking advantage of any of these design-based safe harbors.

In view of the popularity of career average plans, which are not inherently susceptible to abuse, the Committee believes that an additional safe harbor should be created for these plans that would permit the use of compensation on an annual basis.

Areas in Need of Clarification

To avoid the complex testing required under the general test, a plan must meet a safe harbor. It is vitally important for those seeking to rely on the safe harbors to have adequate guidance as to what those safe harbors require The safe harbors for defined benefit plans should be clarified in several respects.

Unit Credit. Safe Harbor. The safe harbor for unit credit plans set forth in Section 1.401(a)(4)-3(b)(2) requires that all employees in the plan be subject to the same unit credit benefit formula and that the same dollar amount or the same percentage of compensation be accrued for the current and all subsequent plan years by all employees : the plan with the same number of years of service. This sa: harbor should be clarified to make clear that a cap (on either benefits or service) which reflects a full career may be placed on accruals without violating the requirement that the same benefits accrue each year for participants with the same number of years of service.

There should also be clarification of the requirement that all employees in the plan be subject to the same benefit formula. Would this provision be violated by an early retirement window, plant closing benefit, or other benefit that is presumably independently tested under Section 1.40l(a) (4)-4 of the Proposed Regulations (relating to nondiscriminatory availability of benefits, rights, and features)? The Committee presumes that providing such benefits would not cause a violation of the "same formula" rule and suggests that the rule so state.

Section 1.401(a)(4)-3(b)(2)(ii)(D) of the Proposed Regulations requires that all subsidized early retirement benefits with respect to benefits accruing in the current and subsequent plan years be available to substantially all employees in the plan on similar terms. In view of the Committee's recommendations (discussed in Section IV below) that subsidized early retirement benefits be tested under the rules set forth in Section 1.401(a)(4)-4, the Committee believes that Section 1.401(a)(4)-3(b)(2)(ii)(D) is unnecessary and should be deleted.

The last sentence of Section 1.401(a)(4)-3(b)(3)(ii)(A) states that for purposes of the uniform flat benefit safe harbor, a plan will not be deemed to violate the uniformity requirement solely due to benefits that were previously accrued under a uniform formula and that are protected under Section 411 (d) (6). The same rule should be made applicable to uniform unit credit formulas by adding a similar sentence to the end of Section 1.401(a)(4)-3(b)(2)(ii)(B).

Flat Benefit Safe Harbor. The safe harbor for flat benefit plans set forth in Section 1.401(a) (4)-3 (b) (3)requires a flat benefit at normal retirement age with benefits accruing under a flat benefit formula that is the same for all employees in the plan. This safe harbor contains some of the same ambiguities as the safe harbor for unit credit plans. For example, the meaning of the requirement that all employees be under the same benefit formula is not clear. Does this preclude early retirement windows, plant closing benefits, or other benefits that are independently tested under a different provision of the Proposed Regulations?

Uniform Allocation Formula. It appears that the concept of a "uniform allocation formula" under Section 1.401(a) (4)-2(b) (2) may prevent defined contribution plans from continuing to include a "last day of the year" requirement for allocation of the employer's contribution.[13] Neither the language of the Proposed Regulations nor the Preamble specifically addresses this issue. In the absence of such clarification, implementation of the "last day of the year" rule would also cause the plan to fail the general rule as currently proposed (if one nonhighly compensated employee completes 1000 hours of service but terminates employment prior to the end of the plan year, such employee's allocation is zero for Section 401(a)(4) purposes). The Committee believes this is a particularly harsh result that should be addressed through clarification of the "uniform allocation formula" requirement or, as discussed below, by liberalizing the general rule.

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[13] See Revenue Ruling 76-250. The same observation is applicable to plans with mid-year entry dates.

III.
Sections 1.401(a)(4)-2 and -3:
General Nondiscrimination Test

The Committee believes that a significant number of plans will not fit within the safe harbors and therefore will be required to satisfy the applicable general test for demonstrating nondiscrimination. Section 1.401(a)(4)-3(c) of the Proposed Regulations sets forth the general test for demonstrating nondiscrimination in benefits. This test is satisfied only if (i) no highly compensated employee in the plan has a normal accrual rate that exceeds the normal accrual rate for any nonhighly compensated employee in the plan, and (ii) no highly compensated employee in the plan has a most valuable accrual rate that exceeds the most valuable accrual rate for any nonhighly compensated employee in the plan. The general test for demonstrating nondiscrimination in contributions, set forth in Section 1.401(a)(4)-2(c), requires that no highly compensated employee in the plan have an allocation rate exceeding that of any nonhighly compensated employee in the plan.

Under both of these general tests, discrimination is tested on an individual basis. If a single highly compensated employee has a better accrual rate or allocation rate than a single nonhighly compensated employee, the entire plan is treated as discriminating in favor of highly compensated employees. This test requires an absolute level of compliance in all cases. Failure to achieve it, however inadvertent, provides a basis for plan disqualification and resultant taxation of benefits for all employees.[14]

As an initial matter, the Committee believes that the individualized testing approach is contrary to the language of, and

[14] In the preamble to the Proposed Regulations, the Treasury and the Service have taken the position that, pursuant to Section 402(b)(2), only highly compensated employees will be taxed. As discussed in Section X below, the Committee believes that this position is not authorized by the existing statutory scheme and that any changes in this area should be left to Congressional action.

the intent underlying, Section 401(a)(4),[15] and is an unwarranted deviation from the approach that has been taken to nondiscrimination testing in the past.[16] The statutory language of Section 401(a)(4) prohibits discrimination in favor of "highly compensated employees." It does not prohibit an individual highly compensated employee from having a better accrual or allocation rate than an individual nonhighly compensated employee, as long as the overall distribution of accrual or allocation rates does not discriminate in favor of highly compensated employees as a group.

Moreover, the Committee seriously questions whether the Service or many employers have the resources to monitor such an exacting compliance standard. For employers with sufficient resources, the Proposed Regulations can be applied and it may be possible to demonstrate that compliance has been achieved for a particular plan year. Even for these employers, however, it is almost a certainty, at least in the case of large employers, that the data will not be accurate — normal turnover of employees and changes in employee demographics resulting from acquisitions and divestitures are only some of the reasons this will be the case. Moreover, there can be no certainty that compliance will be achieved in subsequent years.

For these reasons, the Committee does not believe individual-by-individual testing is legally mandated,desirable from a policy standpoint, or justifiable in terms of the expense of compliance.

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[15] When Congress has intended to require individualized testing, it has incorporated explicit statutory language to that effect. See, for example, Sections 401(a)(17), 401(a)(26)(B)(ii)(III), 415, 416(c)(1)(A), and 416(c)(2)(A).

[16] In the past, Section 401(a)(4) has consistently been interpreted as requiring that nondiscrimination be demonstrated by comparing the benefits provided to highly compensated employees as a group against those provided to other employees as a group. For example, the prior versions of Forms 5300 and 5301 required plans that did not provide accrual or allocation rates based on total compensation to demonstrate nondiscrimination by showing the percentage of total compensation taken into account for different compensation brackets.

Accordingly, the Committee urges the Treasury and the Service to make the general test somewhat more flexible by inclusion of one or more of the following approaches.

Proposed Modification of General Rule

Nondiscrimination Test. The Committee strongly believes that the Proposed Regulations should abandon the individual-by-individual approach to testing for discrimination and instead require a comparison of the average accrual or allocation rates between the group of highly compensated employees and the group of nonhighly compensated employees. Such an averaging approach was apparently found workable for other purposes of the Proposed Regulations.[17] The use of averaging to test for discrimination has,

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[17] For example: (1) the alternative safe harbor for flat benefit plans in Proposed Regulation Section 1.401(a)(4)-3(b)(4) permits a plan to satisfy the safe harbor if the average of the normal accrual rates for all nonhighly compensated employees is at least 70% of the average of the normal accrual rates for all highly compensated employees; (2) the safe harbor for defined contribution plans with a uniform allocation formula weighted for age or service in Proposed Regulation Section 1.401(a)(4)-2 (b)(3) would be satisfied if the average of the allocation rates for highly compensated employees in the plan does not exceed the average of the allocation rates for nonhighly compensated employees in the plan; and (3) under Temporary Regulation Section 1.414(s)-lT(d)(2), an alternative definition of compensation may be utilized if the average percentage of total compensation included under the definition for the highly compensated employees as a group does not exceed by more than a de minimis amount the average percentage of compensation included under the definition for the other employees as a group.

In other cases, although the Proposed Regulations do not specifically provide for an averaging approach by group, the applicable standard is expressed essentially in terms of "group versus group" or "individual versus group," and as such is inconsistent with the individualby- individual approach of the general rule. See, for example, Proposed Regulation Section 1.401(a)(4)-10(b)(2)(ii) and (c)(2)(ii) (a plan satisfies Section 401(a)(4) with respect to the amount of benefits and the availability of benefits, rights, and features to former employees if, among other things, at least 60 percent of the former employees to whom the benefits, rights, and features are provided are not highly compensated employees); Proposed Regulation Section 1.401(a)(4)- 9(c)(3) (an aggregated plan that includes one or more defined contribution plans and one or more defined benefit plans will satisfy the current availability requirements relating to non-core benefits, rights and features if each such benefit, right or feature that is currently available to any highly compensated employee under any defined benefit or defined contribution plan included in the aggregated plan is also currently available to a group of employees that satisfies Section 410(b)(l)(B) or 410(b) (2)'(A) (i))r Proposed Regulation Section 1.401(a)(4)-4 (a plan satisfies the requirements relating to the of course, been accepted under Sections 401(k) and 401(m), and is also an important element of the average benefit percentage test for demonstrating satisfaction of the minimum coverage requirements of Section 410(b). Under the Committee's approach, it would only be necessary for the employer to demonstrate that the average benefit accrual or allocation afforded the group of highly compensated plan participants did not exceed the average benefit accrual or allocation for the group of nonhighly compensated employees.

One objection that might be raised against the averaging approach is that, by providing lower benefits for low and middle-level highly compensated employees, the top level of highly compensated employees could be given better benefits than are provided to nonhighly compensated employees without skewing the average benefits in favor of the highly compensated employees as a group. Even if such an approach were practical for an employer from an employee relations standpoint, one may wonder whether there should be any concern with such a result. The purpose of the prohibition against discrimination in favor of highly compensated employees is to ensure that, if a plan benefiting highly compensated employees is to enjoy the benefits of tax qualification, nonhighly compensated employees must also receive a sufficient level of benefits.

There is no obvious reason why the minimum level of benefits for nonhighly compensated employees should vary depending upon how benefits are allocated within the class of highly compensated employees so long as the average benefits for the nonhighly compensated employees are at least as good as the average for the

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availability of optional forms of benefit, ancillary benefits and other rights or features if each such benefit, right or feature satisfies the current and/or effective availability requirements of Regulation Section 1.401(a)-4, which requirements are expressed in terms of the group of employees to whom optional forms of benefits are made available); and Proposed Regulation Section 1.401(a)(4)-5(b) (a plan does not satisfy Section 401(a)(4) if plan provisions, including plan amendments, that provide past service credit have the effect of discriminating significantly in favor of highly compensated employees) and Example 1 under subparagraph (3) thereof.

highly compensated employees. Indeed, the Section 401(k) and 401(m) rules clearly sanction discrimination within the group of highly compensated employees. Moreover, there are other provisions of the Code (notably Sections 415 and 401(a)(17)) that are designed to ensure that an individual highly compensated employee's benefits are appropriately limited.

The Committee does not think that the problems with the individual-by-individual approach under the general test can be solved adequately by restructuring. First, restructuring creates a significant level of complexity, administrative burden, and resulting cost. Second, even after restructuring, the individual-by-individual approach makes it too easy for a plan to inadvertently lose its qualification because of small variations in the benefits or contributions provided to employees.

In summary, the Committee believes that use of a group averaging approach in the general rule would go a long way toward eliminating the arbitrary and potentially inequitable application of the general rule without compromising the basic purpose and policy objectives of Section 401(a)(4).

Statistical Sampling. In light of the administrative burdens and expenses involved in gathering and calculating individual allocation or accrual rates for each participant under some safe harbors and under the general nondiscrimination rules of the Proposed Regulations, the Treasury and the Service should consider less onerous methods by which average accrual or allocation .rates may be compared. In this regard, the Treasury and the Service have specifically requested suggestions regarding statistical sampling in determining employee benefit percentages under the average benefit test described in Section 1.410(b)-5. Since the rules for calculating employee benefit percentages under this section of the Proposed Regulations "are generally the same as the rules used for calculating allocation and accrual rates under an aggregated plan under section 401(a)(4)" (Preamble to the Proposed Regulations), statistical sampling should be considered with respect to determining allocation and accrual rates for Section 401(a)(4) purposes. This is especially true for a large employer, whose workforce may provide a sufficient population for statistical sampling to be useful. Statistical sampling would allow a large employer to test for discrimination in benefit accruals or allocation rates in a meaningful manner and alleviate the burdens associated with gathering data for each employee and making the appropriate calculations.

De Minimis Rule. As drafted, the general nondiscrimination rules for benefit accruals and contributions involve an unacceptable level of risk for most plans not falling within a safe harbor because the accrual or allocation rate of any one participant could disqualify the plan. In testing for other qualification requirements, such as coverage under Section 410(b), nondiscrimination for elective deferrals under Section 401(k) and for matching and employee contributions under Section 401(m), isolated results with respect to a single individual will not in and of themselves be dispositive of the plan's qualification. To alleviate this result, the Treasury and the Service should consider including a de minimis exception to the general nondiscrimination test, especially if the individual-byindividual approach of the Proposed Regulations is retained. Under such an exception, an employer whose participants' accrual or allocation rates fell within a certain range of the target level could be deemed to have satisfied the Section 401(a)(4) requirements; a de minimis exception would allow plans to pass the Section 401(a)(4) nondiscrimination requirements based on an acceptable degree of accrual or 18 allocation rate equivalence, rather than absolute equality.[18]

Retroactive Correction. The testing requirements under the Proposed Regulations for plans other than those which utilize the purely design-based safe harbors will, for most employers, be performed at the end of the plan year, or, at most, on a quarterly basis (in connection with Section 410(b) testing). In order that the Section 401(a)(4) requirements be used constructively to ensure compliance by employers rather than solely as a method of disqualifying previously qualified plans, the Treasury and the Service should consider providing for a retroactive correction period in the case of inadvertent failures to satisfy the general rule.

The Committee believes that such a correction device should take the form of cutting back accruals or allocations for particular highly compensated employees, especially if the individual-by-individual approach of the general rule is retained, inasmuch as the costs, as well as the ongoing administrative complexities "and related employee communications burdens, of "topping up" nonhighly compensated employees to the level of the highly compensated employee with the greatest allocation or accrual rate are likely to be substantial.

The Committee believes that any such retroactive corrective device should expressly provide for relief from Section 411(d)(6). For example, the Treasury and the service could expressly permit inclusion of a plan provision which makes accruals for all highly compensated employees subject to limitation to the extent necessary

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[18] The Committee believes that the range of permissible accrual or allocation rates under any such de minimis rule should be wider than the ranges presently provided in the "grouping rules of Proposed Regulation Sections 1.401 (a) (4)-2(c)(5) and 1.401(a)(4)-3(c)(3)(v). If the proposed "group averaging" approach were adopted (rather than the "individual-by-individual" approach), the permissible range could be somewhat narrower.

to achieve compliance with Section 401(a)(4). In this way, the potential limitation on benefits of affected highly compensated employees would be no different than that which results from a cutback due to the application of Section 1.401(a)(4)- 5(c)(2) of the Proposed Regulations. If such an approach were expressly permitted, any problems under Section 411(d)(6) would seem to be avoided. If, on the other hand, the "group averaging" approach were adopted, any breakdown in employers' testing methods, or unanticipated testing results for particular highly compensated participants, would be less likely to have substantial financial consequences. Accordingly, it would appear more appropriate in such event - to remedy any failure of the general rule, by mandating increased accruals or contributions for nonhighly compensated employees rather than providing a cutback for highly compensated employees.

Appropriateness of Requiring Calculation of Normal and Most Valuable Rates. To establish that a defined benefit plan meets the general test for nondiscrimination under Section 1.401(a)(4)-3(c), testing must be done on both a normal retirement benefit basis and on a most valuable benefit basis. Many employers will incur significant additional expense to comply with these rules — with little substantive policy rationale underlying the dual testing requirement.

Because, in the Committee's view, the principal objection to this approach is its double level of testing, eliminating either the normal accrual rate or most valuable accrual rate testing would be equally effective in addressing this problem. The Preamble to the Proposed Regulations makes clear that the principal purpose of testing most valuable accrual rates is to ensure nondiscrimination in the context of early retirement subsidies and joint and survivor annuities. Each of these benefits is protected under Section 411(d)(6), and the Committee believes that there is already an adequate mechanism in Section 1.401(a)(4)-4 of the Proposed

Regulations to ensure-nondiscrimination with respect to these subsidized benefits. Subjecting early retirement and joint and survivor subsidies to the current and effective availability requirements of Section 1.401(a) (4)-4 would, in the Committee's view, obviate in most cases the need for separate testing on the basis of most valuable accrual rates, and provide a more administrable, and generally as effective, method of testing early retirement and joint and survivor subsidies. (The methodology of such testing is further explained in Section IV hereof.) Accordingly, the Committee proposes the elimination of the dual testing requirement by limiting testing to normal accrual rates.

Limitations on Restructuring Techniques. Under Sections 1.401(a)(4)-9(d)(2)(i)(B) and (C), a plan may be restructured into component plans using either employee groups or a total rate or rate segment method. These component plans are then tested under the general nondiscrimination rules of Section 1.401(a)(4)-3(c).

Prior to the issuance of the Proposed Regulations, representatives of the Service had suggested that plans could be restructured into component plans on the basis of normal accrual rates and separately restructured on the basis of most valuable accrual rates. Only normal benefits would be tested vis-a-vis the first set of restructured plans and only most valuable benefits vis-a-vis the second set. Sections 1.401(a)(4)-9(d)(2)(i)(B) and (C) of the Proposed Regulations, however, require that a plan be restructured into component plans based on normal accrual rates only. In accordance with Section 1.401(a)(4)-9(d)(3), when these component plans are tested under the general nondiscrimination rules of Section 1.401(a)(4)-3(c), both the normal and the most valuable benefit accrual rates must be tested.

This methodology, if intended, would severely restrict the usefulness of plan restructuring under Section 1.401(a)(4)-3(c). The following example highlights the problem with this methodology:

A plan contains a uniform formula and retirement age and provides a subsidized early retirement benefit. The plan is restructured under the rate segment method based on employees' normal accrual rates. Employees A-Z have a normal accrual rate of 2.0 and are treated as comprising a component plan for testing purposes. Employee A is a highly compensated employee and is age 55. Employees B-Y are nonhighly compensated employees and are also age 55. Employees A-Y have a most valuable accrual rate of.2.5 on account of the early retirement subsidy. Employee Z is a nonhighly compensated employee and is age 65. Because the early retirement subsidy is no longer available to Employee Z, his most valuable accrual rate is equal to his normal accrual rate of 2.0. This component plan (and therefore the plan as a whole) will fail to satisfy the general test of Proposed Regulation Section 1.401(a)(4)-3(c), since a single highly compensated employee has a more valuable accrual rate than a nonhighly compensated employee.

The Committee believes that the problem illustrated in the foregoing example can be adequately addressed in one of two ways. First, by utilizing a group averaging approach with an appropriate de.minimis rule, it is likely (although perhaps not certain) that any variance in most valuable accrual rates will not adversely affect the plan's overall ability to pass Section 401(a)(4)'s nondiscrimination requirement. A preferable approach is to test subsidized early retirement benefits under the standards set forth in Section 1.401(a)(4)-4 rather than under the general rule (as suggested above and in Section IV below), thereby avoiding the added costs and complexities associated with restructuring while at the same time providing adequate protection against clearly abusive situations.

IV.
Section 1.401(a)(4)-4:
Nondiscriminatory Availability
of Benefits, Rights, and Features

The Committee believes there are various nondiscrimination concerns that can be better addressed in the Section 1.40l(a)(4)-4 rules on nondiscriminatory availability of benefits, rights, and features than in the nondiscriminatory contributions and benefit provisions of Sections 1.401(a)(4)-2 and -3. In particular, the Committee recommends that testing of most valuable accrual rates be substantially revised utilizing Section 1.401(a)(4)-4 concepts as opposed to those presently contained in Section 1.401(a)(4)-3. As to other benefits, rights and features, the Committee generally concurs with the Proposed Regulations' conclusion that significant benefits, rights, and features should be provided on a nondiscriminatory basis under Section 401(a)(4). The Committee is of the view, however, that the rules with respect to the availability of ancillary benefits and other rights and features should be liberalized, as further described below.[19]

[19] In addition, as discussed in Section IX below, the special rules for acquisitions, mergers, and similar transactions should be modified significantly so as to operate more consistently with Section 410(b)(6)(C), and in various other technical ways.

Testing the Most Valuable Accrual Rates

As previously stated, the Committee opposes the dual testing approach set forth in Section 1.401(a) (4)-3. In the Committee's view, those quantitative rules should properly focus on normal accrual rates, and testing of the most valuable accrual rates should, to the fullest extent possible, utilize existing current and effective availability testing mechanisms contained in Section 1.401 (a) -4.

These tests are most appropriate because:

I. Most valuable accruals are essentially produced by two plan features — either a subsidized early retirement benefit or a subsidized joint and survivor annuity feature;

II. Both of these features, like optional forms of benefit, are already protected under Section 411 (d)(6);

III. Both of these features, as Section 1.401(a) (4)-4 is currently drafted, constitute "other rights and features" and as such must be tested under the current and effective availability rules of Section 1.401 (a) -4. There is no need' to subject these features to further testing under Section 1.401(a) (4) -3;

IV. Testing of plans with common retirement subsidies would be vastly simplified with no apparent risk of abuse. Expensive and needless restructuring and testing would thus be avoided; and

V. If plans being tested did not contain common subsidies, testing could still be simplified. First, the most valuable accrual rate under a plan could be developed. Such accrual rate might, for example, be based upon the earliest age at which a plan participant could retire with a subsidized early retirement benefit. Then the most valuable accrual rate would be tested under the current and effective availability tests to determine whether it was being offered on a nondiscriminatory basis.

The advantages of this approach are clear. First, plans could avoid the difficult and time-consuming process of gathering data on every plan participant's most valuable accrual rate. In the Committee's view, the benefits of producing such information are not commensurate with the onus imposed on employers, particularly when a simpler method is available. Second, adoption of this approach facilitates the objective of promoting design-based compliance where possible. Plans with a common set of early retirement subsidies should be able to assume with reasonable certainty that they will pass the current and effective availability tests. Third, this approach takes advantage of existing rules rather than adding another level of complexity onto an already difficult compliance process.

The Committee strongly feels that a principal flaw in the current approach of the Proposed Regulations is their complex and burdensome compliance testing mechanism. We urge that rather than liberalize and promote further the ability to engage in multiple plan restructurings to achieve compliance with the nondiscrimination rules, approaches such as the one outlined above, which simplify plan administration, should be adopted.

General Rules

The Proposed Regulations treat ancillary benefits and other rights and features in the same manner as optional forms of benefit by incorporating the current availability requirement of Q&A-2(a)(2) of Section 1.401(a)-4 of the regulations, and the effective availability requirement of Q&A-2(a)(3) of Section 1.401(a)-4 of the regulations. As an initial matter, the Committee urges that the Proposed Regulations provide more precise definitions of "ancillary benefits" and "other rights and features." In particular, only those benefits specifically described as ancillary benefits should fall within the definition of that term, and therefore the word "includes" should be changed to "means" and the phrase "and other similar benefits" should be eliminated. The Committee also urges that the term "other right or feature" be limited as much as possible to provide certainty and to avoid risk of inadvertent disqualification of a plan.

More fundamentally, however, the Committee believes that most ancillary benefits and other rights and features should be treated differently from optional forms of benefit.

Our basis for this view is two-fold:

(i) Optional forms of benefit are protected by the provisions of Section 411(d)(6), and therefore Congress has evidenced the intent to protect those benefits, whereas ancillary benefits and other rights and features are not so protected.

(ii) The negative consequences of a failure to provide such ancillary benefits and other rights and features on a nondiscriminatory basis are severe, and are out of proportion to the positive effect of making these benefits, rights and features available to plan participants on a nondiscriminatory basis.

The principal defect of the Proposed Regulations in this area, in the view of the Committee, is the requirement that all ancillary benefits and other rights and features be subject to the effective availability requirement of the Section 1.401(a)-4 regulations. The Committee agrees that optional forms of benefit and early retirement and joint and survivor subsidies, all of which are protected by Section 411(d)(6), should be both currently and effectively available. If, however, the effective availability requirement is imposed on ancillary benefits and other rights and features, failure to utilize certain plan features by nonhighly compensated employees may disqualify the plan. For example, if the plan offers an aggressive equity fund as one of its investment options, and highly compensated employees select such investment option but no nonhighly compensated employees select that alternative, such benefit may not be effectively available. See, for example, Q&A-2(a)(3), Example 2, of Section 1.401(a)-4. In other words, imposition of an effective availability test will mean that it is not enough for an employer to offer a benefit feature on a nondiscriminatory basis; it must, in essence, be utilized on such a basis. The resulting lack of certainty will present a severe hardship to employers.

The Committee believes that compliance in this area can and should be design-based and, accordingly, proposes that most such benefits, rights, and features be tested solely under the current availability requirement of Q&A- 2(a)(2)(ii) of Section 1.401(a)-4 of the regulations without application of the exception for age and service conditions contained in Q&A-2(b)(1)(ii)(A). The sole exception to this proposal, in the Committee's view, should be ancillary benefits and other rights and features that are inherently age or service related (such as the social security supplement involved in Example 2 of Section 1.401(a)(4)- 5(a)(2) of the Proposed Regulations). The Committee recommends that such benefits also be subjected to the effective availability requirements of Section 1.401(a)-4 Q&A-2(a)(3) of the regulations in the same manner as optional forms of benefit.[20]

In addition, the Committee questions whether it is necessary for certain rights and features which are otherwise sufficiently regulated or which are essentially insignificant to be subjected to further testing under these regulations. For example, the protection of plan loans (an "other right or feature" under Section 1.401(a)(4)-4(f)(2)(i)) seems unnecessary in light of existing statutory requirements under Sections 401(a)(13) and 4975(d)(1).[21] Similarly, the regulations under Sections 401(k) and (m) already adequately protect the rights and features enumerated in Section 1.401(a)(4)-4(f)(2)(v), (vi), and (vii). Moreover, the right to make rollover contributions is a right which may easily be duplicated by a plan participant outside the plan by utilizing an individual retirement account, and therefore

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[20] To the extent that the current regulations may not be broad enough to take into account, for purposes of effective availability testing, the amendment of a plan causing the elimination of a form of benefit, the Committee recommends that they be broadened to cover that situation. The Committee believes this would obviate the need for the special rules on plan amendments contained in Section 1.401(a)(4)-5 of the Proposed Regulations (see Section V of this Report).

With respect to current availability testing, the exception for age and service conditions set forth in Q&A-2(b)(1)(ii)(A) should remain applicable with respect to benefits, rights, and features that are inherently age or service related.

[21] An attempt to circumvent those statutory requirements through the establishment of separate plans would be prevented in many instances by the minimum participation requirements of Section 401(a)(26).

need not be afforded special protection under the regulations.

To summarize, the Committee proposes that the following provisions govern the testing of ancillary benefits and other rights and features:

1. Section 411(d)(6) protected features and certain non-protected features (those that are inherently age or service related, such as a social security supplement) would be tested under both the current and effective availability rules of Section 1.401(a)(4)-4.

2. All other benefits, rights, and features, unless covered by (3) below, would be subject only to current availability testing, but for this purpose age or service eligibility requirements would not be permitted to be disregarded.

3. Benefits, rights, and features which are sufficiently regulated elsewhere or which are insignificant would simply not be tested under Section 401(a)(4).

V.

Section 1.401(a)(4)-5:
Plan Amendments, Past Service Credit,
and Pre-Termination Restrictions

General Recommendations Regarding Plan Amendments and Past Service Credit

The Committee recommends the elimination of the special discrimination rules relating to plan amendments and the granting of past service credit, which, in the Committee's view, unnecessarily compound the regulations' complexity without appreciably advancing the purposes of Section 401(a)(4).

As an initial matter, the Committee questions the theoretical underpinning of the proposed rules, under which discrimination in favor of active highly compensated employees is tested by examining hypothetical benefits to former nonhighly compensated employees.[22] This "apples and oranges" comparison runs counter to the general requirement of Section 1.401(a)(4)-l(c)(3) that current and former employees be tested separately, and deviates from the general scheme of the Section 401(a)(4) rules, which (in contrast to Section 410(b)) tests discrimination without reference to

[22] In the context of past service credit, for example, the Proposed Regulations would place primary weight on whether former employees would have benefited under a plan had it been in place throughout the period to which the past service credit applies. Similarly, the proposed rules on plan amendments treat as a relevant factor the turnover of employees prior to the plan amendment.

individuals ineligible to participate. A comparison of current employees in the Section 401(a)(4) prohibited group with former employees outside that group was never thought to be necessary to ensure nondiscrimination in the past, and nothing in the legislative history of Section 401(a)(4) evidences an intent to introduce this additional layer of discrimination testing.[23]

Apart from this conceptual issue, the Committee is concerned that the proposed rules present an additional impediment that will cause employers to refrain from extending qualified plan benefits to employees in situations that are clearly nonabusive. For example, in the early stage of the life cycle of many companies, financial circumstances simply preclude the creation of a qualified retirement plan. The proposed rules would apparently prevent such a company from later creating a pension plan that granted full past service credit if there had been significant turnover among nonhighly compensated employees, even though the same formula

[23] The Committee recognizes the need to test for discrimination in favor of former highly compensated employees in cases where such former employees accrue additional benefits. This subject is addressed in Section 1.401(a)(4)-10 of the Proposed Regulations (discussed in Section VII of this Report). With the exception of the provisions dealing with plan amendments and prior service credit, the Proposed Regulations properly compare such former employees to former nonhighly compensated employees (see Sections 1.401(a)(4)-1(c)(3) and 1.401(a)(4)-10).

and service credit rules under the plan were extended to all then active employees.

The Committee has an additional concern that because the determination under the proposed rules is based on facts and circumstances, employers will be unable to reach definitive conclusions as to the status of any given amendment or granting of past service credit. The chilling effect that is likely to result will discourage the adoption of amendments or the granting of prior service credit in excess of five years where there is even a remote chance of being found in violation of the Proposed Regulations — even though the amendment may in fact principally benefit nonhighly compensated employees. Moreover, analyzing the way in which former employees hypothetically might have been affected by a plan or a plan provision in many cases will be an extraordinarily complex exercise necessitating access to data that are not readily available — particularly if mergers and acquisitions have occurred during the period being analyzed.

In the face of the serious theoretical, practical, and policy concerns raised by the proposed rules, and the tension which they create with the underlying goal of achieving simplicity, the Committee believes (in line with the underlying philosophy articulated in the introduction to this Report) that the added complexity of these rules cannot be justified unless they materially advance the statute's objectives. In this regard, the Committee believes that the ten-year phase-in rules of Section 415(b)(5) already foreclose the most serious situations that are the target of the plan amendment and prior service credit provisions of the Proposed Regulations. It appears likely, for instance, that the abuse contemplated in Example 1 of Section 1.401(a)- 5(a)(2) of the Proposed Regulations would be largely curbed by the limitations on additional accruals attributable to plan amendments set forth in Section 415(b)(5)(D). As noted previously, the Committee also feels that the effective availability rules under Section 1.401(a)-4 of the regulations provide the appropriate framework for addressing certain types of amendments that could be tested for nondiscrimination in availability of benefits, rights, and features under Section 1.401(a)(4)-4 of the Proposed Regulations.

It is the Committee's view that the benefits to be derived from the rules on plan amendments and past service credit are insubstantial in comparison to their costs, and the Committee urges that they be eliminated. Simply stated, the Committee believes that discrimination should be tested on the basis of an entire plan as it exists from time to time, and not by analyzing a plan amendment in isolation.

Other Comments Regarding Plan
Amendments and Past Service Credit

The following additional comments on sections 1.401(a)(4)-5(a) and (fa) of the Proposed Regulations are relevant only if the Treasury and the Service do not adopt the recommendation to eliminate totally the special rules relating to plan amendments and grants of past service credit.

Plan Amendment Rules. The regulations should set forth a general rule that a plan amendment does not violate Section 401(a)(4) if the plan as a whole satisfies that section after the amendment, unless unusual facts and circumstances exist in connection with the amendment. To illustrate, consider a plan which satisfies the nondiscrimination requirements by favoring nonhighly compensated employees, and which is subsequently amended to eliminate any prior distinctions in the plan between the two groups by improving benefits for highly compensated employees. After the amendment, the plan also passes all provisions of the regulations other than Section 1.401(a)(4)-5. By definition, the amendment favors the highly compensated employees but not in a manner that causes the plan as a whole to fail to comply with the regulations after the amendment. There is no reason to test that amendment separately.

With regard to Example 1 of Section 1.40l(a)(4)- 5(a)(2), the Committee agrees that an employer should not be able to increase benefits to highly compensated employees within a highly compressed time frame between the termination of employment of all or substantially all of its nonhighly compensated employees and the termination of the plan. However, it would seem that Section 1.40i(a)(5)-5(c)(2), which provides that in the event of a plan termination, the benefit of any highly compensated employee must be limited to a benefit that is nondiscriminatory, could be interpreted to preclude such a result independently. If, in Example 1, the employer had continued its business without nonhighly compensated employees for some significant period of time, the Committee presumes that the conclusion in the example would be different.

With respect to Example 2 of Section 1.401(a)(4)- 5(a)(2), the situation would already appear to be subject to testing under the current and effective availability requirements of Section 1.401(a)(4)-4 of the Proposed Regulations, since the social security supplement is an ancillary benefit.[24] There is no reason why it should be subjected to additional testing under the plan amendment provisions.

The Proposed Regulations state that whether a plan amendment discriminates in favor of highly compensated employees is determined on the basis of all relevant facts and circumstances. Although various relevant factors are enumerated, the rules provide no guidance as to how these factors are to be taken into account. Contrary to the statement in the Preamble, the Committee believes

[24] As discussed in footnote 19 above, the Committee recommends that the effective availability rules be clarified, if necessary, to provide that an amendment reducing or eliminating a benefit, right, or feature to which the effective availability requirements apply could be taken into account for purposes of effective availability testing.

that if separate testing of plan amendments (including provisions providing past service credit) is retained, it is imperative for employers to have meaningful guidance regarding application of the relevant concepts. Such guidance would, in the Committee's view, minimize rather than exacerbate administrative complexity.

Past Service Credit. Additional guidance is needed as to the meaning of "discriminating significantly," the standard set forth in Section 1.401(a)(4)-5(b). In Example 3, which provides the only concrete illustration of significant discrimination, the average past service for highly compensated employees is 3-1/3 tines that of nonhighly compensated employees. Additional examples with a smaller differential would be useful, as would a specific acknowledgment that the average length of past service of the two groups is an appropriate means of measuring the significance of the past service credit. In addition, it would be helpful to include a rule establishing a safe-harbor level of disparity in average length of service (for example, a safe harbor allowing an average length of service for highly compensated employees equal to 150 percent of the average for nonhighly compensated employees, or the nonhighly compensated average plus five years).

It would also be useful if additional language were added to explain the relationship between Example 6 and the special rules for mergers and acquisitions in Section 1.401(a)(4)-4(c) and Section 410(b)(6)(C). In this connection, the Proposed Regulations on past service should contain more guidance on the common practice of a buyer granting past service credit under its plan for service credited under seller's plan. As indicated earlier in this Section, to the extent the buyer's plan passes the general standards of Section 401(a)(4) after the amendment (including a transition period which should be permitted to conform to Congressional intent as reflected in Section 410(b)(6)(C)), there is no reason to subject that past service credit itself to a separate test.

Specific comments on the examples in Section 1.401(a)(4)-5(b)(3) follow.

<u>Example 1</u>

Current employees with prior service are described as being "primarily" highly compensated employees. The example should clarify whether that term means simply a majority, or a percentage in excess of some higher threshold.

It would be helpful to have a second example similar to Example 1, but with nonhighly compensated employees constituting a majority of active employees, and with the conclusion that in these circumstances the amendment would not discriminate significantly in favor of highly compensated employees.

The example should focus more specifically on what is meant by a “significant” number of former employees who are not highly compensated as compared to former employees who are highly compensated.

With respect to former employees, the example should clarify that only former employees who became participants in the plan are to be taken into account. In addition, weight should be given to whether any increase in benefits with respect to the past service credit would have been vested based on the former participant's length of service in the plan.

<u>Example 2</u>

While equivalency in past service between highly and nonhighly compensated employees is clearly nondiscriminatory, some differences must be permissible since only "significant" discrimination is prohibited. Additional examples showing a less than equivalent, but still acceptable, past service for the two groups should be added.

Example 3

Additional examples with less extreme degrees of disparity between the past service levels of the two groups would be helpful to give more effective guidance as to the scope of the term "significant."

Example 5

Prior employment of a nonhighly compensated employee who never satisfied the plan's eligibility criteria, or who became a participant but terminated without any vested benefit, should not be relevant and should not affect the conclusion of the example. Furthermore, a small number (relative to the current workforce) of former nonhighly compensated participants who left with some vested benefits should not cause the past service credit to be treated as significantly discriminating in favor of highly compensated employees.

The regulations should also clarify the effect of former highly compensated employees who terminated employment with a vested benefit and who do not benefit from the granting of the past service credit.

Example 6

The granting of past service credit to employees of Division B is tested by the level of past service credit available to the other employees under the plan maintained by Employer Y.

The example should clarify that the composition of Employer Z's workforce is not relevant to the result (i.e., the granting of past service credit would not discriminate significantly in favor of highly compensated employees even if all of Employer Z's employees were highly compensated).[25]

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[25] The Committee questions the consistency of the Proposed Regulations as presently drafted. For example, there is no reason for the result in Example 6 to be any different than if Division B had always been part of the controlled group of the buyer (Employer Y), but had never been included in Employer Y's plan. Specifically, if Employer Y amended its plan to include Division B employees and granted them past service credit to 1971, there appears to be no reason to test that amendment separately. However, under the Proposed Regulations as presently drafted, such an amendment might be impermissible if Division B's workforce tended to be highly compensated. As stated in the text above, the Committee believes that the appropriate mode of analysis is merely to test Employer Y's plan both before and after the amendment without regard to the fact that the amendment itself favors highly compensated employees.

Pre-Termination Restrictions

The Committee supports the inclusion in the regulations of Section 1.401(a)(4)-5(c)(2), which limits the benefit of any highly compensated employee or former employee, in the event of plan termination/ to a nondiscriminatory benefit. This provision avoids a potential conflict between the need to cut back discriminatory benefits if a plan terminates, and the prohibition against plan cutbacks under Section 411(d)(6). In addition, as noted previously, the Committee believes this provision will help to insure against abuses of the type described in Example 1 of Section 1.401(a)(4)-5(a)(2) of the Proposed Regulations (relating to an amendment increasing plan benefits after all nonhighly compensated employees have terminated employment and shortly before the plan is terminated).

The Committee believes, however, that the Proposed Regulations should clarify that these rules replace the existing "high-25" rule, and should provide additional guidance as to the permitted use of security and refunding arrangements agreed to by the restricted employee.

VI.
Section 1.401(a)(4)-9:
Plan Aggregation and Restructuring

Plan Aggregation

Core Benefits. In determining whether an aggregated plan that includes both defined benefit and defined contribution plans satisfies the requirements of Section 401(a)(4) with respect to the availability of benefits, rights, and features, only what the Preamble refers to as a "limited" group of core benefits, rights and features must satisfy the general availability .test applicable to single plans. Other benefits, rights, and features may satisfy the current availability requirements under the liberalized rules set forth in Section 1.401(a)(4)-9(c)(3)(i)(A).[26]

The Preamble states that this rule is designed to avoid requiring an employer to offer benefits, rights, or features characteristic of one type of plan and difficult to provide under the other type in order to satisfy Section 401(a)(4). Because the list of core benefits, rights, and features consists largely of items associated with defined contribution or defined benefit

[26] It is not clear to the Committee whether, in addition to the current availability test, these benefits, rights, and features are also subject to effective availability testing. Clarification of this point would be helpful.

plans but not with both,[27] this portion of the Proposed Regulations does not appear to achieve its objective. For example, the rule would apparently require lump sum options to be incorporated into defined benefit plans if such plans were to be aggregated with defined contribution plans with a single sum form of payout. Moreover, in the case of employees leaving before retirement age, such lump sum payments would have to be offered at the time of termination of employment.[28] In terms of the goals of the private pension system, the Committee questions the wisdom of requiring such a result. In the Committee's view, the establishment of a new category of "core benefits" adds complexity to the regulations that does not appear to be justified in terms of the incremental

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[27] For example, defined benefit plans generally do not offer loans, may not offer in-service withdrawals of employer contributions and quite often do not provide a lump-sum option, while social security supplements, disability benefits, and shut-down benefits would rarely be found in a defined contribution plan. The fact that Section 411(d)(6) precludes the elimination of an in-service withdrawal right could render it impossible for a defined contribution plan with such a feature and a defined benefit plan to satisfy Section 401(a)(4) on an aggregated basis under these rules.

[28] Because of Section 411(d)(6) prohibitions, the problem could not be remedied by requiring that distribution of the defined contribution plan benefit be deferred to the participant's early or normal retirement date.

benefit derived.[29] Accordingly, the Committee recommends the elimination of this category and the extension of the special availability rules of Section 1.401(a)(4)-9(c)(3)(i) to all benefits, rights, and features that are otherwise subject to testing under Section 1.401(a)(4)-4.[30]

Aggregation of 401(k) and (m) Plans. Under the Section 410(b) proposed regulations, a plan subject to the provisions of Section 401(k) could be subject to mandatory disaggregation if, for example, the plan covered both union and nonunion employees. It would be helpful for the Proposed Regulations to clarify that the aggregation of the component plans is permissible for purposes of Section 401(k) and Section 1.401(a)(4)-2(d), even though not permitted for Section 410(b) purposes.[31] Similar clarification is needed with respect to plans subject to Section 401(m).

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[29] If the concept of core benefits is preserved in the regulations, the term "include" in Section 1.401(a)(4)- 9(c)(3)(b)(ii)(A) should be replaced by "means." it is unclear in the present definition whether items other than those enumerated in the regulation could be considered as "core benefits."

[30] See Section IV of this Report, which recommends modification of testing with respect to the availability of certain benefits, rights, and features.

[31] See Sections 1.401(a)(4)-9(c)(l), 1.401(a)(4)- 2(d)(4), and 1.401(k)-l(b)(5)(i).

Restructuring

The committee supports the general concept of restructuring articulated in the Proposed Regulations, and views the concept as quite helpful in enabling plans which cannot otherwise satisfy the general nondiscrimination requirements to attempt to do so. However/ in the Committee's view, the Proposed Regulations should not overemphasize the use of restructuring as a panacea for otherwise burdensome and overly complex requirements. Rather, the Committee believes that the emphasis of the Proposed Regulations should be to simplify, where possible, the process of demonstrating compliance with the nondiscrimination rules without the need to resort to restructuring.

With respect to the restructuring rules themselves, Section 1.401(a)(4)-9(d) provides that plans may be restructured using three different methods: employee groups, total rates, and rate segments. While the regulations give examples of the total rates and rate segments methods, no example is given for the employee groups method and it is unclear whether any limitations apply to the manner in which the employee groups may be defined.[32] Under Section 1.401(a)(4)-9(d)(2)(ii), a plan may only use the employee group, total rate, or rate segment method for any one plan year. This rule seems unduly restrictive. It is not clear to the Committee, for example, why an employer should be prevented from applying the total rate or rate segment method to a component plan that results from plan restructuring under the employee group method.

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[32] The Committee recognizes that if a component plan is unable to satisfy the percentage-ratio test, the classification used in defining the employee group would have to qualify as a "reasonable classification" under Section 410(b).

VII.
Section 1.401(a)(4)-10:
Testing of Former Employees

The Proposed Regulations generally provide that the requirements of Section 401(a)(4) apply separately to employees and to former employees. The comments below relating to the examination of the amount of contributions or benefits[33] provided to former employees also apply to the examination of availability of benefits, rights, and features offered to former employees.

The fact that employees usually retire when they are earning the highest rate of compensation in their careers may skew the percentage of former employees who are deemed to be highly compensated employees. Under Section 414(q)(9), a former employee will be treated as highly compensated if the employee was highly compensated at the time of separation from service or at any time after attaining age 55. For purposes of the Proposed Regulations, an employee who meets the Section 414(q)(9) definition will always be treated as a highly compensated former employee for purposes of

[33] Section 415 would, it appears, generally prohibit defined contribution plans from receiving additional contributions on behalf of former employees. The Committee also seriously question* whether any additional accruals to a defined benefit plan's former employees (with the possible exception of. cost-of-living adjustments for retirees) would be permissible under Section 415(b)(5).

Section 401(a)(4). This is true even though the employee was not highly compensated for most of his or her career. Accordingly, an inordinately high percentage of former employees could be highly compensated in many cases.

The Committee believes that the existing special rule should be expanded to address this skewing of former employees toward the highly compensated category. The special rule contained in Section 1.401(a)(4)-10(b)(2)(ii) of the Proposed Regulations would currently exempt benefits provided to former employees if the formula under which the benefits are provided does not by its terms favor highly compensated employees[34] or highly compensated former employees, the benefit is currently provided to at least five former employees, and at least 60% of the former employees to whom the benefit is currently provided are not highly compensated former employees. The Committee suggests that this rule be expanded by incorporating, as an alternative to the 60% requirement noted above, a provision of the type currently set forth in Section 1.401(a)(26)-4(c)(1), namely, that the benefit be currently provided to at least 95% of the former employees.

[34] The Committee questions the relevance of the condition in the safe harbor requiring that a formula by its terns not favor highly compensated current employees, since those employees are tested separately from former employees under the Proposed Regulations, and accordingly are not otherwise considered for purposes of Section 1.40l(a)(4)-10.

VIII.
Section 1.401(a)(4)-11(c):
Vesting Provisions

Section 1.401(a)(4)-ll(c) of the Proposed Regulations sets forth two principles: (i) that a plan will not pass the general nondiscrimination rule contained in Section l.401(a)(4)-l(b)(2) if the manner in which employees vest in their accrued benefits discriminates in favor of highly compensated employees; and (ii) that when two or more plans are aggregated for testing purposes and treated as a single plan, the 5-year cliff and the 3-to-7 year graded vesting schedules prescribed in Section 411(a)(2) will be deemed equivalent and the top-heavy 3-year cliff and 2-to-6 year graded vesting schedules prescribed in Section 416(b) will be deemed equivalent. In both instances, the difference in vesting schedules will not cause the plans to fail to satisfy Section 401(a)(4).

In Revenue Procedure 89-29, the Service has taken the position that for purposes of issuing an advance determination letter as to whether a plan's vesting schedule is sufficiently rapid, a plan that satisfies the minimum vesting schedules under Section 411(a)(2) (or, in the case of a top-heavy plan, the requirements of Section 416(b)) will be deemed sufficiently rapid unless there has been a pattern of abuse or actual misuse in the operation of the plan. For plan years beginning after 1988, Revenue Procedure 89-29 supersedes Revenue Procedure 75-49, which set forth elaborate tests (the "key employee" and "turnover" tests) to determine under certain circumstances whether a plan was required to contain a more rapid vesting schedule than would otherwise be required, in order to alleviate actual or potential discrimination in favor of the prohibited group.

The Proposed Regulations also state that the determination of whether the general nondiscrimination rule is satisfied is to be made after taking into account "any relevant provisions of Sections

401(a)(5)(E), 411(d)(l), 411(d)(2), and 411(e)." The most significant of these provisions is Section 401(a)(5)(E), which provides generally that when two or more plans of an employer are combined for testing purposes, differences in rates of vesting under these plans will not be per se discriminatory if, in the case of a defined contribution plan, contributions bear a uniform relationship to compensation, and in the case of a defined benefit plan, benefits satisfy the requirements of Treasury Regulations to account for differences in vesting rates.

Heretofore, there have been no regulations on the subject of adjustments to benefits in defined benefit plans to account for differences in vesting schedules between highly compensated and nonhighly compensated employees. The Service's current position on this subject is contained in Revenue Ruling 74-166, on which the Treasury and the Service have solicited comments in the Preamble to the Proposed Regulations.

Revenue Ruling 74-166 provides two acceptable methods for adjusting the value of benefits under two or more plans to reflect differences in vesting when those plans are treated as a single plan for testing purposes. Under both methods, the vested percentage of accrued benefits for each year of plan participation is averaged for each participant over a 25-year period. The value of benefits for each participant (expressed as a percentage of compensation) is then compared after having increased such benefits (under one method, solely for highly compensated participants in the plan with more rapid vesting, and under the other method for all participants) by an adjustment factor reflecting 50 percent of the difference in average vesting percentages.

Committee Recommendations

Prior to ERISA, vesting schedules could range from immediate vesting to vesting at age 65 (or normal retirement age). Indeed, after the enactment of ERISA but prior to the Tax Reform Act of 1986, vesting schedules could range from immediate vesting to full vesting after 10 or 15 years, depending upon the particular vesting schedule chosen. It was much more appropriate under those circumstances for the Service to adopt guidelines of the type set forth in Revenue Procedure 75-49 (for advance determination letter purposes) and in Revenue Ruling 74-166 to ameliorate the potential for prohibited discrimination created by a single vesting schedule or, in the case of plan aggregation, by different vesting schedules. Under current law, however, participants must become fully vested after no more than five years (if cliff vesting is utilized) or after seven years (if ratable vesting is utilized), thereby substantially minimizing the opportunity for abuse. Indeed, in many cases plans provide vesting schedules which are more liberal than the statutory minimums. Accordingly, differences (if any) in the annual rates of vesting between highly compensated employees and nonhighly compensated employees will be much smaller under current law than under previous rules.

In view of these statutory developments, and in keeping with the goals of simplification and ease of administration, the Committee believes that the standard set forth for ruling purposes in Revenue Procedure 89-29 should be specifically included in the Proposed Regulations (i.e., in the absence of a pattern of abuse or actual misuse in its operation, a plan which otherwise satisfies the general nondiscrimination rule contained in Section 1.401(a)(4)- l(b)(2) will not fail to satisfy such rule if such plan contains a vesting schedule which satisfies section 4ll(a)(2) or 416(b), as applicable).[35]

For the same reasons, the Committee believes the additional administrative cost associated with having to adjust benefits under Revenue Ruling 74-166 is no longer warranted in most circumstances. In the Committee's view, significant differences in vesting schedules are too rare in practice (and any resulting differences in benefit values between highly compensated and nonhighly compensated employees are too speculative) to require the testing contemplated by Revenue Ruling 74-166 wherever multiple vesting schedules exist. Rather, the Committee believes such adjustments should be required only in situations of the type set forth in the Preamble to the Proposed Regulations, namely, where a plan with immediate vesting for highly compensated employees is combined with a plan which covers nonhighly compensated employees and contains a statutory minimum vesting schedule. The Committee believes that Section 1.401(a)(4)-ll(c)(2) should be expanded to provide that different rates of vesting would be deemed equivalent in all other cases.

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[35] In this regard, the final regulations could provide that a pattern of abuse would be deemed to exist if a plan provided immediate vesting (or something close to immediate vesting) for highly compensated employees, while providing a statutory minimum vesting schedule for nonhighly compensated employees.

IX.
Special Rule for Mergers and Acquisitions

The Committee supports the concept of the special rule (presently set forth in Section 1.401(a)(4)-4(c))applicable to mergers and acquisitions to protect from the nondiscrimination requirements optional forms of benefit and other rights and features. However, the Committee believes that a more comprehensive approach to the effect on plans of mergers and acquisitions is desirable. In this regard, the Committee has several suggestions.

First, the Committee believes that, in general, variations in benefit structures resulting from mergers and acquisitions should be protected by the provisions of Section 410(b)(6)(C). The provisions of that Code section are instructive and, the Committee believes, relevant to any nondiscrimination rule that may be adopted. The Committee believes that it is important to achieve consistency between the provisions of Section 410(b)(6)(C) and any special merger and acquisition rule (including the special rule of the Proposed Regulations), so that transactions will not be subject to completely different analyses under Sections 410 and 401(a)(4), Such consistency could be achieved by adding new "merger and acquisition" safe harbors and by adopting the changes to the Proposed Regulations described below, in this regard, final regulations should make clear that during the transition period prescribed by Section 410(b)(6)(C), benefits afforded by a merged plan (the predecessors of which were separately maintained by buyer and seller) will continue to be protected due to the application of that section and the ability of an employer to divide a plan into segments . under Section 401(a)(4). Thus, if the seller's plan is merged into the buyer's plan, the successor merged plan may, for purposes of continuing qualification, be deemed to consist of two plans, each of which satisfies Section 410(b) by reason of Section 410(b)(6)(C). Accordingly, such plans may continue to provide different levels of benefits during the transition period.

The Committee recommends the following changes to the merger and acquisition rule contained in Section 1.401(a)(4)-4(c):

1. The special rule should be renamed "special rules for certain dispositions or acquisitions,11 thus clarifying that these rules only apply in circumstances described in Section 410(b)(6)(C).

2. The events giving rise to the application of the special rule should be conformed with Section 410(b)(6)(C); i.e., the special rule should be applicable whenever an employee becomes, or ceases to be, employed by a member of a group described in subsection (b), (c), (m) or (o) of Section 414 as a result of an acquisition or disposition.[36] This would make unnecessary the definition of an "asset or stock acquisition, merger or other similar transaction" and/or "change of control of a trade or business" in the Proposed Regulations. The use of a special rule that does not coordinate with Section 410(b)(6)(C) will merely promote questions and unnecessary complexity.

3. As in the case of Section 410(b)(6)(C), the special rule should apply both to the seller and the buyer. As presently drafted, only transferred employees of the seller are eligible for protection under the rule; however, in the Committee's view the form of transaction should not dictate the treatment of the plans affected by the transaction. For example, the application of Section 401(a)(4) should not depend on whether Company X merges into Company Y or vice versa.

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[36] The Committee contemplates that rules similar to Section 1.401(a)(26)-l(b)(5)(i) and (iii) would be adopted in the context of Section 401(a)(4). These rules clarify that the Section 410(b)(6)(C) transition period is available with respect to asset as well as stock acquisitions or dispositions.

4. The special rule as proposed is too inflexible. First, it does not allow for statutorily mandated changes in benefits, rights, or features. For example, changes in the qualification requirements could mandate changes to otherwise protected plans which would cause them to lose the protection of the special rule. Clearly, changes made to permit a plan to continue to qualify should not render the special rule inapplicable. Second, changes in the protected benefit, right, or feature which cause such benefit to more closely approximate the benefit, right, or feature generally provided to employees should be protected. For example, if the protected benefit or right is superior to the plan's general rights and features, and is cut back, but not to the level generally afforded, the decreased right or feature should continue to be protected.

5. The special rule should apply if the buyer creates a "mirror" plan to that maintained by the seller, with no transfer of assets and liabilities between plans, and even if the buyer's plan is not a "successor plan."

6. There is no apparent reason why the special rule should be available with respect to other rights or features, but not ancillary benefits. If there is a rationale for this approach it has not occurred to the Committee and it again seems to overly complicate the special rule.

X.
Sanctions for Noncompliance

The Preamble to the Proposed Regulations under Sections 401(a)(4) and 410(b) contains the following statement:

> Under the integrated approach to sections 401(a)(4) and 410(b) underlying the proposed regulations, any failure to satisfy section 401(a)(4) can be viewed as failure to satisfy section 410(b). Consequently, failure to meet the requirements of section 401(a)(4) will cause section 402(b)(2) to apply with respect to a plan and will therefore subject highly compensated employees to the special sanctions contained in that section. Similarly, if the plan satisfies all qualification requirements other than sections 410(b) and 401(a)(26), no adverse tax consequences will be imposed on nonhighly compensated employees.

It is difficult to ascertain the legal effect of this statement, which is not part of the Proposed Regulations but might be included in the Treasury Decision accompanying the final regulations. Since no regulations are proposed under Section 402(b)(2), it is unlikely that a statement accompanying regulations relating to other Code sections would constitute an interpretation of Section 402(b)(2) having the force of law accorded to final regulations. In any event, the statement appears to express an unauthorized position of the Treasury and the Service with respect to the application of Section 402(b)(2) to the failure to comply with Section 401(a)(4). As discussed below, it is the Committee's view that this position is an impermissible interpretation of the relevant Code provisions.

If a plan is found not to be a qualified plan because of its failure to meet any of the requirements of Section 401, the income of the trust is not exempt from tax, and the tax treatment of the employee and the employer is governed by Sections 83 and 404(a)(5).[37] Section 402(b)(2) modifies this rule by providing a special sanction for highly compensated employees where a plan is disqualified and the plan has failed to meet the requirements of Section 410(b) or 401(a)(26). In such a case, the tax effects of Section 402(b)(l) do not apply to highly compensated employees, but instead the highly compensated employee is taxed on the employee's vested accrued benefit as of the close of the taxable year less any such amounts previously taxed. In addition, if the failure to meet the requirements of Section 410(b) or 401(a)(26) is the sole cause of disqualification, there are no adverse tax effects to the nonhighly compensated employees.

The special sanction of Section 402(b)(2) was introduced into the Code by the Tax Reform Act of 1986, and was completely revised by the Technical and Miscellaneous Revenue Act of 1988, which extended the application of Section 402(b)(2) to plans that fail to satisfy Section 401(a)(26).

The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation states (at page 678) that the sanction of Section 402(b)(2) is to apply with respect to "a plan that fails to qualify due solely to a failure to satisfy the new coverage rules.11 No mention is made of Section 401(a)(4).

However, the Senate Finance Committee Report on the Technical and Miscellaneous Revenue Act of 1988 expands on the discussion of the sanction, stating (at page 161) that a plan could fail to satisfy

[37] Specifically, with respect to the taxation of the employee, Section 402(b)(l) provides that contributions to a nonexempt trust are includible in the gross income of the employee in accordance with Section 83 and distributions from the trust are taxable under Section 72, without regard to Section 72(e)(5).

"the minimum participation rule or the coverage rules (either directly or indirectly through the application of sec. 40l(a)(4))."[38] It is not clear what is meant by the phrase "indirectly through the application of sec. 401(a)(4)),"[39] but it seems to contemplate a situation

in which an employer elects to aggregate two plans (in accordance with Section 410(b)(6)(B)) in order to meet the coverage requirements, but the aggregated plan is nevertheless discriminatory under Section 401(a)(4). If, as a consequence, the election to aggregate is viewed as ineffective, this will cause one or both plans to fail to satisfy Section 410(b). In this way, the failure to satisfy the coverage requirements could be said to be the indirect result of the application of Section 401(a)(4). The statement in the Committee Report, as applied to this situation, simply means that the consequences of Section 402(b)(2) cannot be avoided by an aggregation which fails to satisfy Section 401(a)(4).

The Committee believes that extending this concept beyond the aggregation situation is not permissible. Section 402(b)(2) was designed specifically to cover Section 410(b) and Section 401(a)(26). It can be said to apply to Section 401(a)(4) in the aggregation context in the manner described above. However, there does not appear to be any statutory authority for extending Section 402(b)(2) either to Section 401(a)(4) in the context of a

[38] The ambiguity of' this statement is accentuated by the fact that it is difficult to tell whether the parenthetical referring to Section 401(a)(4) applies to the minimum participation rules as well as the coverage rules. It is believed that it applies only to the coverage rules because there is no particular interrelationship between the Section 401(a)(26) rules and the Section 401(a)(4) rules.

[39] The only reference to Section 401(a)(4) in Section 410(b) is the following language in Section 410(b)(6)(B), relating to the aggregation rules: "If an employer elects to treat any trusts or annuity plans as one plan under this subparagraph, such trusts or annuity plans shall be treated as one plan for purposes of Section 401(a)(4)."

nonaggregated plan or to any other of the provisions of Section 401.[40]

Accordingly, the Committee believes that any extension of the application of Section 402(b)(2) beyond the circumstances discussed above should be left to Congress. The Preamble's sweeping statement on sanctions is overbroad and should be clarified, preferably in the text of final regulations under Section 401(a)(4) or 402(b)(2) rather than in a preamble thereto.

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[40] The Senate Committee Report on the Technical and Miscellaneous Revenue Act of 1988 referred to above specifically states: "Except for these changes [410(b) and 401(a)(26)] the sanctions applicable under present law, including rules regarding the disallowance of an employer's deduction for contributions to a disqualified plan, continue to apply."

The Committee recognizes that enforcement of Section 401 is made difficult because the nonhighly compensated employees, who may be considered the victims of the discrimination which caused the plan disqualification, suffer the effects of disqualification along with the highly compensated employees, i.e., current taxation of the nonforfeitable contributions and of the trust fund earnings. This may well be an unjust result, but the rule of Section 402(b)(l) has applied for a considerable period of time and Congress has not expressed any intention to change it generally.

XI.
Effective Date and Transition Rules

The proposed rules are scheduled to become effective for plan years beginning on or after January 1, 1991, except in the case of governmental plans described in Section 414(d), for which a January 1, 1993 effective date is to apply. In view of the fact that the final regulations will not be issued until late 1990 at the very earliest, the Committee urges the postponement of the general effective date to plan years commencing on or after the date that is 180 days after the publication of final regulations. Complex testing and analysis will be required of many employers merely to determine the extent to which current plans comply with the new nondiscrimination rules. In many cases, it is anticipated that plan design changes will be desirable, if not essential, and unless the presently proposed effective date rules are relaxed, employers may be well into their 1991 plan years before such changes can be made. At that time, retroactive plan amendments may be difficult, particularly if changes in benefits protected under Section 411(d)(6) are involved.

The Committee supports the Proposed Regulations' general standard that plans must operate in accordance with a reasonable, good faith interpretation of Section 401(a)(4) prior to the effective date of the new regulations. Given the state of flux of the nondiscrimination rules and the lack of any concrete guidance with respect to compliance with Section 401(a)(4) in its current form, the Committee would hope that the Treasury and the Service will be liberal in its application of this standard.

XII.
Proposed Regulations Under
Section 401(a)(26)

Under the minimum participation requirement of Section 401(a)(26), a qualified plan must cover, without aggregation with other plans, the lesser of 50 employees of the employer or 40% of that employer's employees. Lengthy proposed regulations under Section 401(a)(26) issued on February 14, 1989 and subsequently amended were the subject of a public hearing held on October 30, 1989, at which the pension community expressed frustration -with the length and complexity of the proposed regulations. Criticism was specifically directed at the extension of the minimum participation rule to current benefit structures under plans of even the largest employers, and at the inflexibility of the proposed regulations (in some cases resulting in potential conflict with Section 411(d)) with respect to benefit programs assumed as a result of mergers and acquisitions.

The Committee commends the Treasury and the Service for withdrawing those proposals and substituting in the Proposed Regulations provisions that eliminate the requirement for testing of current benefit structures with respect to all plans. The Committee further supports the extension of grandfather rules and simplified testing procedures set forth in the Proposed Regulations. As discussed below, however, the Committee has identified certain areas that it believes require modification or clarification, and certain instances in which the intent of Congress could be implemented by rules that are less restrictive of plan sponsors.

Section 1.401(a)(26)-1: Minimum Participation Requirements

The Committee suggests that two of the exceptions to the minimum participation rule be modified and clarified as follows.

Plans Not Benefiting Highly Compensated Employees. Section 1.401(a)(26)-l(b) provides that a plan that satisfies Sections 401(a)(4) and 410(b) without regard to any other plan of the employer and is not top-heavy during a plan year does not violate Section 401(a)(26) if no highly compensated employee or former employee accrues a benefit under the plan in such plan year. The Committee believes that the status of the plan under the top-heavy rules should not be relevant to this exception. Those rules measure historical accruals going back to the plan's inception, which nay have been decades before the effective date of Section 401(a)(26). Thus, limiting this exception to plans that are not top-heavy has a substantial and inappropriate retroactive effect.

Acquisitions and Dispositions. in general, the Proposed Regulations (in accordance with Section 401(a)(26)(F)) provide that if plans of an employer satisfied section 40l(a)(26) prior to an acquisition or disposition, they will be deemed to satisfy that Section for a transition period beginning on the date of the acquisition or disposition, and extending through the last day of the first plan year beginning after such date. A special rule covers acquisitions and dispositions in the year before the effective date of Section 401(a)(26). This section should be amended to clarify that transition relief applies regardless of whether the seller's employees are covered under a separate plan that is adopted by the buyer or participated in an "umbrella plan" covering other employees of the seller.

Section 1.40l(a)(26)-2; Minimum Participation Rule

Definition of Plan. The Proposed Regulations state that each plan within the meaning of Section 414(1) is a separate plan for purposes of Section 401(a)(26). Because there is not a great deal of published authority as to what constitutes a separate plan under Section 414(1), this section of the Proposed Regulations should be expanded to include more examples of separate plans.

Section 1.401(a)(26)-4(b) and (c):
Testing Former Employees

Section 1.401(a)(26)-4 generally provides that a plan that benefits former employees and does not meet one of the exceptions set forth in the Proposed Regulations must benefit the lesser of 50 former employees of the employer or 40% of the former employees of the employer. Under a special rule, a plan is deemed to meet these requirements if it benefits at least five former employees and either (i) more than 95 percent of all former employees with benefits under the plan benefit under the plan for the plan year, or (ii) at least 60 percent of the former employees who benefit under the plan are nonhighly compensated former employees.

The Committee questions the need for subjecting former employees to separate testing under Section 401(a)(26) in view of the similarity of these provisions to Section 1.401(a)(4)-10(b)(2).

Section 1.401(a)(26)-7; Correction of Violations

The Proposed Regulations should clarify the discussion relating to retroactive correction of violations (or comparable guidance in the form of announcements or releases should be issued). The following specific items should be discussed in greater detail.

Availability of Remedial Amendment Period. The Proposed Regulations should clearly state that a plan sponsor has until the last day of the remedial amendment period to make the revisions necessary to bring the plan into compliance with Section 401(a)(26). Although Section 1.401(a)(26)-7(c) states that action must be taken by the last day of the plan year, the example at the end of that section implies that the action may be taken by the end of the remedial amendment period.

Exclusion of Highly Compensated Employees. Section 1.401(a)(26)-l(b)(1) states that a plan does not violate Section 401(a)(26) if, among other requirements, the plan is not top-heavy and no present or former highly compensated employee accrues a benefit for the plan year. The Committee believes that the Proposed

Regulations should be modified to state that it is permissible to retroactively exclude such employees from participation provided that they have not yet accrued a benefit for the plan year (because of the adoption of a model amendment, for example).

Expansion of Eligibility, The testing rules under Section 1.401(a)(26)-7(b) permit compliance to be determined as of one annual testing date. Presumably, a December 31 testing date would not be reasonably representative of a plan's coverage (and would therefore not permit the use of the simplified method) if in December the employer, for the purpose of complying with Section 401(a)(26), expanded eligibility under a calendar year plan to include employees who had only a December accrual. However, the Treasury and the Service should clarify that, in the common situation of a plan with semi-annual entry dates, the fact that employees are added during the year and accrue benefits for only half the year would not prevent use of the simplified method in testing for compliance with Section 401(a)(26) for the plan year.

XIII.
Compensation Definitions

The Treasury and the Service are to be commended for significantly increasing plan sponsors' flexibility in defining compensation by means of the safe harbor rules and alternative definitions available under the temporary regulations. The options of using the FICA or income tax withholding wage definitions should be particularly helpful for many employers.

Set forth below are comments on some technical points raised by the new rules, as well as a response to the request for comment on needed changes to the Section 1.415- 2(d)(2) provisions excluding certain items from the definition of compensation.

Nondiscrimination Requirement for Alternative Definitions

Under Section 1.414(s)-lT(d), an alternative definition of compensation must, among other limitations, satisfy the nondiscrimination requirement of Section 1.414(s)-lT(d)(2). Under that provision, an alternative definition of compensation is nondiscriminatory if the average percentage of total compensation included under the alternative definition for highly compensated employees as a group does not exceed by more than a *de minimis* amount the corresponding average percentage for the employer's other employees as a group. In the Committee's view, the rules for determining whether an alternative definition is discriminatory should be clarified. For example, the regulations should provide more guidance as to the meaning of the term "*de minimis*," and should include at least one safe-harbor level of permitted disparity that would be considered *de minimis* in all cases.

The Committee also feels that the discussion in the Preamble interpreting the nondiscrimination requirement should be clarified and incorporated into the text of the regulations. Here again, more certainty should be provided by including a safe harbor rule establishing when the use of the alternative method (i.e., calculating the aggregate compensation percentage for each group by dividing the aggregate amount of compensation of all employees in the group by the aggregate amount of total compensation of all employees in the group) will be deemed not to produce distortion as a result of the .extra weight given employees with higher compensation in the relevant group.

Self-Employed Individuals.

It is not clear that the temporary regulations will operate properly to protect against the use of a discriminatory compensation definition by a sole proprietorship or partnership. To illustrate the apparent difference in the proposed rules as applied to a corporation versus a sole proprietorship or a partnership, consider first a corporation with two employees, X and Y, having total compensation (determined before application of an assumed $200,000 annual compensation limit under Section 401(a)(17))" of $40,000 and $300,000 respectively. Pursuant to Section 1.414(s)-IT(d), the employer proposes to adopt an alternative definition of compensation under which X and Y's compensation would be reduced to $30,000 and $225,000, respectively. Although the alternative definitions in- each case represent 75 percent of uncapped total compensation, the Proposed Regulations properly require that for discrimination testing purposes, the limitation of Section 401(a)(17) be applied in determining total compensation.[41] Since the alternative definition in the example represents 75 percent of X's total compensation, but (after application of the $200,000 limit) 100 percent of Y's total compensation, the nondiscrimination requirement would not be satisfied. This is the correct result, since only the nonhighly compensated employee is adversely affected by the alternative definition.

[41] The Proposed Regulations should clarify, however, that in applying the nondiscrimination test, the Section 401(a)(17) limitation is applied to the alternative definition being tested as well as to total compensation.

The same result would not appear to obtain in the partnership context. Consider the example described above, except that Y is a partner with total earned income (as defined in Section 401(c)(2)) of $300,000. The alternative definition of compensation would not violate the discrimination test, since self-employed individuals are not taken into account. If the alternative definition is used for X, then Y's compensation, by application of Section 1.414(s)-1T(e)(1), will be $225,000. Since his compensation for plan purposes is limited to $200,000, only the nonhighly compensated employee is adversely affected by the alternative definition. The Committee questions whether this result, which is difficult to reconcile with the previous example, is intended. The result would be avoided if the self-employed individual's total earned income were limited by Section 401(a)(17) before being multiplied by the percentage of total compensation included under the alternative definition for the employer's common-law employees.

Other Section 414(s) Issues

Total compensation definition. The Committee questions why the safe-harbor alternative definition of compensation set forth in Section 1.414(s)-1T(c)(3) cannot be used to determine "total compensation" in tasting whether an alternative definition of compensation is nondiscriminatory under Section 1.414(s)-1T(d)(2), since each other safe harbor definition of compensation may be so used.

Safe-Harbor Alternative Definition. Clarification of the term "fringe benefits" in Section 1.414(s)-1T(c)(3) would be helpful, since that term is not defined in the Code or the regulations.

Section 415 Definition

Section 1.415-2(d)(1). By stating that compensation "includes" certain items, this provision creates an inference that items other than those described in that section may be includable in compensation. The Committee recommends that the term "includes" be changed to "means."

Section 1.415-2(d)(2). With regard to changes that are needed to Section 1.415-2(d)(2) of the current regulations, dealing with items excluded from the definition of compensation, the Committee questions the distinction drawn in the regulations between amounts received under an unfunded nonqualified deferred compensation plan, which may be counted as compensation, and amounts includable in income under Section 83 as a result of a lapse of forfeiture or transferability restrictions, which are not counted. As a result of this distinction, a distribution of stock or cash from a phantom stock plan could be included as compensation, whereas income arising upon the lapse of restrictions on Restricted stock could not. In view of the existence of many forms of incentives compensation, only some of which are subject to Section 83, the policy justification for this bifurcation is not apparent. While the Committee suspects that the proper treatment of such items is that they be included rather than excluded from compensation,[42] in either event the treatment of the both types of items should be consistent.

[42] If this approach is taken, subparagraphs (ii) and (iii) of Section 1.415-2(d)(2) of the current regulations should be deleted.