1993

Qualified Employee Benefit Plans - Legislation, Regulation and Compliance

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I. The Omnibus Budget Reconciliation Act of 1993 ("OBRA '93")

A. Maximum Compensation for Qualified Plans Reduced to $150,000

1. Section 13212 of OBRA '93 reduces the maximum compensation that a qualified plan may recognize under Code section 401(a)(17) from $235,840 to $150,000. Corresponding reductions are made in the deduction limit under Code section 404(l), the simplified employee pension compensation limit under section 408(k) and the funded benefit plan compensation limit under section 505(b).

   (a) The new compensation limit will be adjusted for inflation after 1994, but only when cumulative inflation would increase the limit by at least $10,000. For example, if inflation is 3% per year in 1994, 1995 and 1996, then the limit will not increase in 1995 and 1996 because $150,000 x 1.03 x 1.03 equals $159,135, just short of the $10,000 threshold. In 1997, the limit would increase to $160,000.

   (b) The estimated budget effects: increase receipts by $2.460 billion over fiscal years 1994 through 1998.

   (c) Effective date and transition rules

      (i) The general effective date of the reduction in the compensation limit is for benefits accruing in plan years beginning after December 31, 1993. A delayed effective date applies to collectively bargained plans and a special rule applies to governmental plans.

      (ii) Benefits accrued prior to the effective date for compensation in excess of the new reduced limit are grandfathered. Presumably the regulations, when issued, will follow the same approach adopted by the Regulations § 1.40(a)(17)-1(d) and (e) (final
regulations adopted September 19, 1991) to transition the original enactment of the section 401(a)(17) $200,000 limit effective for plan years beginning on or after January 1, 1989.

(d) Model Amendments -- The IRS has informally indicated that it intends to publish a model amendment to aid plan sponsors in making the necessary plan amendments to reflect the reduced compensation limitation.

2. In addition to raising revenue the legislative history indicates that Congress believes that lowering the limit will strengthen the nondiscrimination requirements applicable to qualified plans. However, in practice, employers will seek ways to comply with the new limit while maintaining existing benefit levels for their highly compensated employees and, yet, avoid increasing benefits for nonhighly compensated employees.

(a) The decreased compensation limit will make it more difficult for most 401(k) plans to satisfy the average deferral percentage (ADP) and average contribution percentage (ACP) tests that apply under Code sections 401(k) and 401(m). For employees earning more than the 1993 compensation limit of $235,840, the maximum deferral percentage currently is $8,994/$235,840, or 3.81%, whereas the same deferral next year would yield a percentage of $8,994/$150,000, or 6%.

(b) The lower deduction limit under Code section 404 will cause a delay in the funding of pension benefits, since pension plans will not be able to project and fund for increases in final pay exceeding the $150,000 limit. Regulations § 1.412(c)(3)-1(d)(1).

Example, an employee earning $50,000 at age 35 with 5% annual pay increases might be expected to retire at age 65 with a salary exceeding $216,000. (In fact, any 25-year-old employee with compensation greater than about $21,300 would exceed the $150,000 limit at age 65.) Because the employer may not assume that the employee's final pay will exceed $150,000, the employer's
ability to fund the expected benefit will be delayed, leading to smaller contributions in the earlier years of the employee's career and larger contributions later on—a result at odds with many employers' budgeting and financial objective of contributing a constant percentage of pay.

(c) Many employers will adopt or expand their nonqualified, unfunded pension plans to make up for the benefits lost under their qualified plans. ERISA permits employers to maintain unfunded "top-hat" plans primarily for the purpose of providing deferred compensation for "a select group of management or highly compensated employees." As employers expand their top-hat plans to employees further down in their organizations, there is some question whether the eligible group will meet the definition of a "select group." The Department of Labor, which has interpretive jurisdiction for this purpose, has never issued official guidance on this question, but has indicated informally that the appropriate cut-off for a top-hat plan is considerably higher than the level considered "highly compensated" for purposes of the Internal Revenue Code (generally, employees earning more than $64,245 in 1993). Until the DOL rules otherwise, many will assume that those adversely affected by the 401(a)(17) limit constitute a "select group."

B. Repeal Health Insurance Wage Base Cap

1. Section 13207 of OBRA '93 repeals the dollar limit on wages and self-employment income subject to the Medicare hospital ("HI") tax. (The limit is $135,000 for 1993.) The HI tax is 1.45% on both employees and employers.

   (a) The repeal of the HI cap is effective for income received after 1993.

   (b) The OASDI tax (6.2% on both employers and employees) remains capped at social security wage base, e.g., $57,600 in 1993.

2. Important collateral effect: HI tax on deferred compensation.
(a) Under section 3121(v)(2) of the Code amounts deferred under a "nonqualified deferred compensation plan" are subject to HI and OASDI tax when the related services are performed or when vested, if later.

(b) As a result of the repeal of the HI cap, all nonqualified deferred compensation will be subject to the HI tax by reason of section 3121(v)(2). This will present some important interpretative issues in 1994.

(i) How broad is deferred compensation under a nonqualified defined contribution plan taxed under section 3121(v)(2)?

(ii) How is deferred compensation under a nonqualified defined contribution plan taxed under section 3121(v)(2)?

(iii) How are accruals under a nonqualified, defined benefit type, supplemental retirement plan (SERP) taxed?

C. Compensation Deduction Denied for Executive Pay Over $1 million

1. Section 1321 of OBRA '93 limits the deduction allowable to corporations for compensation paid or accrued with respect to the top five executive of a publicly held corporations to no more than $1 million per year. See section 162(m) of the Code. Applies to compensation otherwise deductible by corporation in taxable years beginning on or after January 1, 1994.

(a) The top five executives are the chief executive officer of the corporation and the four other most highly paid officers, as determined under rules of the Securities and Exchange Commission.

(b) The deduction limitation applies to all remuneration for services, including cash and the cash value of all non-cash remuneration (including benefits). However, the following types of compensation are not subject to the limitation:

(i) remuneration payable on a commission basis;
(ii) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met;

(iii) payments to a tax-qualified retirement plan (including salary reduction contributions);

(iv) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits); AND

(v) any remuneration payable under a written binding contract that was in effect on February 17, 1993, and remains in effect without material modification.

2. "Performance goals" exception

(a) Organizational and procedural requirements:

(i) Outside directors -- Performance goals must be established by a compensation committee of a board of directors which is comprised solely of two or more "outside directors." The definition of "outside director" is different from the SEC Rule 16b-3 concept of "disinterested directors." For example, a disinterested director is a director who has not received a grant of an equity security from the corporation for the 12 months immediately preceding becoming a committee member. However, such a disinterested director may nevertheless not qualify as an "outside director" because he or she was an employee of the corporation or is a service provider.

(ii) Shareholder approval -- The material terms of performance goals must be disclosed to, and approved by, the shareholders in a separate vote before payment.

(iii) Certification -- Prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.
(b) Special rules re stock options and stock appreciation rights

(i) Considered "performance based" because the amount of compensation received is normally based upon increase in the corporation's stock price. However, discount options (i.e., options with excessive price of less than 100% of fair market value on date of grant), and options subject to automatic repricing mechanisms will not qualify.

(ii) Shareholders must approve the maximum number of shares subject to an option that can be granted to any executive. Presumably, this requirement will be satisfied on overall limitation on shares available for grant to any one individual.

3. Grandfather rule

(a) Compensation paid pursuant to a written binding contract (e.g., an employment or stock option agreement) in effect on February 17, 1993, is exempt from the deduction ceiling.

(b) Compensation paid pursuant to commencement of participation in a plan providing for nondiscretionary awards after February 17, 1993 qualifies if the right to participate in the plan is part of a written binding contract (e.g., an employment agreement) that is in effect on February 17, 1993.

(c) The grandfather rule ceases to apply if the binding contract or plan is materially modified after February 17, 1993.

D. Extension of Employer Provided Educational Assistance

1. Section 13102 of OBRA'93 extends for 30 months, i.e., from July 1, 1993 through December 31, 1994, the exclusion from gross income, and from wages, for up to $5,250 for employer-provided educational assistance. See section 127 of the Code.

2. Procedures for obtaining employee and employer refunds resulting from the retroactive reinstat-
ment of the exclusion have been issued by the IRS. See IR 93-85, September 16, 1993.

E. Qualified Plan Investments in Real Estate

1. Section 13144 through 13149 of OBRA '93 amended several Code provisions to facilitate retirement fund investments in real estate. The two principal themes of the amendments are to make the exemption from the unrelated business income tax more readily available to retirement plans, and to facilitate the disposition of properties held by distressed financial institutions, or the government agencies that have succeeded them.

2. Retirement plans, charitable organizations and similar tax-exempt entities are taxable on the income they earn if the source is an "unrelated trade or business," or if the income is derived from property acquired with debt. Sections 501(b), 511, and 514 of the Code. On the other hand, income derived from passive sources, such as rents, royalties, dividends, capital gains, and payments with respect to securities loans, or interest generally, is tax-exempt. Section 512(b) of the Code. There is a special exemption from the debt-financed property rules for real estate acquisitions by retirement funds and educational institutions, but this exemption is subject to a number of conditions and limitations that make it difficult for these organizations to engage in modern real estate transactions without becoming subject to the unrelated business income tax. Section 514(c)(9) of the Code. OBRA '93 made a number of liberalizing changes to these rules, effective for transactions and years beginning on or after January 1, 1994:

(a) Facilitate Investments in Debt-Financed Property. In general, the income from debt-financed real property is excluded from unrelated business taxable income ("UBTI") if six detailed conditions are satisfied. The conditions include requirements that the property not be leased back to, nor financed by, the seller. OBRA '93 permits a leaseback to the seller of no more than 25% of the leasable floor space of the building, or the building complex, to the seller on commercially reasonable terms. Section 514(c)(9)(G)(i) of the Code. (Of course, as under present law, a leaseback to certain related persons may be subject to the prohibited transactions rules under the Code
and ERISA.) In addition, the seller may provide financing to the retirement plan on commercially reasonable terms. Section 514(c)(9)(G)(ii) of the Code. Finally, OBRA '93 makes the UBTI exclusion available even when the purchase price of real property is contingent or is finance with a participating loan if the property is acquired from a financial institution in conservatorship or receivership that itself acquired the property by foreclosure. Section 514(c)(9)(H) of the Code.

(b) Exception for Certain Dealer Transactions. Gains or losses from the sale, exchange or other disposition of property held primarily for sale to customers in the ordinary course of a trade or business are generally UBTI because the seller is considered a dealer. Section 512(b)(5) of the Code. OBRA '93 provides an exception to this dealer UBTI rule by excluding gains or losses from the sale, exchange or other disposition of certain real property acquired from financial institutions that are in conservatorship or receivership. The exclusion is limited to properties designated as "disposal property" within nine months of acquisition by the financial institution and disposed of within two and one-half years of acquisition. Improvements to the properties cannot exceed 20% of the net selling price of the property. Section 512(b)(16) of the Code.

(c) Parity for Investments In Publicly Traded Partnerships. Whether partnership income in the hands of a retirement plan is UBTI depends upon the character of the income; i.e., whether the income would be exempt if it was received directly by the plan. The nature of the partnership interest, whether general or limited, generally does not determine whether there is UBTI but there is an exception in the case of publicly traded partnerships. Under OBRA '93, plan investments in publicly traded partnerships will be treated the same as investments in other partnerships. Section 512(c) of the Code.

(d) Preservation of Tax Exemption for Title Holding Companies. Two separate Code sections provide tax-exempt status to certain corporations or trusts that hold title to real property for other tax-exempt organizations. Before OBRA '93, the receipt of any amount of UBTI by these organizations would result in the loss of tax exemption.
by these entities. OBRA '93 permits incidental receipt of UBTI by these organizations without loss of their tax exemption. The amount of incidental income cannot exceed 10% of the title holding company's income. Section 501(c)(25) of the Code. An example of such incidental income would be parking fees on real property owned by a title holding company.

(e) REITs. Real estate investment trusts ("REITs"), unlike corporations, do not pay taxes on the income they distribute as dividends to their shareholders, nor are the dividends treated as UBTI unless the interest in the trust purchased by the retirement plan was itself debt-financed. Favorable REIT treatment is available only if no more than 50% of the REIT is owned by five or fewer individuals. Until OBRA '93, a retirement plan was treated as a single individual. Under OBRA '93, the underlying beneficiaries of the retirement plan will be treated as holding interests in the REIT in proportion to their interests in the retirement plan, permitting expanded investment by retirement plans in REITs. This attribution of ownership to the beneficiaries will not be available if disqualified persons own 5% or more of the REIT. In addition, dividends paid to a pension fund owning more than 10% of the REIT will be treated as UBTI if any one pension trust owns more than 25% of the REIT, or a group of trusts individually holding more than 10% of the REIT collectively own more than 50% of its value. Section 856(h) of the Code.

(f) Loan Commitment Fees and Option Premiums. Under OBRA '93, loan commitment fees and premiums from unexercised options on real estate are expressly excluded from UBTI. Section 512(b)(1) and (5) of the Code. The legislative history indicates that the option exclusion applies even if the option itself was not written by the plan; i.e., it was written by a previous owner of the property. In addition, good faith deposits for the purchase, sale or lease of real property that are made consistent with established business practices will not result in UBTI if they are forfeited on account of the depositor's failure to complete the real estate transaction. H.Rept. 103-213, Statement of Managers on Revenue Portion of Title XIII of Conf. Report on HR 2264, p. 48.
II. The Qualified Plan Nondiscrimination Regulations

A. Background

1. On August 30, 1993, the Treasury Department and the IRS released Treasury Decision 8485, containing amendments to the final regulations under section 401(a)(4) originally published on September 19, 1991. TD 8485 is the culmination of a regulation project which has been pending in Treasury since 1988.

2. In the spring of 1990, the Treasury originally published proposed regulations under section 401(4)(4), along with proposed regulations under related provisions of the Code (section 410(b) relating to qualified plan coverage; section 401(a)(26) relating to certain special minimum coverage rules; section 401(1) relating to "permitted disparity" resulting from taking social security benefits into account; section 414(s) relating to the definition of compensation for purposes of these rules; 401(a)(17) relating to limits on compensation taken into account). Together, (along with the separate line of business regulations—see 3 below) these regulations are intended to provide taxpayers with comprehensive guidance for testing nondiscrimination by supplying a consolidated and integrated framework of rules.

3. The separate line of business regulations (section 414(r)) have proceeded on a somewhat separate tract: they were originally proposed on February 1, 1991; final regulations were issued on December 4, 1991; proposed amendments to the final regulations were published on September 7, 1993. The IRS has stated that the September 7, 1993 proposals may be relied upon by taxpayers pending issuance of final regulations.

4. Several public hearings were held on various parts of the nondiscrimination package as they were proposed. Many, many written comments were filed.

5. In addition to the regulation, the IRS has issued a number of administrative procedures and notices in support of the regulations: See, e.g., IRS Announcement 93-130 and Revenue Procedure 93-42, containing guidance for substantiating compliance with the regulations (see II,B,1 supra; Revenue Procedures 93-39 and 93-40, relating to separate line of businesses determinations. The IRS has
also modified and expanded its advanced determination letter program for qualified plans in light of the nondiscrimination package. See Revenue Procedure 93-30.

6. Effective Dates and Transition Rules

(a) The nondiscrimination regulations are generally effective for plan years beginning on or after January 1, 1994. Governmental plans and plans maintained by tax-exempt organizations have a delayed effective date; i.e., for plan years beginning on or after January 1, 1996.

(b) For plan years beginning on or after the first day of the first plan year to which the qualified plan coverage amendments in the Tax Reform Act of 1986 ("TRA '86") apply and before the effective date of the nondiscrimination regulations, the regulations provide that the plans must be operated in accordance with a reasonable, good faith interpretation of the requirements of the statute, i.e., section 401(a)(4), "taking into account pre-existing guidance and the amendments made by TRA '86 to the related Code provisions," i.e., sections 401(l), 401(a)(17), and 410(b). See § 1.401(a)(4)-13 and IRS Directive to Field Officers on Good Faith Compliance dated June 12, 1992.

(c) Plan Amendments

(i) The IRS has attempted to ease administrative burdens on plans by permitting plan amendments required by TRA '86 as well as plan design changes required to comply with the nondiscrimination regulations, to be made at the same time and before the last day of the plan year for which the regulations are effective, i.e., before the end of the 1994 plan year generally, and the 1996 plan year for governments and tax exempts. IRS Notice 92-36, 1992-2 C.B. 364.

(ii) The IRS has also provided transitional relief to permit plan sponsors to preserve plan design options while waiting for final regulations and, yet, avoid violating the section 411(d)(6)
"anti-cutback" rules. See e.g., IRS Notices 88-131, 89-92, 92-36.

B. Policy Underlying Nondiscrimination Package

1. In TRA '86 Congress changed the overall structure of the plan qualification rules by tightening the coverage rules, the minimum participation rules, and the social security integration rules. Section 401(a)(4), the most fundamental rule in the entire nondiscrimination regime, required reinterpretation to become relevant in the new context.

   (a) The legislative history of TRA '86 indicates that Congress believed that section 401(a)(4) guidance needed to be updated, e.g., Congress said the comparability analysis of Rev. Rul. 81-202, need to be modified in several ways. See H.Rep. 841, 99th Cong. II-414 (1986).

   (b) Although general guidance under section 401(a)(4) existed before TRA '86 in the form of revenue rulings, etc., the nondiscrimination rules were basically facts and circumstances determinations made by local pension trust examiners in the determination letter process. This led to disuniformity as between various Internal Revenue districts.

2. Aggressive qualified plan designs had become common; some employers took advantage of the loose rules to design plans which discriminated significantly in favor of highly compensated employees.

   (a) Example. Defined benefit plans with a "flat benefit" formula under which the benefit accrues ratably over all of an employee's years of participation in the plan. The rate of accrual under these plans favors older, generally more highly compensated employees; Rev. Rul. 81-202 permitted testing for nondiscrimination on a projected benefits basis without regard to rate of accrual. At one time, the Treasury estimated that over one-half of all the defined benefit plans in existence were flat benefit plans and most of these accrued benefits ratably over years of participation.
(b) Under Rev. Rul. 81-202, certain contingent benefits in defined benefit plans (e.g., early retirement subsidies, death and disability benefits) were valued at their maximum potential value in testing for discrimination, even though a substantial part of the value of benefits for nonhighly compensated employees were contingent benefits that might never actually be received.

C. General Scope of the Section 401(a)(4) Regulations

1. Section 1.401(a)(4)-1 of the final regulations provides an overview of the requirements a plan must satisfy and a guide to where the detail on the requirements may be found. The regulations state that the rules therein are the exclusive means of determining whether the nondiscrimination requirements are satisfied. The IRS position is that a plan will satisfy section 401(a)(4) only if it complies both in form and in operation with the regulations.

2. There are three basic requirements:

(a) The contributions or benefits under a plan must be nondiscriminatory in amount.

   (i) A plan may generally satisfy this requirement on the basis of either contributions or benefits, regardless of whether the plan is a defined contribution plan or a defined benefit plan.

   (ii) Elective contributions under section 401(k) plans, and employee after-tax or employer matching contributions subject to section 401(m), have their own nondiscrimination regime, i.e., the ADP test (see sections 401(k)(3)) and the ACP test (see section 401(m)(2)).

(b) Other benefits, rights, or features under the plan must be available to a nondiscriminatory group of employees.

(c) The timing of plan amendments (including grants of past service credit and plan terminations) must not have the effect of discriminating significantly in favor of highly compensated employees.
3. The fundamental concepts

(a) Plans may satisfy the nondiscriminatory "amounts" requirement (C,1,(a) above) by adopting a plan design which satisfies one of the designed based safe harbors in the regulations, or by satisfying a general test which requires an analysis of each participant's allocation or accrual rates.

(i) There is one defined contribution plan designed based safe harbor (see § 1.401(a)(4)-2), four defined benefit plan designed based safe harbors (see § 1.401(a)(4)-3), and two special safe harbors (target benefit plans and cash balance plans--see § 1.401(a)(4)-8). Access to the safe harbors generally requires the plan to provide uniform allocations or uniform benefits to plan participants. However, the regulations specifically authorize certain deviations from the uniformity rule. See §§ 1.401(a)(4)-2(b)(4) and-3(b)(6). The safe harbors generally require the plan to use a definition of compensation which satisfies the requirements of section 414(s). See the definition of "plan year compensation" in § 1.401(a)(4)-12. Plans that comply with section 401(1) and the regulations thereunder may ignore the permitted disparity for purposes of safe harbor compliance.

(ii) The general test

(aa) In order to perform the general test, the annual rate of accrual of benefits (e.g., benefits accrued as a percentage of compensation) or the annual rate of allocation of employee contributions (e.g., employer contributions to employee's account as a percentage of compensation) must be determined for each participant. These rates may then be adjusted to include an imputed amount for employer-provided social security benefits. See § 1.401(a)(4)-7.
Each "rate group" under the plan must satisfy the minimum coverage rules of section 410(b) applied as if the employees in the rate group were the only employees in the plan.

Note: Under certain circumstances up to 5% of the highly compensated employees in a defined benefit plan can be ignored. See § 1.401(a)(4)-3(c)(3).

- A rate group exists for each highly compensated employee in the plan; it consists of every participant in the plan with the same or higher accrual or allocation rate.

- Example: Assume a defined contribution plan covering two highly compensated employees ("HCE's") and six non-highly compensated employees ("NHCE's"). The adjusted allocation rates are as follows:

<table>
<thead>
<tr>
<th>HCE 1</th>
<th>5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE 2</td>
<td>4%</td>
</tr>
<tr>
<td>NHCE 1</td>
<td>6%</td>
</tr>
<tr>
<td>NHCE 2</td>
<td>5%</td>
</tr>
<tr>
<td>NHCE 3</td>
<td>5%</td>
</tr>
<tr>
<td>NHCE 4</td>
<td>4%</td>
</tr>
<tr>
<td>NHCE 5</td>
<td>4%</td>
</tr>
<tr>
<td>NHCE 6</td>
<td>3%</td>
</tr>
</tbody>
</table>

The plan has 2 rate groups—the HCE-1 rate group and the HCE-2 rate group. The HCE-1 rate group consists of HCE-1, NHCE1, NHCE2, and NHCE-3; the HCE-2 rate group consists of HCE-2, HCE-1, and NHCE's-1 through -5. Each of these rate groups is tested separately for minimum coverage under section 410(b).

(iii) There is an intermediate way to comply -- adopt one of the so-called "non-designed based safe harbors"--see § 1.401(a)(4)-2(b)(3) re defined contribution plans using uniform points
allocation formulas; and §1.401(a)(4)-3(b)(4)(i)(C)(3) for a safe harbor for defined benefit plans using a flat benefit formula.

(c) Plan "benefits, rights, and features" are generally tested for discrimination on the basis of availability rather than actual utilization. See §1.401(a)(4)-4.

(i) "Benefits" for this purpose includes optional forms of retirement benefits (e.g., early retirement options, lump sum options, 10-year certain annuities) and ancillary plan benefits (disability, health insurance, death benefits). "Rights and features" include e.g., plan loan provisions, the right to direct investments, the right to make after-tax contributions to the plan.

(ii) Section 1.401(a)(4)-4 provides that a benefit, right or feature satisfies the current availability requirement if the group of employees to whom it is available during the plan year satisfies a section 410(b) coverage group (without regard to the average benefit percentage test of section 410(b)(2)(B)(ii)).

(iii) There is also an "effective availability" requirement—this is an anti-abuse rule to prevent situations where only the highly compensated ever actually satisfy the criteria that is nominally available to all participants. See §1.401(a)(4)-4(c).

(d) Plan amendments, grants of past service, and plan terminations

(i) The requirement that amendments not have the effect of discriminating significantly in favor of highly compensated employees or former highly compensated employees, goes to the timing of the amendment.

(ii) Except for a special five-year safe harbor for certain grants of past service credit (see §1.401(a)(4)-5(a)(3)), this part of the regulations...
is a subjective, facts and circumstances, rule.

Examples of relevant facts and circumstances: relative numbers of current and former highly compensated and non-highly compensated employees affected by the plan amendment, the relative length of service of current and former highly compensated employees and non-highly compensated employees, the length of time the plan or plan provisions being amended has been in effect, and the turnover of employees prior to the plan amendment.

(iii) The regulations continue to impose certain formal plan requirements for defined benefit plans relating to the 25 highest paid employees, but those requirements are considerably more liberal than prior law. See §1.401(a)(4)-5(b).

(e) Cross testing

(i) The regulations provide rules whereby defined contribution plans can be tested on the basis of equivalent employer-provided benefits and defined benefit plans can be tested on the basis of equivalent employer-provided contributions. See §1.401(a)(4)-8.

(ii) Cross testing facilitates aggregating defined contribution and defined benefit plans for purposes of satisfying sections 410(b) and 401(a)(4). See §1.401(a)(4)-8 and -9. The cross testing mechanism is also necessary for purposes of applying the average benefit percentage test under section 410(b)(2)(A)(ii). See §1.410(b)-5(d).

(iii) The ability to cross-test a stand-alone defined contribution plan has led to the proliferation of so-called "age-weighted profit sharing plans." Using age as a factor in allocating contributions in a defined contribution plan provides a method of increasing benefits for older (and usually more highly compensated) employees while
avoiding the requirements and funding obligations of the defined benefit plan or target benefit plan regimes. The Administration has indicated that it will propose legislation to curtail the use of cross testing under these circumstances.

D. Procedural and Administrative Matters

1. Data Collection and Testing Issues -- Revenue Procedure 93-42

(a) Data -- Many employers who maintain defined benefit plans cannot produce and organize the data necessary to compute accrual rates for individual plan participants without incurring significant additional costs. Rev. Proc. 93-42 permits employers to substantiate compliance with the non-discrimination requirements by using reliable substitute data. In most cases the data used for the annual actuarial valuation of the plan will meet the standard for "substantiation quality data."

(b) Testing -- Employers may substantiate compliance with the regulations on the basis of employees present on a single day of the plan year. The employer may choose the day provided that the day is reasonably representative of the employer's workforce and the plan's coverage throughout the plan year.

(c) Simplified identification of HCE's -- Employers may identify the highly compensated employees for the year based upon "snapshot" testing (see (b) above).

(d) Three-year testing cycle -- Generally, Rev. Proc. 93-42 allows testing to be performed only once in every 3-year period, provided there are no significant changes subsequent to a test date.

2. Retroactive Correction -- § 1.401(a)(4)-11(g)

(a) Generally, except as otherwise provided in section 401(b), qualification defects cannot be corrected after the close of the plan year. The regulations contain an exception to the rule and permits retroactive amendments to satisfy the minimum coverage
requirements, the nondiscrimination in amounts requirements, the nondiscriminatory plan amendment requirement, and the nondiscriminatory availability requirement for benefits, right and features.

(b) Retroactive amendments must satisfy the following rules:

(i) Benefits cannot be reduced, i.e., they must be increased to the extent necessary to satisfy the applicable requirement.

(ii) Generally, the amendment must be effective for all purposes as of the first day of the plan year in which the defect occurred; however, as to defects relating to the availability of benefits, right and features this requirement is modified.

(iii) The corrective amendment must be adopted before the 15th day of the 10th month after the close of the plan year, except the period may be extended for the section 401(b) remedial amendment period if a determination letter is requested.

(iv) In the case of coverage and/or amounts testing defects, the participants affected by the corrective amendment must separately satisfy section 410(b) and section 401(a)(4).

3. Qualified Plan Determination Letters -- Revenue Procedure 93-39

(a) Effective October 12, 1993, the IRS will issue determination letters that rule on whether a plan satisfies a non-designed-based safe harbor or the general test under the section 401(a)(4) regulations, and whether the plan satisfies the minimum coverage requirements on the basis of the average benefit test.

(b) Under section 4 of Rev. Proc. 93-39 plan sponsors are given the option of electing whether the determination letter issued on their plan considers certain requirement:
(i) The general test for amounts testing under §§ 1.401(a)(4)-2 and -3.

(ii) The average benefit test of section 410(b)(2).

(iii) The current availability of benefits, right and features as required under § 1.401(a)(4)-4(b).

(c) Under section 5.13 there is a new graduated user fee schedule for applications filed for a determination letter.

(d) Section 11 provides guidance on the submission of determination letters involving plans that are relying on the separate line of business rules under section 414(r) to satisfy the minimum coverage and minimum participation requirements.

(e) Provides extended reliance procedures for individually designed defined contribution and defined benefit plans.

III. New IRS Compliance Rules for Qualified Plans

A. Introduction

1. Qualified plan sponsors and the Internal Revenue Service have both struggled for a long time with the rigidity of the disqualification sanction under the Internal Revenue Code, particularly in cases of operational errors in plan administration.

(a) In the early 1980's, the IRS adopted detailed, formalized procedures permitting certain plans which otherwise would be disqualified retroactively to correct errors of form and operation and thereby avoid disqualification (the "ENCEP" procedures, i.e., the ERISA Noncompliance Enforcement Program, Notice 80-7, 1980-1 C.B. 578.)

(b) Congress has also reacted to the problem by adopting special sanctions to moderate the severity of plan disqualification. See, for example, section 402(b), as amended by the Tax Reform Act of 1986; and section 4974 which applies in the case of violation of the minimum distributions rules of section 401(a)(9).
The reported cases generally deal with the most egregious situations.

(i) *Container Service Co.*, 345 F.Supp. 235 (S.D. Ohio 1972); plan that covered only the employer's shareholder-officers, a foreman and a bookkeeper and not its 14 or 15 union hourly employees was not qualified.

(ii) *Myron v. United States*, 550 F.2d. 1145 (9th Cir. 1977): upholding Commissioner's disqualification of retirement plan where amounts were contributed to plan solely for the benefit of sole shareholder of corporations when five other individuals were eligible to participate in the plan.

(iii) *Fujinon Optical, Inc. v. Commissioner*, 76 T.C. 499 (1981): plan that failed to cover members of the controlled group of corporations not qualified.

B. New IRS Compliance Rules

1. Administrative Policy Regarding Sanctions (APRS)

(a) The IRS baseline position on operational noncompliance is expressed in the APRS as follows:

"A qualified plan must satisfy section 401(a) of the Code both in form and in operation. As a technical matter, claims that a plan is qualified under section 401(a) because operational violations are insubstantial, de minimis in amount, or resulted in "no harm" have no merit and should not be considered. Such plans are nonqualified." Revision of IRM 7(10)54 - Employee Plans Examination Guidelines Handbook.

(b) The IRS relies upon three Tax Court cases decided in 1989 and 1990 which emphasize that plans must satisfy the plan qualification rules both in form and in operation. *Buzzetta Construction Corporation v. Commissioner*, 92 T.C. 641 (1989), *Martin Fireproofing v. Commissioner*, 92 T.C. 1173 (1989), and *Basch Engineering*

(c) To the contrary, there is discussion in the case law which supports the proposition that not all operational errors automatically result in plan disqualification. See, e.g., Ray Cleaners, Inc. v. Commissioner, 27 T.C. M 23 (1968); Ludden v. Commissioner, 68 T.C. 826 (1977), aff'd. 620 F.2d 700 (9th Cir. 1980); Myron v. U.S., 382 F. Supp. 590 (C.D. Cal. 1974), aff'd. 550 F.2d 1145 (9th Cir. 1977).

(d) In the APRS, the IRS specifically identifies certain plan operational factors that will not result in plan disqualification:

(i) The operational defect must be isolated and insignificant. This determination will be based on the facts and circumstances of each particular case. However, if violations occur in more than one year, or if multiple violations occur in one year, then the violations will not be characterized as nondisqualifying events.

(ii) The Plan must have a history of compliance. For this purpose, compliance is determined not only with respect to the type of violation involved, but also with respect to the overall compliance with section 401(a). A new plan cannot have a history of compliance for this purpose, and the policy requires that new plans correct the violation prior to examination. This requirement leads to the conclusion that a new plan that does not discover and correct the violation prior to examination will be required to participate in the CAPP regardless of the severity of the violation, although if the plan satisfies the other requirements of the APRS equities would weigh in favor of a substantively reduced penalty under the CAPP.

(iii) The plan administrator must adopt compliance practices and procedures. Significantly, use of the plan document alone to administer the plan will not satisfy this requirement. A plan sponsor must not only have a tax
qualified plan document, but should also adopt detailed compliance procedures in addition to the official plan. The APRS indicates that a plan operation "checklist" may satisfy this requirement. The degree of formality required may well depend upon the size and sophistication of the particular plan involved. Outside advisors may help plan sponsors satisfy this requirement by pointing out areas where it is helpful to have procedures.

(iv) The defect arose from oversight or mistake. The IRS believes that mere innocence or an inadvertent mistake will not prevent disqualification if all of the other factors are not satisfied.

(v) The dollar amounts must be insubstantial. Apparently the IRS does not have absolute criteria for applying this test. IRS officials have stated that the monetary test is a facts and circumstance test in which some latitude is appropriate.

(vi) The Plan sponsor must make immediate and complete correction of the defect. The violation must be corrected to the extent possible. Correction means restoring benefits to adversely affected participants, and eliminating any carryover effect that a violation might have for subsequent years.

(e) The IRS will not exercise its discretion to classify a defect as nondisqualifying when the exclusive benefit rule has been violated or the Plan has not been amended for the most recent qualification rules then in effect, i.e., currently TEFRA, DEFRA and REA. Revision of IRM 7(10)54 - Employee Plans Examination Guidelines Handbook, page 3.

(f) Examples (paraphrased from APRS)

(i) The only violation during the plan year is an allocation to one key employee of an amount in excess of the $200,000 section 401(a)(17) limit on compensation. The violation is a one
time mistake attributable to an oversight by the plan administrator in reviewing the plan's checklist of highly compensated employees. The plan had a history of compliance and corrected the violation prior to the IRS reviewing the plan. In this case the violation is a nondisqualifying event.

(ii) The plan's vesting schedule was incorrectly applied on a participant's termination of service, resulting in a lower single sum distribution than the participant would have otherwise received. Again the plan had a history of compliance and the mistake was corrected prior to review by the IRS. This violation also would be treated as nondisqualifying.

(iii) A new plan where the plan administrator misread the plan's service computation rules and failed to include an otherwise eligible employee. The IRS examined the plan and found the mistake and the employer corrected the mistake at that time by restoring the benefits to the employee. In this case the plan failed to correct the mistake prior to the IRS examination and because the plan was a new plan with no history of compliance the event may not be treated as a nondisqualifying event.

(iv) A plan administrator failed to obtain spousal consent prior to making a single sum distribution under a plan subject to the qualified joint and survivor annuity rules. The plan administrator caught the error prior to examination by the IRS and sent the forms to the spouse who completed and returned them. The plan otherwise complied with the requirements of section 401(a). This violation would be a nondisqualifying event.

2. Employee Plans Closing Agreements Program

(a) In those situations in which all of the conditions of the APRS do not apply, the Closing Agreement Program (CAPP) may prove helpful. The CAPP is a closing agreement
the IRS and the responsible parties enter into that mitigates the full consequences of plan disqualification. The CAPP is administered by the key district offices of the IRS. CAPP and IRM 8(13)10 Closing Agreement Handbook.

(i) Instead of the usual loss of sponsor deductions and taxation of the trust and participants that are vested, the plan sponsor can avoid disqualification of the plan by agreeing to make a payment directly to the IRS. In addition, the plan sponsor must make retroactive and prospective correction of the defect.

(ii) The IRS position is that past disqualifying defects that affect current years must be corrected, even if the defect arose in a closed year. For example, suppose an employer made a contribution to a defined contribution plan in excess of the applicable section 415 limit resulting in a disqualifying defect. Apparently, the IRS' theory is that if the plan does not remove the excess contribution from the employee's account, a tax subsidy (i.e., tax exemption for the income earned on the excess contributions) will continue to be allowed for the excess amount. To qualify for CAPP, the plan sponsor must correct the mistake for all plan years, including any closed plan years. Apparently the justification for this position is that CAPP does not seek a sanction for the closed year(s), only correction.

(c) The CAPP was originally designed to be applied in cases involving:

(i) failure to amend for TEFRA, DEFRA and REA;

(ii) improper application of an integration formula;

(iii) partial plan termination; and

(iv) operational top-heavy violations.

(d) The IRS has expanded CAPP so that it may be applied in the discretion of the local
District Offices in other areas, e.g., the joint and survivor rules, and for section 415 and the section 401(a)(17) $200,000 compensation limit allocation violations. However, CAPP is specifically not applicable in the case of:

(i) exclusive benefit violations;

(ii) significant discrimination in favor of the highly compensated; and

(iii) repeated, deliberate or intentional violations.

(e) As an alternative to CAPP, plan sponsors may want to consider whether to take their case to the Appeals Office of the IRS or to litigate, and how much it will cost to pursue the matter further. However, in making this decision plan sponsors should keep in mind that CAPP does not apply to the Appeals Office, and that appeals officers generally do not consider the equities in settling cases.

3. Voluntary Compliance Resolution Program (VCR) - Revenue Procedure 92-89

(a) In Rev. Proc. 92-89, the IRS established an experimental program (VCR) to encourage employers to correct operational plan defects. The program is administered from the national office of the IRS. The VCR program was created in response to plan sponsors who told the IRS that they want to correct operational defects but are reluctant to incur the significant penalties that may be imposed under CAPP.

(i) Under VCR, the national office of the IRS issues a compliance letter indicating the plan is in conformance with qualification requirements to employers who voluntarily disclose operational plan defects, make full correction of all defects for all years that the defects existed, pay a voluntary compliance fee, and, in appropriate cases, implement administrative procedures to keep the plan in compliance.
(ii) Compliance letters are not available to nonamenders or to plans that have qualification defects involving exclusive benefit violations relating to the misuse or diversion of plan assets; or repeated, deliberate, or flagrant violations.

(iii) VCR is only available to plans that are not subject to a current employee plan examination.

(b) On August 31, 1993, the IRS released Rev. Proc. 93-36, modifying and extending the VCR program.

(i) The types of defects that can be corrected under the VCR program are expanded, i.e., the VCR program will now be available to correct all qualification defects unless "they involve issues that the IRS deems inappropriate for the VCR program." Plans in which the violations have been "egregious" are said to fall within this category.

(ii) A standardized correction procedure is provided for certain defects.