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RETIREMENT PLANS AND NEWEST NONDISCRIMINATION RULES

By: Matt W. Zeigler, Esq.

The Internal Revenue Service published on May 10, 1990 its long awaited regulations dealing with discrimination in qualified employee retirement plans. These regulations were supposed to have been published last summer, but apparently have been revised and simplified. Because of the move toward simplification, other previous proposed regulations have been have been modified. The favorable determination letter process have finally been opened, the amount of compensation that can be utilized in determining the benefits of the highly paid employees has been limited, and the IRS has announced increases in the already significant User Fees.

PROPOSED NEW NONDISCRIMINATION REGULATIONS UNDER §401(a)(4).

These regulations are designed to test in a general way whether the amount of contributions or benefits discriminate in favor of the highly compensated employees. The rule is tested as a percentage of compensation, so the actual dollar amount can be greater for highly compensated employees as long as these employees don't receive a larger percentage of pay.

For Defined Contribution Plans.

Of the seven new safe harbor tests, two will probably encompass the usual form of a majority of the plans adopted by employers. The first safe harbor test for defined contribution plans will permit automatic passage of the §401(a)(4) tests. For example, in a profit sharing plan, if all participants receive the same share of the employer's contribution as a percentage of compensation, that plan will pass the test. Employers who wish to take their employees years of service into account have a separate safe harbor test. Although frowned upon by the IRS in the past, these new proposed regulations permit a "single uniform formula weighted for age or service "if that formula "allocate(s) to each employee the same percentage of compensation or the same dollar amount, (assuming) every employee had the same age and the same number of years of service or plan participation. Thus, the dollar amount of allocations may vary solely on account of compensation, age, years of service, or years of plan participation".

Also, it is even possible for some highly compensated employees to receive a larger share of the contribution if the percentage of variance meets certain requirements called the "Permitted Disparity Rules". These rules keep in place the idea of "social security integration", so long as every employee under the plan has the same integration level, the same base contribution percentage, and the same excess contribution percentage.

Plans can "sail into" in these new safe harbors made by the IRS on a plan design basis. So, all that a plan sponsor needs to do is to review the language of the plan document in order to

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determine whether or not it meets the safe harbor criteria, rather than doing complex employee testing based upon the actual data used for the year.

For Defined Benefit Plans.

The safe harbor for defined benefit pension plans enables these plans to satisfy the nondiscrimination requirements on the basis of plan design as well and not on complicated after the fact testing. A "unit credit plan" is one that contains a formula under which all employees accrue a benefit, either as a percentage of compensation or as a dollar amount, for each year of service, and all employees with the same number of years of service accrue the same benefit. Again, some discrimination in favor of the highly compensated employees is permissible so long as those employees do not receive a benefit in excess of 133% of the amount of benefit for the nonhighly paid employees.

However, these new sets of regulations have retained the other general nondiscrimination requirements and look to a facts and circumstances test. These rules still prohibit any favored treatment by plans of the owners or other highly compensated employees of the plan sponsors either on a plan design basis or whether there is any discrimination in the actual operation of the plan. Such favoritism may be demonstrated by giving a lump sum payment to a highly compensated employee when he or she leaves employment while the non-highly compensated employee must wait until age 65 or allowing the highly paid employees to have self-directed accounts when that option is not available to the lower paid employees.

REVISION OF PROPOSED MINIMUM PARTICIPATION REGULATIONS.

In a significant about-face, the IRS has withdrawn the proposed regulations under Internal Revenue Code Section 401(a)(26) published February 14, 1989 and reproposed them. These regulations address the minimum participation of employees in qualified plans. The basic rule set out in the Internal Revenue Code is that a qualified plan must benefit the lesser of 50 employees or 40% or more of all employees of the employer. Thomas D. Terry, Acting Treasury Benefits Tax Counsel, said that this section "has become the symbol of complexity".

The old regulations were 93 pages in length and, in their reissued form, have been cut by over half to 40 pages. As reproposed, the Service decided not to exercise the statutory authority granted it to identify and require separate testing of separate benefit structures, explained Nancy J. Marks, a technical assistant in the Office of Assistant Chief Counsel. The six tests provided under last year's regulations have been replaced with a single facts and circumstances test. "This should significantly simplify testing under the minimum participation rules," she said.

This column will address the simplified rules under Section 401(a)(26) in the August issue.

COMPENSATION LIMIT.

The Internal Revenue Service has limited the amount of compensation that any plan can take into account when allocation a participant's share of employer contributions, in a defined contribution plan, or the amount of benefit to be received, in a defined benefit plan. The amount

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of compensation that can be taken into account for such purposes each year is $200,000.00. Any compensation received by a participant in excess of that amount is disregarded in applying the nondiscrimination rules. This annual compensation limit will be adjusted upward annually by the Commissioner of the IRS. The base year is 1989 and the first limit is $200,000.00. The effective date for this compensation is for plan years commencing on or after January 1, 1991.

EFFECTIVE DATE FOR NONDISCRMINATION REGS.

The effective date for these nondiscrimination regulations is the first day of the plan year commencing after December 31, 1990. This gives the plan sponsors time to review their plan design to determine whether any change is necessary.

INCREASE IN IRS USER FEES SET FOR OCTOBER 1, 1990.

The IRS has imposed "User Fees" on those persons that utilize its services. Any sponsor of a qualified retirement plan will be required to amend that plan this year. The User Fee is determined by how many participants that are in the plan. For example, a qualified defined contribution plan with less than 100 participants, has a user fee of $450.00; for those plans with 100 or more participants, the user fee will be $750.00.

Effective October 1, 1990, the User Fee for qualified defined contribution plans with less than 100 participants, $700.00; for those plans with 100 or more participants, the user fee will be $825.00.

For those plan sponsors who adopt a so-called "Regional Prototype Plan" used by law firms, banks, insurance companies with a large volume of similar plan applications, the present User Fee is $100.00 with the increase to $125.00 on October 1st.

OPENING OF THE DETERMINATION LETTER PROCESS.

For Defined Contribution Plans, the determination letter has opened effective May 1, 1990. Filing now will enable a plan sponsor to take advantage of not only the Special Reliance Procedure, discussed in this column in January, 1990 issue, but also for those sponsors, with less than 100 participants, a lower user fee.

For Defined Benefit Plans, the determination letter process will be opened in mid to late August, 1990, slightly before the scheduled user fee increase set for October 1, 1990.

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