APPENDIX B

REQUIREMENTS FOR PLAN QUALIFICATION

Since the Revenue Acts of 1938 and 1942, the Congress has placed substantial conditions on pension, profit-sharing, and stock-bonus plans qualifying for the tax advantages described in Chapter I. The conditions generally require that, in order to qualify, plans must include the rank and file of employees as well as those who have the most to gain from the tax advantages. The plans are also restricted in the extent to which benefits and contributions may favor the highly compensated. With these conditions, the Congress and the Treasury have attempted to use the desire for tax-advantaged saving among a firm's highly paid employees to enhance and encourage retirement saving among all workers. 1/ Still other conditions limit the amount of saving in qualified plans.

Section 401(a) of the Internal Revenue Code lists over 20 separate paragraphs defining the conditions for pension or profit-sharing plans to qualify for tax-favored treatment. The major conditions are set forth in sections 410 through 417 of the code, and in extensive Treasury Department regulations. 2/ The Treasury and the Internal Revenue Service provide additional guidance in general counsel memoranda and Revenue Rulings. The major requirements discussed here are:

- Participation standards,
- Minimum vesting standards,
- Nondiscrimination in coverage,

---

1. See Chapter IV for a discussion of how these incentives affect negotiations over compensation.

2. The rules about nondiscrimination in coverage and in benefits and contributions are unique to the tax code. The "labor law" requirements imposed by Title I of ERISA on employee pension plans parallel the qualification rules imposed by the code in the areas of participation, benefit accrual, vesting, and joint-and-survivor requirements.

- o Nondiscrimination in benefits and contributions,
- o Special rules for top-heavy plans, and
- o Limitations on contributions and benefits

There are two consequences of not complying with these requirements. First, employers may not deduct their contributions until such time as workers vest in their accounts (in the case of funded nonqualified plans) or begin to receive payments (in the case of unfunded nonqualified plans). Second, in general, workers would have to pay taxes on savings in these accounts substantially in advance of their actual retirements. This is because ERISA requires that, in any broad-based nonqualified plan, accounts must be funded and vesting must occur within five years. For income tax purposes, workers would be deemed to receive the money in these nonqualified accounts at the time of vesting, rather than at the time of retirement. (Under current law, this result can be avoided only in unfunded nonqualified plans that cover relatively small numbers of upper-income workers.) In addition, any investment income in a nonqualified plan is taxable under the ordinary tax rules applicable to trusts or the sponsoring employer. Though the issue of deductions is not relevant for public and nonprofit employers, their plans must also comply with the requirements for qualified plans in order for their workers to be exempt from current taxation of the contributions made on their behalf and of associated investment earnings.

Participation Standards. In general, section 410(a) prevents plans from excluding from participation workers of the type covered by the plan once they are at least 21 years of age and have completed one year of service (more than 1,000 hours in one year). In addition, very specific rules concerning breaks in service control the circumstances under which a returning worker can be disqualified after a lapse in employment under the retirement plan.

Minimum Vesting Standards. To be qualified a plan must give its covered workers full rights to their contributions or accrued benefits--that is, vest them at least as rapidly as one of the schedules specified in section 411. Before the Tax Reform Act of 1986, three schedules were available: 10-year cliff vesting (the schedule most private plans currently follow); graded vesting rising from 25 percent at 5 years of service to 100 percent at 15 years; and one that combined age and length of service.

Tax reform has shortened the permissible vesting periods. At a minimum, all plans generally must either vest workers after five years or use a graded schedule that rises from 20 percent after three years to 100 percent after seven years. Most defined benefit plans will have to shorten their vesting schedules to meet these tighter standards. Multiemployer plans may, however, still use 10-year cliff vesting.

Finally, as under prior law, plans may exclude workers for more than one year if they vest them fully once the exclusion period is over; tax reform has shortened this alternative exclusion period from three years to two years.

Nondiscrimination in Coverage. The minimum eligibility requirements of sections 401(a)(3) and 410(b) are intended to insure that a broad cross-section of an employer's workers are covered in the plans that the employer sponsors. Before the Tax Reform Act of 1986, a plan was qualified if one of two tests was met. The percentage test was met if the plan covered at least 70 percent of all the employer's workers. The fair cross-section test was met if the plan covered a representative sample of the employer's workers even though large categories of employees--for example, hourly workers--were excluded. The fair cross-section test is prescribed by the Secretary of the Treasury in regulations and revenue rulings.

The Tax Reform Act of 1986 has modified these tests for qualification in ways that will make them harder to satisfy. A plan will qualify if either it covers at least 70 percent of all non-highly compensated employees ("percentage" test), or if the percentage of non-highly compensated employees covered is at least 70 percent of the percentage of highly compensated employees covered ("ratio" test). Alternatively, plans wishing to qualify under the fair cross-section test must meet the additional requirement that the benefit-to-salary ratio for all the employer's non-highly compensated workers must be at least 70 percent of the benefit-to-salary ratio for all highly compensated employees.

Nondiscrimination in Benefits and Contributions. Under sections 401(a)(4), 401(a) (5), 401(l), and 401(m), plans qualify only if the benefits or contributions they provide do not discriminate in favor of covered employees who are highly compensated. Plans may, however, include as benefits and contributions a share of Social Security attributed to the employer. Regulations assume that employers pay half the cost of the old age insurance portion of Social Security. Using this assumption and others, regulations have long specified the maximum adjustments plans may make to account for Social Security (that is, "integrate" with Social Security).

The Tax Reform Act of 1986 altered and restricted the extent of integration. In an offset plan, the maximum offset under any circumstances cannot exceed 50 percent of what the benefit would be without integration. Alternatively, the percentage reduction cannot exceed a percentage factor times the years under the plan (up to 35 years) applied against the participant's final average salary under the plan; the percentage factor for any given participant is a function of the participant's income. Similarly, in excess benefit plans, the plan's annual replacement rate above the integration level cannot exceed twice its rate below that level or, if smaller, 0.75 percent for each year of service under the plan. The requirements for offset plans are a very substantial departure from past requirements, and their effect on offset plans, even on whether such plans will continue to exist, is uncertain.

The defined contribution percentage for salaries above the integration level can be no greater than twice the contribution percentage below, and in no case greater than 5.7 percentage points above, the contribution percentage applicable below the integration level. Thus, if the integration level is $25,000 and the contribution percentage below that level is 5 percent, then the maximum contribution rate on wages in excess of $25,000 is 10 percent. Alternatively, if the contribution rate is 6 percent on wages below $25,000, the maximum contribution on excess wages is 11.7 percent. The 5.7 percentage-point differential represents the employer's share of the Social Security payroll tax.

Separate nondiscrimination rules apply to thrift and salary reduction plans. The contribution rates by, and on behalf of, all highly compensated employees cannot exceed contribution rates by, and on behalf of, all other employees by more than specified ratios that decline from 2.0 at minimal contribution rates to 1.25 at higher contribution rates.

<u>Special Rules for Top-Heavy Plans</u>. Plans in which the accrued benefits for key employees exceed 60 percent of accrued benefits for all employees are classified as top-heavy. Key employees are, generally, top officers, owners, and the highly compensated.

The special rules are designed to provide greater benefits for non-key employees and limit benefits for key employees. Thus, stricter vesting standards require three-year cliff vesting or graded vesting reaching 100 percent by the sixth year. Defined benefit plans must provide minimum benefits to non-key employees equal to 20 percent of pay or, if less, 2 percent for each year of service. Defined contribution plans must contribute as a general rule 3 percent of pay to non-key employees. The minimum benefit and contribution requirements cannot be integrated with Social Security. Maximum benefits for key employees are constrained by allowing only $200,000 of annual compensation to count in the calculation of benefits or contributions, and by stricter limits on what combined plans may pay such employees.

Top-heavy rules apply primarily to small plans where key employees make up a higher fraction of all employees. The rules were enacted in 1982 when special rules for the self-employed (Keogh plans) were removed. Some of the top-heavy rules are extensions of the previous restrictions on plans for the self-employed.

<u>Limitations on Contributions and Benefits</u>. For qualified plans, maximum benefits per employee are limited both as a percent of salary and in absolute dollars. A defined benefit plan can fund a pension no greater than 100 percent of salary, averaged over the last three years of employment, and, in any case, not greater than $90,000. A defined contribution plan can contribute no more than 25 percent of salary and, in any case, not more than $30,000. Inflation indexing for the $90,000 limit is scheduled to resume in 1988. Indexing for the defined contribution limit has been delayed by the Tax Reform Act of 1986 until its value falls to one-fourth of the defined benefit limit. Employees participating in multiple plans--for example, a basic defined benefit pension and a supplementary salary reduction plan--face combined limits designed to avoid the pyramiding of benefits.

The current defined contribution limit is more generous than the defined benefit limit for young high-salaried workers. The reverse is true for older high-salaried workers. Contributions of $30,000 per year for many years will be able to purchase a retirement annuity of more than $90,000 per year, while those made for only a few years will not provide an annuity of $90,000 per year. The exact age at which the two limits are equally constraining depends on market interest rates, the retirement age, and the expected years in retirement. 3/ By raising the defined benefit maximum relative to the defined contribution limit, tax reform has reduced the age at which defined benefit plans accruing the maximum become more generous.

For funding purposes, the $90,000 maximum benefit in defined benefit plans is reduced for early retirement. Before tax reform the re-

3. For example, if market interest rates are 7.1 percent, the retirement age is 65, and the expected length of retirement is 13 years, then a person age 50 would be equally constrained. That is, if the person contributed $30,000 per year for 15 years, a retirement benefit of $90,000 could be paid for 13 years.

duced maximum was $75,000 at age 55. The Tax Reform Act of 1986 requires that the reductions be strictly actuarial and start from age 65 (instead of 62 as in prior law). This reduction will lower the maximum benefits that can be funded for retirement at age 55 from $75,000 to approximately $40,000 depending on actuarial assumptions.

The Tax Reform Act of 1986 also has added a special $7,000 limit for elective deferrals to most salary reduction plans. The limit will be indexed beginning in 1988.

In addition, an employer is limited in its aggregate contributions to qualified plans to no more than 25 percent of its total compensation base or, if larger, the amount necessary to fund its primary defined benefit plan. Within this limit profit-sharing and stock-bonus plans cannot exceed 15 percent of payroll.