

Decisions, Decisions, Decisions... (Part 1)

By Arthur H. Tepfer, A.S.A., M.A.A.A.

Coping with the new laws in your pension documents

As we approach the end of 1998, one refrain rings clear-- "It's that time again!" Time to make some decisions about our retirement plans for the year that is ending. Decisions like...will we be making a discretionary match in our 401(k) or will we be making a profit sharing contribution?...can we afford to increase our match for 1998 to increase participation for 1999?...will our 401(k) plan pass the discrimination tests or will we be forced to make refunds to our highly compensated employees or consider a qualified non-elective contribution?

But 1998 is also a special year with regard to some of these decisions, because it is also the year prior to the year the transition period expires for compliance amendments under "GUST". "GUST" is the umbrella acronym for the Uruguay Round Table Agreements Act, also called GATT, the Uniformed Services Employment and Reemployment Rights Act (USERRA), the Small Business Job Protection Act of 1996 (SBJPA) and the Taxpayer Relief Act of 1997 (TRA '97) -- the latest round of laws which are not yet in your plan document.

Here's a little historical background on the laws and the acronyms for some of the newcomers. It all started in 1974 with the Employee Retirement Income Security Act -- ERISA, our first acronym. The late 1970's were filled with consultants and attorneys trying to interpret the provisions of this new law and wrestling with fresh concepts like, "Form 5500", "required joint and survivor annuities" and "Summary Plan Descriptions". The Internal Revenue Service was promulgating new rules but not new regulations. It seems that the IRS also had some difficulty understanding what this ERISA really was about. Finally, the regulations came, and the bottom line was that all pension plans had to be rewritten and lots of decisions had to be made.

In the early 1980's a new stack of tax laws appeared -- the inimitable Tax Equity and Fiscal Responsibility Act -- TEFRA, the Deficit Reduction Act -- DEFRA, and the Retirement Equity Act -- REA. Once again the consultants and the attorneys were scurrying around investigating and interpreting the laws for top heavy testing, death benefit protection and equality for all (remember the Equal Rights Amendment?). The IRS once again promulgated rules but delayed the issuance of regulations. Finally, the regulations came, and the bottom line again was that all pension plans had to be rewritten and lots of decisions had to be made.

In 1986, we were once again rewarded with a new law -- the Tax Reform Act of 1986. The acronym creators were stymied. At last, one creative consultant developed the acronym TRASH to describe this law. TRASH, of course, was

derived from the first three letters of the new Act and the first two letters of a common four-letter word often used to describe the law's impact on the benefits community. Still another time the consultants and the attorneys were scurrying around investigating and interpreting the laws for excise taxes on failure to make minimum distributions, excise taxes on premature distributions, excise taxes on excess contributions, excise taxes on pension reversions, excise taxes on...well, you get the picture. The IRS once again promulgated rules but delayed the issuance of regulations. Finally, the regulations came, and the bottom line again was that...you guessed it... all pension plans had to be rewritten and lots of decisions had to be made.

So here we are again. It's the end of 1998 and now we have GUST. Have you noticed how the consultants and attorneys have been scurrying around investigating and interpreting the laws on highly compensated employees, prior year and current year 401(k) discrimination testing, safe harbor contributions for 401(k) plans, and family aggregation (oops--that was the law but isn't anymore -- it may be the shortest duration pension law on record, but that's another article!)? Nevertheless, the IRS once again has promulgated rules but delayed the issuance of regulations. Actually, some of the regulations are here...but the bottom line once again is that...all together now... all pension plans have to be rewritten and lots of decisions have to be made!

Revenue Procedure 98-14 issued in January, 1998 announced the April, 1998 opening of the determination letter program for GUST. Revenue Procedure 98-14 was actually a modification and extension of Revenue Procedure 97-41, which provided that the remedial amendment period under Internal Revenue Code Section 401(b)--that's the section that says that you have some extra time to retroactively amend your plan if you have a qualification amendment--was extended to the last day of the first plan year beginning on or after January 1, 1999. According to the rules, not only must you make the amendments required by the new laws, you must also incorporate into the plan documents all the changes in operation that you have made during the periods that they were in effect.

Some of these are quite simple. For example, suppose that you increased the threshold for non-consensual distributions to \$5,000 on July 1, 1997. You have been making these distributions since that date even though your plan documents say that distributions above \$3,500 require the consent of the taxpayer and the spouse. In your GUST amendments you must specify the date of the change in operation.

Let's complicate the problem. Suppose in April, 1999 you decide that you want to go back to the \$3,500 level. You can do this as long as you provide proper notification and disclosure and make the new amendment prospective only, but your GUST amendments must reflect the dates in which you actually were cashing out amounts between \$3,500 and \$5,000.

The new laws contain many potential changes in operation. Some of these already might have been implemented in your plan's procedures, others not yet initiated, and some still not decided. This all sounds fine as long as you, or someone, has been keeping track of what you have done and when you did it. If this information is not at your fingertips it is time to start the research.

In January we'll examine the future impact regarding some of the decisions on the changes you already may have made and the future impact on some of the decisions which still await. See you then.

Decisions, Decisions, Decisions... (Part 2)

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Now that we have an understanding of the historical perspective, let's look at some of the actual decisions that plan sponsors face in this new round of plan amendments and restatements. This month we will examine the basic decisions which are generally applicable to all types of retirement plans; next month we will look at the decisions specific to 401(k) plans, other defined contribution and defined benefit retirement plans. I hope that you won't be disappointed, but there is no way that CBBM can resolve the decisions for you. This article, therefore, will not give you any answers--in fact, it will probably only raise some other questions. But it will, at least, alert you to the areas where decisions must be made.

Family Aggregation

With the repeal of family aggregation under SBJPA, the first decision is "should we retain family aggregation as part of our plan or eliminate it?" Yes, believe it or not, there actually are cases where the retention of family aggregation in a 401(k) plan will actually increase the amount that the highly compensated group can defer. These generally apply to non-owner spouses who are not deferring. In money purchase and defined benefit plans, there are also situations where retention is more beneficial. Ask your consultant or administrator to run a few alternative tests to see if there is a possibility that retention of the family aggregation rules will be advantageous.

But be aware that the IRS has announced that "a plan will not satisfy a nondiscrimination in amount safe harbor for a plan year beginning after December 31, 1996, unless family aggregation is disregarded in the operation of the plan and the plan is amended within the remedial amendment period, retroactive to the first day of such plan year, to eliminate its family aggregation provisions. Therefore, in an application for a determination letter an employer may not designate a plan as one that is intended to satisfy a nondiscrimination in amount safe harbor if the family aggregation rules continue to apply under the plan. Instead, the employer must either demonstrate that the plan satisfies the general test for nondiscrimination in amount or request a letter that contains a caveat regarding the nondiscrimination in amount requirement." [Section 6.03, Rev. Proc. 98-14, 1998-4, I.R.B. 22]

Definition of Highly Compensated Employee

While we are speaking of "highly compensated employees" we should look at another decision affecting the operation of your retirement plan.

For plan years beginning on or after January 1, 1997, an employee is a "highly compensated employee" for the plan year if the employee:

1. was a 5% owner at any time during the plan year or the preceding year, or
2. had compensation for the preceding year from the employer in excess of \$80,000 (to be indexed).

At the election of the employer, the group of employees described in (2) above may be further limited to those who are in the "top-paid group" for the preceding year (generally, the highest paid 20% of the employees based on compensation paid during that year) and an employer's election to impose the "top-paid group" restriction can be made on a year-by-year basis, without the consent of the IRS.

CBBM Observation:

Presumably, the "preceding year" can include a calendar year "lookback" year, but it is not clear to what extent this or other special rules on periods to be taken into account in identifying highly compensated employees will carry over from pre-1997 law.

If the employer chooses this election, all employees of the employer must be taken into account and the determination may not be made separately for each line of business. Moreover, in identifying highly compensated employees, related employers must be aggregated and treated as one employer to the extent required by Sections 414(b), (c), (m) and (o). Finally, leased employees must also be taken into account as employees to the extent required by Section 414(n).

This is a very powerful tool in limiting the highly compensated employee group which works well in small plans as well as larger plans. Again, your consultants and administrators are the best source of determining whether this choice is helpful to your plan.

Increase in non-consensual distribution limit

TRA '97 increased the amount of the accrued benefit subject to involuntary distribution under section 411(a)(11) from \$3,500 to \$5,000, effective for plan years beginning after August 5, 1997. A plan that contains the \$3,500 limit may, for plan qualification purposes, be operated during the remedial amendment period in anticipation of a retroactive amendment reflecting the increase in the limit.

Once again, this is a choice on the part of the plan sponsor. The limit can be increased, presumably to eliminate the maintenance of small account balances or small projected pension payments; or, the limit can be retained at the \$3,500 level to restrict the former participant from direct access to his future retirement funds--a type of forced savings argument.

Elimination of the mandatory minimum distribution requirements

In one of the most convoluted battles within the recent history of the Internal Revenue Service, the IRS found itself in a peculiar position. SBJPA repealed the requirement that non-owner employees must receive a minimum distribution at age 70½. The IRS then, in a self imposed quandary, determined that the right to receive this benefit was a protected form of benefit and could not be eliminated from a plan which provided this benefit to individuals who were currently over age 70½. The IRS finally relented, (to itself?), that the plan sponsor could eliminate this benefit, but only if it allowed the employees who were receiving this benefit the choice to continue or not continue receiving the benefit which had already commenced. Confused?? So was the IRS. In fact, they went so far as to separate the group into employees who were receiving the benefit and those who were not yet receiving the benefit, but who had the right to receive the benefit at a later date, and set up different rules for each classification.

So once again, plan sponsors are faced with a whole flurry of decisions regarding what to do with the, now, non-mandatory minimum distribution rules which affect only some participants in the plan. Again, no solutions, just an alert that the decision is necessary and must be addressed as part of the plan restatement process.

Those are the biggies!! By the way, here's a neat little one which most lawyers or consultants probably won't even let you know is there: USERRA allows the sponsor to suspend loan repayments during a participant's period of military service. Now that is just a nice thing to do!

Next month--choices for compliance testing in 401(k) plans, choices regarding cross-tested plans, and interest rates for lump sum distributions in defined benefit programs-- plus, if we're lucky, any new revelations from the IRS. See you in February!!

Decisions, Decisions, Decisions... (Part 3)

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Here we are again for the final installment of this series. We've looked at the historical perspective and some of the GUST [see Part 1] changes which affect all types of retirement programs. This month let's examine the effects on some particular types of plans.

Elimination of Additional Participation Requirements

The major change which affects all non-defined benefit plans is the elimination of the applicability of the minimum participation rules contained in IRC Section 401(a)(26)--that's the section which requires at least 50 employees or 40% of the total eligible group to participate in a plan. This restriction now only applies to defined benefit plans for post-1996 years. Decisions: Should we restructure our retirement programs to cover smaller groups or separate divisions? Should we set up a special plan to cover only the partners or maybe only the associates? Should we consider spinning off the plan for the hourly employees from the plan for salaried employees?

Remember, that even though you can now set up smaller and perhaps more manageable programs, all the plans still must comply with the multitude of non-discrimination rules and generally still must be tested on an aggregated basis. Talk to your consultants.

Changes For 401(K) Plans

There have been so many changes to the rules regarding 401(k) plans that it is virtually impossible for one short article to possibly cover all of them. Let's look at the two most dramatic changes that will require some type of plan amendment language to be incorporated into the GUST restatements.

Discrimination in amount testing for 401(k) programs was essentially overhauled by SBJPA with the introduction of prior year testing. Revenue Notice 98-1 (not to be confused with Revenue Ruling 98-1 which we will discuss later) provides that a plan will use prior year testing unless an employer elects to use current year testing. Once current year testing has been elected, then a change to prior year testing may only be made subject to the following two rules:

1. The plan document must be amended to reflect which testing method is going to be used and when it is in effect.

2. A plan using current year testing may not be permissively aggregated with a plan using prior year testing.

There are special rules regarding switching back and forth (generally five years later is the first opportunity) and special rules when you merge plans or establish new plans. Again, everything must be contained in your plan document for your plan to retain its qualified status. The attorneys are going to be very busy as they incorporate this language into your 401(k) program.

The second most overwhelming change was the announcement in the recently released IRS Notice 98-52 which sets out guidance for sponsors who wish to provide safe-harbor plan design for 401(k) plans and **eliminate testing once and for all!!**

CBBM observation--Plan sponsors that already provide a generous match or non-discretionary profit sharing contribution should seriously consider the possibilities of safe-harbor 401(k) design.

There are four rules which must be followed if the plan adopts safe-harbor design.

1. The plan must provide 100% vesting for safe-harbor contributions.
2. The plan must not contain a last day of employment or a 1000 hours of service requirement as a condition of receipt for the safe-harbor contribution.
3. The sponsor must decide before the beginning of each plan year that the plan will provide, under its terms, fixed safe-harbor contributions (i.e. no discretion).
4. The sponsor must provide participants with a written notice of the safe-harbor provisions each year.

So what are the safe-harbor contributions you ask? Well--there are two (actually three--but who's counting). A plan may provide a "Safe-Harbor Non-Elective Contribution" by making a contribution of 3% of compensation for each eligible non-highly compensated employee [see Part 2 of this series] whether or not this employee defers under the 401(k) plan. Or a plan may provide a "Safe-Harbor Matching Contribution" using either a "basic matching formula" or an "enhanced matching formula".

A plan satisfies the "basic matching formula" if it provides a 100% match on deferrals up to 3% of compensation and a 50% match on deferrals from 3% to 5% of compensation for each non-highly compensated employee.

A plan satisfies the “enhanced matching formula” if it provides a matching contribution for each non-highly compensated employee of an aggregate amount that, at any rate of deferral, is at least equal to that which would be provided by the basic matching formula, and the formula may not provide for a greater rate of match as an employee’s deferrals increase. (Leave it to the IRS to come up with that design!).

A word of caution about some of the other restrictions in safe-harbor 401(k) design. Safe-harbor contributions may not be withdrawn for hardship, they must be made within twelve months after the close of the plan year and they may not be used as qualified matching or qualified non-elective contributions.

Nonetheless, a great advantage of using a safe-harbor 401(k) design is that the safe-harbor contribution can serve so-called “triple duty”. The contribution first eliminates the testing requirement under 401(k) and 401(m) rules; next, the plan can use this contribution to satisfy the minimum top heavy requirements under Internal Revenue Code Section 416; and finally the contribution can be used for testing under the general discrimination rules contained in Internal Revenue Code Section 401(a)(4).

Look at safe-harbor design very carefully and if you decide it is for you, make sure that it is properly reflected in your plan amendments and restatements.

General Testing Under the 401(A)(4) Rules

By now there has been so much written about cross-tested allocations in defined contribution plans and different formulas for defined benefit plans, that most plan sponsors have examined these issues fully. The real news came in 1998 when the National Director of the IRS Employee Benefit Plans sent a memorandum to the Chief of Employee Benefit Plans in Cincinnati clarifying the national office position with regard to the requirement that a profit sharing plan must have a definite predetermined formula for allocating employee contributions.

The memorandum once and for all completely rescinded a 1994 field directive (which had actually been rescinded in 1996, but left some peculiar doubt among some practitioners). The new memorandum required that the plan language be specific with regard to the portion of each year’s contribution to be allocated to each group of employees in a profit sharing plan which gave the employer discretion to determine the amount contributed for each group.

The 1998 memorandum states as follows:

Although the plan can provide for employer discretion to determine the amount of employer contributions for each group, the plan must require that the employer notify the trustee, in writing, of the amount of the contributions for each group. This requirement does not

mean that the plan must provide the specific amount of contributions for each group. Instead the plan must provide that the trustee be given written notification from the employer as to the amount of the contribution to be allocated to each group.

Since most cross-tested plans were drafted prior to the issuance of this memorandum, this language needs to be added to your amendment or restatement. Make sure that both your administrators and your attorneys are aware of this "generous gift" from the IRS.

Changes To Defined Benefit Programs

Defined benefit plans were not left untouched by GUST. The most universal change is contained in IRS Revenue Ruling 98-1 (see--I told you we would get here) which outlines the IRS position regarding determination of the limits under Code Section 415. In a bit of convoluted IRS reasoning, which still has the actuarial profession reeling, the IRS developed a set of calculation procedures which are at best unworkable and at worst will cost plan participants thousands of dollars in lost benefits. I could try to explain this --but candidly I'm not sure that I understand how to properly calculate a lump sum benefit for a participant who is at the Section 415 limit (and I am an enrolled actuary who has been practicing for 30 years!!).

Nonetheless, your plan will need to be amended to add the appropriate changes to the Section 415 calculation sections and the general changes for the "GATT amendments" for actuarial equivalence. If you haven't already had a face-to-face sit down with your actuary, the time has come to make the decisions for all those nasty actuarial matters.

Well that about sums them all up. Remember, these amendments must be adopted by the end of the plan year which begins in 1999. The IRS has stated unequivocally, as it has in the past, that this is a final deadline and will not be extended. Would you doubt them? But, you see, there have been these rumors...