Minimum Coverage Prop. Regs. Contain Several New Tests

A restrictive view of the average benefit percentage test is but one of the IRS' narrow readings of the requirements of Section 410(b).

BY WILLIAM L. SOLLEE

Recently issued Proposed Regulations under Section 410(b) reflect some of the radical changes made by TRA '86 to the minimum coverage requirements for qualified plans. The new rules are generally effective for plan years starting after 1988. As usual, there are exceptions for plans maintained pursuant to one or more collective bargaining agreements.[1] (These Proposed Regulations do not deal with other nondiscrimination issues, such as the method for determining whether contributions or benefits satisfy Section 401(a)(4), and they do not provide any detailed guidance on the average benefit percentage test of Section 410(b). Regulations on these issues will be forthcoming.)

Basic tests. Under Prop. Reg. 1.410(b)-2, a plan is qualified only if it satisfies one of two minimum coverage tests: the ratio percentage test or the average benefit test.[2] Under the ratio percentage test, a plan must benefit a percentage of the nonhighly compensated employees that is at least 70% of the percentage of the highly compensated employees who benefit under the plan. Under the average benefit test, a plan must benefit a classification of employees that the Service finds not discriminatory in favor of the highly compensated (nondiscriminatory classification test) and the average benefit percentage of the nonhighly compensated employees must be at least 70% of the average benefit percentage of the highly compensated (average benefit percentage test).[3] Active and former employees must be tested separately for compliance with the minimum coverage rules.[4]

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Interrelationship With Section 401(a)(4)

In a major policy statement, the Preamble to the Proposed Regulations (5/18/89) provides that "[b]y adding the average benefit test to section 410(b), TRA '86 effectively combined the section 410(b) minimum coverage rules and the section 401(a)(4) general nondiscrimination rules." In effect, Sections 401(a)(4) and 410(b) will be applied as a single, overriding rule of nondiscrimination which will have quite far-reaching effects on many aspects of qualified plans. The legislative history to TRA '86 indicates that the average benefit percentage test generally is to be applied in the same manner as the general nondiscrimination rules have been applied with respect to contributions or benefits under an employer's qualified plans.

Before TRA '86, *Rev. Rul.* 81-202, 1981-2 CB 93, provided the Service's primary statement on the calculation of contributions and benefits.[5] According to the legislative history, a revised version of *Rev. Rul.* 81-202 will form the basis for applying the average benefit percentage test.[6] The Service is to modify the *Rev. Rul.* 81-202 approach, both for the average benefit test and for determining whether two or more plans that are treated as a single plan for purposes of Section 410(b) discriminate in favor of the highly compensated under Section 401(a)(4). In a statement which is of dubious validity, the Preamble also provides that "the legislative history indicates that the approach developed by the Service is to be the exclusive approach for applying the average benefit percentage and general nondiscrimination tests."[7] The facts-and-circumstances test used since 1942 will no longer be valid.[8]

In any event, the Preamble informs us that the Service is developing interrelated Regulations under Sections 410(b) and 401(a)(4), addressing the minimum coverage rules of the former and the general nondiscrimination rules of the latter. These interrelated Regulations, according to the Preamble, will generally reflect the basic view that, even though there are two Code Sections that govern nondiscrimination—Section 410(b) for coverage and Section 401(a)(4) for contributions and benefits—these provisions are substantially interwoven, focus on similar issues, and require substantially similar determinations.[9] This rule will result in a coordinated nondiscrimination rule for qualified plans. As the Preamble succinctly states: "In general, this rule requires that a nondiscriminatory

group of employees actually benefit under one or more of an employer's qualified plans at each level of contribution or benefit and with respect to each other benefit, right or feature."[10] This statement of the rule gives significant insight into the standard that the Service will apply in testing nondiscrimination in qualified plans, *i.e.*, each element of a qualified plan will be tested.

Affected Employees

Former employees. A plan under which no former employee is currently benefiting satisfies Section 410(b) with respect to its former employees. A plan under which a former employee is currently benefiting (*e.g.*, a plan that is amended to provide an *ad hoc* cost-of-living adjustment to the benefit provided a former employee under the plan) must satisfy Section 410(b) with respect to *all* of its former employees.[11] While former employees benefiting under the plan must generally pass one of the two coverage tests outlined above, Prop. Reg. 1.410(b)-2(c)(2)(ii)(B) provides what should in most cases be a more easily met special rule. A plan satisfies Prop. Reg. 1.410(b)-2(b) with respect to its former employees with a current benefit if at least ten former employees are currently benefiting under the plan and at least 60% of these currently benefiting former employees are not highly compensated former employees.[12]

Acquisitions or dispositions. Section 410(b)(6)(C) provides a special rule relating to certain dispositions or acquisitions whereby a plan may be treated as satisfying Section 410(b) for a limited period. This Section does not apply to acquisitions or dispositions that occur prior to the first plan year to which Section 410(b) as amended by TRA '86 applies. Thus, under Prop. Reg. 1.410(b)-2(d), employers who have a transaction described in Section 410(b)(6)(C) that occurs in the year prior to the first plan year in which post-TRA '86 Section 410(b) applies must satisfy Section 410(b) (without regard to Section 410(b)(6)(C)) in the first such plan year.

Employees currently benefiting. The coverage rules apply to employees who currently benefit under the plan. This concept of "benefiting" versus mere eligibility to benefit under the plan is critical to the proper application of the coverage tests. Under Prop. Reg. 1.410(b)-3(b)(1), only an employee who receives an allocation or accrues a benefit for such year "benefits" under a plan for that year.[13] Thus, an employee generally is not benefiting under a plan (and thus would not be considered to be covered) merely because the employee is currently eligible to receive an allocation or to accrue a benefit under the plan. Similarly, an employee who has an accrued benefit under a plan generally is not benefiting under the plan if the employee is not currently receiving an allocation or accruing an additional benefit under the plan.

There is, however, a special rule in Prop. Reg. 1.410(b)-3(b)(2)(ii) for arrangements under Sections 401(k) and 401(m). Under this rule, an employee is benefiting if the employee is currently eligible to make elective contributions (in the case of the 401(k) feature) or to make after-tax employee contributions or receive matching contributions (in the case of the 401(m) feature).

In response to comments on a similar "benefiting" rule prescribed in the Proposed Regulations under Section 401(a)(26), Prop. Reg. 1.410(b)-3(c) provides a special minimum service accrual rule. Under this rule, the excludable employee provisions will apply if the participant fails to accrue a benefit or receive an allocation solely because of a minimum

[1] Prop. Reg. 1.410(b)-10. Under Prop. Reg. 1.410(b)-10(b)(1), an employer may elect not to apply the objective tests of Prop. Reg. 1.410(b)-4 applicable to determining whether a plan benefits a nondiscriminatory classification of employees for plan years beginning before 1990. Thus, for plan years beginning in 1989, the employer may elect to apply the pre-TRA '86 facts-and-circumstances standards. This transition relief applies for purposes of all provisions (e.g., Section 125) to which the nondiscriminatory classification test applies. Taxpayers may rely on these Proposed Regulations pending the issuance of final Regulations. If more restrictive rules are then adopted, such guidance will be applied without retroactive effect.

[2] The ratio percentage test encompasses both the percentage test and ratio test of Sections 410(b)(1)(A) and (B), respectively; if a plan satisfies the percentage test of Section 410(b)(1)(A), it will necessarily also satisfy the ratio test of Section 410(b)(1)(B). See Prop. Reg. 1.410(b)-2(b)(2)(i).

[3] Under Prop. Reg. 1.410(b)-5, the average benefit percentage is determined by dividing the actual benefit percentage for the nonhighly compensated active employees by the actual benefit percentage for the highly compensated active employees. The actual benefit percentage for a group of active employees is the average of the benefit percentages calculated separately with respect to each employee in the group. All active employees who are not excludable under Prop. Reg. 1.410(b)-6 are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account. Prop. Reg. 1.410(b)-7 sets forth the rules for determining which qualified plans of the employer are taken into account.

[4] See Prop. Reg. 1.410(b)-2(a). The legislative history provides for the separate testing of former employees. See H. Rep't No. 99-841, 99th Cong., 2d Sess. II-416 (1986) (Conference Report).

[5] Rev. Rul. 81-202, 1981-2 CB 93, sanctioned what many considered to be abuses of the qualified plan rules (for instance, individual defined benefit plans). There is little doubt that this Ruling will in many circumstances be tightened.

[6] See, e.g., Conference Report, *supra* note 4, at II-413.

[7] The Statement of Managers provides that "the conferees expect that the Secretary will consider providing an objective safe harbor based on these and other relevant factors to facilitate compliance with the test." *Id.* Nowhere does the legislative history state or imply that the Service may prescribe an exclusive classification test. Rather, the exclusive test in determining contributions or benefits is to be the approach of Rev. Rul. 81-202, *supra* note 5. *Id.* Those employers with plans that have coverage that comes within the unsafe harbor provided by the Proposed Regulations (discussed in the text, below) will no doubt need to consider whether it is worthwhile challenging the Service on this (assuming that when finally adopted, the Regulations do not back off this position).

[8] See, e.g., Pepsi-Cola Niagara Bottling Co., 48 TC 75 (1967), *rev'd* 399 F.2d 390 (CA-2, 1968).

[9] For example, Reg. 1.401(a)-4, Q&A-2(a)(2)(i), provides that the availability of an optional form of benefit in a plan must be tested for discrimination under Section 410(b) for purposes of the Section 401(a)(4) nondiscrimination requirement.

[10] For example, the qualified status of profit-sharing plans that base allocations partly on service, rather than totally on compensation as defined in Section 414(s), will be jeopardized if highly compensated employees have greater service than the nonhighly compensated.

service requirement or a requirement that the employee be employed on the last day of the plan year and the participant terminates employment with not more than 500 hours of service.[14] Under a transitional rule in Prop. Reg. 1.410(b)-10(b)(2), for plan years commencing during 1989, employers may treat employees as benefiting under a plan for purposes of Sections 410(b) and 401(a)(26) if such employees fail to accrue a benefit or receive an allocation solely by reason of failing to accrue 1,000 hours of service or failing to be employed by the employer on the last day of the plan year.[15]

Nondiscriminatory Classification Test

Under Prop. Regs. 1.410(b)-4(a) and (b), a plan must provide that employees are eligible to benefit under a nondiscriminatory classification properly set up by the employer. To be "properly set up by the employer," the classification must be reasonable and established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (*i.e.,* salaried or hourly), etc. An enumeration of employees by name (or other specific criteria having substantially the same effect) is not a reasonable classification.

Safe and unsafe harbors. According to Prop. Reg. 1.410(b)-4(c), a classification is nondiscriminatory for a plan year only if the group of employees so classified who benefit under the plan satisfies either a safe harbor rule or a facts-and-circumstances rule.[16] Under the safe harbor rule, the nonhighly compensated employee benefiting percentage must equal or exceed the safe harbor percentage multiplied by the highly compensated employee benefiting percentage.

The safe harbor test is met if the percentage of nonhighly compensated employees who benefit under the plan is at least 50% of the percentage of highly compensated employees who benefit. As the "concentration percentage" increases, the safe harbor test may also be met when the ratio percentage drops below 50%. Thus, as the concentration percentage increases from 60% to 99%, the ratio percentage drops proportionally from 50% to 20.75%.

The Proposed Regulations provide an unsafe harbor under which a classification is discriminatory if the percentage of nonhighly compensated employees who benefit under the plan is less than 40% of the percentage of the highly compensated who benefit. The ratio percentage decreases proportionally from 40% to 20% as the concentration percentage increases from 60% to 99%.[17]

Prop. Reg. 1.410(b)-4(c)(4)(vi) contains a table which sets forth the safe harbor and unsafe harbor percentages at each nonhighly compensated employee concentration percentage.

Where a plan's coverage falls between the safe and unsafe harbors, Prop. Reg. 1.410(b)-4(c)(3) provides that the relevant facts and circumstances of the particular employer are to be examined to determine whether the plan's classification is nondiscriminatory. Facts and circumstances considered relevant in determining whether a classification is nondiscriminatory include the following:

1. The underlying business reason for the classification (the greater the business reason, the more likely the classification is to be nondiscriminatory).

2. The percentage of employees benefiting under the plan (the higher the percentage, the more likely the classification is to be nondiscriminatory).

3. Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce (the more representative the percentages, the more likely the classification is to be nondiscriminatory).

4. The difference between the nonhighly compensated employee benefiting percentage and the safe harbor percentage times the highly compensated employee benefiting percentage (the smaller the difference, the more likely the classification is to be nondiscriminatory).

Broad applicability of classification test. The nondiscriminatory classification test set forth in the Proposed Regulations is applicable not only with respect to the Section 410(b) minimum coverage rules, but also applies —until other guidance is provided—to cafeteria plans under Section 125(b)(1), group legal service plans under Section 120(c)(3), educational assistance plans under Section 127(b)(3), and dependent care assistance under Section 129(d)(4).[18] For reasons not explained, the Proposed Regulations do not apply to Section 89 or to the line-of-business determinations under Sections 410(b)(5)(B) and 414(r).

Excludable Employees

All active employees of the employer, other than certain excludable employees described below, are taken into account in applying Section 410(b) to active employees. Generally, these rules, under Prop. Reg. 1.410(b)-6, are applied by reference only to the plan or plans being tested.

If a plan applies minimum age and service eligibility conditions permissible under Section 410(a)(1) (without regard to Section 410(a)(1)(B)) and excludes all active employees who do not meet such conditions, then all active employees who fail to satisfy such conditions may be treated as excludable employees with respect to that plan.[19] In certain situations, employees who would be excludable under Prop. Reg. 1.410(b)-6(b)(1) but for the fact that the plan does not apply the greatest permissible minimum age and service conditions may be excludable if the plan satisfies the ratio percentage test or the average benefits test. In such a case, the plan may be treated as comprising two separate plans: one for the otherwise excludable employees and one for the other employees for purposes of applying Section 410(b).[20]

If a plan (or two or more plans that are considered as one plan for coverage purposes) has two or more different sets of minimum age and service eligibility conditions, those employees who fail to satisfy *all* of the different sets of age and service conditions may be treated as excludable employees. An employee who

satisfies any one of the different sets of conditions is not an excludable employee.[21]

Other excludable employees. In addition to the above, Prop. Reg. 1.410(b)-6 contains additional rules for excludable categories:

1. *Nonresident aliens.* An employee who is a nonresident alien and who receives no earned income (within the meaning of Section 911(d)(2)) from the employer that constitutes income from sources within the U.S. (within the meaning of Section 861(a)(3)) is excludable under Prop. Reg. 1.410(b)-6(c), even if such nonresident alien benefits under the plan.

2. *Collective bargaining.* An employee included in a collective bargaining unit is an excludable employee with respect to the portion of any plan that does not benefit such employees, under Prop. Reg. 1.410 (b)-6(d).

Section 413(b)(1) provides that Section 410(b) is applied to collectively bargained plans described in Section 413(a) as if all employees of each of the employers who are parties to the collective bargaining agreement and who are subject to the same benefit computation formula were employed by a single employer. Consequently, such a plan satisfies Section 410(b) with respect to such employees because all other employees are excludable employees and are therefore disregarded.[22]

3. *Employees of separate lines of business.* In testing a plan that benefits the employees of one of an employer's separate lines of business, Prop. Reg. 1.410(b)-6(g) states that the employees of the other separate lines of business are excludable employees. This rule is not applicable to the nondiscriminatory classification requirement of Section 410(b) (5)(B).

Plan Aggregation and Disaggregation

Prop. Reg. 1.410(b)-7 generally adopts the "plan" definition applicable to plan mergers and spin-offs under Section 414(l). Thus, each single plan under Section 414(l) is a single plan for purposes of Section 410(b), no matter how many plan documents or trust agreements there are.

Under Prop. Reg. 1.410(b)-7(c), certain plans are separate plans, each subject to Section 410(b). These mandatory disaggregation rules reflect the rules governing whether certain different types of plans may be aggregated for purposes of Sections 410(b) and 401(a)(4), and are designed to prevent employers from accomplishing through one plan a result that cannot be accomplished through two or more plans. For purposes of the ratio percentage test and the nondiscriminatory classification test, an employer may elect to aggregate certain separate plans to form a single plan. Finally, in applying the average benefit percentage test, certain separate plans must be aggregated to form a single plan.

A plan that benefits both employees included in a collective bargaining unit and employees who are not so included is treated as comprising separate plans for purposes of applying Section 410(b). This rule is applied separately with respect to each collective bargaining unit.[23]

Separate plan treatment under Section 410(b) applies to:

1. The portion of a plan that is an ESOP described in Section 4975(e)(7) or 409 and the portion of such plan that is not an ESOP.[24]

2. The portion of a plan that consists of contributions under a qualified cash-or-deferred arrangement (Section 401(k)) and the portion of a plan that does not consist of such contributions.

3. The portion of a plan that consists of matching contributions and employee contributions (Section 401(m)) and the portion that does not consist of such contributions.[25]

Under Prop. Reg. 1.410(b)-7(c)(4), if an employer elects to apply Section 410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions that are lower than the

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[11] Prop. Reg. 1.410(b)-2(c)(2)(ii)(C). At the election of the employer, employees who are not currently benefiting and who became former employees either prior to calendar 1984 or prior to the beginning of the tenth year before the year being tested may be disregarded.

[12] As with several other newly prescribed tests, this special rule may be supplemented or modified only in documents of general applicability. This supposedly means that the key district directors, for example, do not have discretion to vary the regulatory rule for a particular taxpayer.

[13] Requiring a current benefit is consistent with the approach taken by the Service under Section 401(a)(26). Under Prop. Reg. 1.401(a)(26)-3(c), only an employee who receives a current accrual of benefits currently benefits. See Oliphant III, "Minimum Participation Prop. Regs. Are Complex, Burdensome," 71 JTAX 78 (August 1989).

[14] A similar rule was added under Section 401(a)(26); see Prop. Reg. 1.401(a)(26)-3(b)(8)(i). According to the Service, this design-based rule enables an employer to impose a minimum service requirement to ease plan administration, thereby lessening the risk that employee turnover may cause the plan to fail in operation. Thus, for example, a plan (including a standardized plan) that otherwise benefits all employees, but which provides that those who terminate employment and complete less than 501 hours of service in a plan year will not accrue a benefit for such year, is treated as benefiting 100% of the employees.

[15] According to the Preamble to the Proposed Regulations, Rev. Ruls. 76-250, 1976-2 CB 124, and 81-210, 1981-2 CB 89, are superseded to the extent they conflict with the general rule that an employee is treated as benefiting for purposes of Section 410(b) only if the employee actually accrues a benefit or receives an allocation.

[16] Under prior law, the nondiscriminatory classification test generally was applied on only a facts-and-circumstances basis; see Reg. 1.410(b)-1(d)(2). The new minimum coverage rules and the objective approach to the nondiscriminatory classification test provided in those rules are, according to the Service, intended to minimize the uncertainty employers have experienced in applying the facts-and-circumstances approach. See the Preamble to the Proposed Regulations.

[17] This unsafe harbor rule can be criticized on several counts. For one, as discussed in note 7, *supra,* a rule that would automatically find a plan's coverage discriminatory does not seem to be justified by Section 410(b) or its legislative history. Second, the 20% unsafe harbor cutoff would arguably have qualified under Rev. Rul. 83-58, 1983-1 CB 95. This Ruling, along with the other Rulings and cases dealing with the standards for determining what is a reasonable classification, were approved by the TRA '86 conferees. "For purposes of the average benefits test, the conferees intend that the classification test is generally to be based on the present-law section 410(b)(1)(B) (as modified judicially and administratively in the future). Thus, the test is to be applied on the basis of the facts and circumstances of each case." Conference Report, *supra* note 4, at II-413.

greatest minimum age and service conditions permissible under Section 410(a), such plan is treated as comprising separate plans. One plan benefits the employees who have satisfied such lower minimum age and service conditions but not the greatest minimum age and service conditions permissible under Section 410(a). The other plan benefits employees who have satisfied the greatest minimum age and service conditions permissible under Section 410(a).

An employer who is treated as operating two or more separate lines of business under Section 414(r) may elect to apply Section 410(b) separately to such business lines. If Section 410(b)(5) is satisfied, Prop. Reg. 1.410(b)-7(c)(5) provides that a plan that benefits the employees of such a separate line of business is separate from any plan that is maintained by any other line of business.

According to Prop. Reg. 1.410(b)-7(c)(6), a multiemployer plan is treated as comprising separate plans, each of which is maintained by a separate employer, and must satisfy Section 410(b) by reference only to such employer's employees. The portion of a plan that benefits employees who are included in a collective bargaining unit, the portion of such plan that benefits employees who are included in another collective bargaining unit, and the portion of such plan that benefits noncollective bargaining unit employees are all separate plans for purposes of Section 410(b). Consistent with Section 413(b), the portion of the plan that is maintained pursuant to a collective bargaining agreement is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollective bargaining unit employees who benefit under the plan are employed by one or more employers.

Permissive aggregation. Generally, for purposes of applying the ratio percentage and nondiscriminatory classification tests, an employer may designate two or more of its separate plans as a single plan under Prop. Reg. 1.410(b)-7(d). If an employer so elects, such plans must be treated as a single plan for all purposes under Sections 401(a)(4) and 410(b).[26] In a departure from prior law, Prop. Reg. 1.410(b)-7(d)(2) states that an employer cannot aggregate two or more plans that are mandatorily disaggregated. Thus, for example, a plan that benefits both collective bargaining unit employees and noncollective bargaining unit employees that must be disaggregated under Prop. Reg. 1.410(b)-7(c)(1) may not be permissively aggregated.

In applying the average benefit percentage test (except as provided below), Prop. Reg. 1.410(b)-7(e) requires that all qualified plans of the employer be taken into account to form a single plan, including contributions or benefits under qualified cash-or-deferred arrangements (Section 401(k)) and matching contributions and employee contributions (Section 401(m)). In other words, for purposes of the average benefit percentage test, all plans (including deemed separate plans) of an employer that *may* be aggregated under the permissive aggregation rules *must* be aggregated and treated as a single plan. However, plans that are mandatorily disaggregated must separately satisfy the average benefit percentage test. Thus, plans benefiting collective bargaining unit employees, ESOPs, plans of separate lines of business, and plans maintained by more than one employer must separately satisfy the average benefit percentage test.

There will be significant consequences to this mandatory disaggregation in some cases. For example, an ESOP may not be combined with another plan (other than perhaps another ESOP, although even this is not clear) in testing such other plan under Section 410(b). This lack of ability to aggregate will certainly make it more difficult for some plans to pass the average benefit percentage test. Section 401(k) and 401(m) arrangements and plans benefiting

[18] See also Reg. 1.132-6(d)(1) (classification test for certain fringe benefit purposes is to be based on principles similar to those applied under Section 410(b)(2)(A)(i)).

[19] It thus appears that plans using the special two years of service, 100% vesting rule of Section 410(a)(1)(B)(i) may not treat employees with more than one year of service who are also age 21 as excludable employees.

[20] See Prop. Regs. 1.410(b)-6(b)(2)(i) and -(6)(b)(4), Example 4.

[21] See Prop. Reg. 1.410(b)-6(b)(4), Example 1.

[22] There are special rules in Prop. Reg. 1.410(b)-6(e) with respect to a collectively bargained plan described in Section 413(a). Section 413(b)(1) provides that Section 410(b) is applied to a Section 413(a) plan as if all employees of each of the employers who are parties to the collective bargaining agreement and who are subject to the same benefit computation formula were employed by a single employer. Consequently, such a plan satisfies Section 410(b) with respect to such employees because all other employees are excludable employees and are therefore disregarded. Prop. Reg. 1.410(b)-6(e)(3) contains an exception, however, for collective bargaining agreements where more than 2% of the employees covered are professional employees (none of the employees so covered are excludable with respect to employees who are not covered by the agreement). Under Prop. Reg. 1.410(b)-7, the portion of a plan that benefits employees under a collective bargaining agreement is treated as a separate plan from the portion of the plan that benefits noncollective bargaining unit employees and from the portion that benefits employees under a different collective bargaining agreement.

[23] See Prop. Reg. 1.410(b)-7(c)(1).

[24] Prop. Reg. 1.410(b)-7(c)(2). An employer may treat this rule as not effective for plan years beginning before 1990. This is consistent with the nonaggregation rule adopted with respect to ESOPs and 401(k) and 401(m) arrangements, although the effective date of the Section 401(k) and (m) rules is a year earlier. See Reg. 1.401(k)-1(b)(5) and Prop. Reg. 1.401(m)-1(b)(4).

[25] Thus, for example, a plan that includes contributions under a qualified cash-or-deferred arrangement under Section 401(k), matching contributions and employee contributions under Section 401(m), and other contributions is treated as three separate plans for purposes of Section 410(b). Prop. Reg. 1.410(b)-7(c)(3).

[26] This is consistent with existing Reg. 1.410(b)-1(d)(3). What this means in practice, however, will have to await further guidance. For plan years starting after 1989, if two or more plans are treated as a single plan for purposes of Section 410(b), such otherwise separate plans cannot have different plan years. Prop. Reg. 1.410(b)-10(b)(3).

[27] See Oliphant III, *supra* note 13.

otherwise excludable employees must be aggregated with other plans when performing the average benefit percentage test.

Special Rules

A plan must meet at least one of the tests set forth in Prop. Regs. 1.410(b)-2(b)(2) through (6) on each day of the year being tested, according to Prop. Reg. 1.410(b)-8(a)(1). Generally, a plan meets the relevant test if it satisfies such test on at least one day in each quarter of the year being tested.

A plan meets the average benefit percentage test if the plan satisfies such test on an annual basis. For purposes of this test, all employees employed by the employer during the year being tested are taken into account.

If a plan fails to satisfy Section 410(b) for one or more days during a plan year, Prop. Reg. 1.410(b)-8(a)(2) provides that the plan may be amended by the last day of that plan year to satisfy Section 410(b) retroactively (based on the facts as they existed on the day or days of failure) by expanding coverage or by improving benefits or contributions or by modifying eligibility conditions under the plan. The need to retroactively amend to satisfy Section 410(b) does not justify eliminating or reducing a benefit in violation of Section 411(d)(6).

For purposes of Section 410(b), the plan year is the plan year of the qualified plan as defined in the written plan document. The determination of whether the average benefit percentage test in Prop. Reg. 1.410(b)-5 is satisfied is made on the basis of plan years ending with or within the same calendar year, according to Prop. Reg. 1.410(b)-8(b)(4). Consequently, an employer with two plans, one with a calendar plan year and the other with a June 30 plan year-end, will have to compute the average benefit percentage for the two plans where one of the plans may not yet have been amended to comply with TRA '86 (the June 30 plan).

Definitions. Prop. Reg. 1.410(b)-9 contains several definitions of key terms. For the most part, these definitions seem to track the definitions in the Proposed Regulations under Section 401(a)(26).[27]

Conclusion

The Proposed Regulations have done little, if anything, to alleviate the burdensome administrative requirements imposed by the TRA '86 amendments to the minimum coverage provisions. Nevertheless, there is some room for planning in the safe/unsafe harbor rules and the permissive aggregation provisions. □

RULING PROCEDURES FOR M&P PENSION PLANS MODIFIED

The IRS has indicated, in *Ann.* 89-79, IRB 1989-25, 37, that it will modify the procedures recently announced in *Rev. Procs.* 89-9, IRB 1989-6, 6, and 89-13, IRB 1989-7, 25, for obtaining opinion and notification letters on master and prototype (M&P) pension and profit-sharing plans and regional prototype plans. (See "IRS Issues New Procedures for Rulings," 70 JTAX 348 (June 1989).)

Trade and professional organizations. *Rev. Proc.* 89-9 will be expanded to allow exempt trade and professional organizations to sponsor a standardized defined contribution plan for adoption by nonmember employers, if the member institutions are eligible to be M&P sponsors in their own right.

Opinion letter applications filed by such organizations should not be filed earlier than the time permitted under *Rev. Proc.* 89-9. The user fee for each basic plan document filed will be $1,000, and for each adoption agreement it will be the lesser of $15,000 or $50 times the number of member institutions that furnish the adoption agreement to employers.

Employee contributions. *Rev. Proc.* 89-13 provides that the Service will not issue a notification letter for a regional prototype plan that permits after-tax employee contributions unless the plan includes a qualified CODA. The Service will expand these rules to accept applications from such a plan if the basic plan document designates the plan sponsor as plan administrator.

Compensation. The Service will also modify its procedures to accept opinion letter applications for certain M&P plans and regional prototype plans that base participant benefits on less than total compensation. It will permit use of an alternative definition of compensation in nonintegrated nonstandardized M&P plans and regional prototype plans, including plans that contain a CODA.

Model CODAs discontinued. The IRS has also announced, in *Notice* 89-68, IRB 1989-26, 24, that after 10/31/89 it will no longer accept requests for opinion letters on M&P profit-sharing plans that contain model CODAs, because of changes made by TRA '86 and the Regulations under Sections 401(k) and (m). Until 10/31/89, requests for opinion letters under *Rev. Proc.* 89-9 can continue to use the model CODA language contained in *Notices* 87-34, 1987-1 CB 490, and 87-51, 1987-2 CB 359, but such plans will no longer be given special priority and sponsors are warned the model CODAs do not comply with changes effective for 1989. □

IRS WILL RULE ON PLAN CONTRIBUTION NONDEDUCTIBILITY

IRS has issued procedures for administrators and sponsors of qualified defined benefit plans to obtain a ruling disallowing the Section 404 deduction for purposes of applying *Rev. Rul.* 77-200, 1977-1 CB 98, so that contributions can be returned to the employer without adversely affecting the plan's qualified status. *Rev. Proc.* 89-35, IRB 1989-21, 28, applies to employer contributions made for the 1988 plan year or made to satisfy the quarterly contributions requirement of Section 412(m) for the first plan year beginning after 1988 (see below).

Avoiding the 10% excise tax. Under Section 4972, a 10% tax is imposed on nondeductible plan contributions unless they are returned to the taxpayer by the time for filing that year's tax return (including extensions).

Rev. Rul. 77-200, 1977-1 CB 98, held that a qualified plan can include language providing for the return of em-

ployer contributions if they are disallowed under Section 404. The return must take place within one year from the date of disallowance.

Obtaining a disallowance ruling. Requests for a disallowance ruling must comply with *Rev. Proc.* 83-36, 1983-1 CB 763, and contain the information outlined in *Rev. Proc.* 89-35. The Service may request additional information as needed.

The maximum that may be returned to the employer is the excess of the contribution over the amount that would have been contributed had the contribution been limited to the amount deductible. Earnings attributable to the excess contribution may not be returned, but losses attributable thereto must reduce the returned amount.

If the request is approved, a form letter will be issued to the taxpayer, which must be attached to Schedule B of Form 5500 for the plan year for which the disallowance is effective. □

QUARTERLY PLAN CONTRIBUTIONS EXPLAINED

Changes made to Section 412 by RA '87 require that contributions to non-multiemployer pension plans be made in quarterly installments. *Notice* 89-52, IRB 1989-19, 142, explains this change in question and answer form.

According to Q&A-1, starting with the first plan year beginning in 1989, quarterly installments are due 15 days after the end of each quarter (*e.g.,* April 15, July 15, October 15, and January 15 for a calendar-year plan). Q&A-2 states that Section 412(b) requires that the funding standard account (FSA) be charged with interest at the appropriate rate, consistent with the rate used under the plan to determine costs. If an installment is paid late, the interest charged to the FSA with respect to the late amount is based on 175% of the applicable Federal mid-term rate (from the due date to the date the amount is actually contributed), or, if greater, the otherwise applicable interest rate for the FSA. The interest charge on late payments does not apply to money-purchase pension plans, according to Q&A-3. Quarterly installments are not required for the first plan year to which Section 412 applies, according to Q&A-13.

Determining installments. Q&A-4 states that each quarterly installment equals the applicable percentage of the required annual payment (RAP). For any plan year, the RAP is generally the *lesser* of:

1. 90% of the amount required to be contributed under Section 412 for the current plan year (adjusted to the beginning of the plan year).

2. 100% of the amount required to be contributed to the plan for the preceding plan year.

In addition, in determining 90% of the current year's minimum funding requirement (MFR), the employer must take into account any accumulated funding deficiency that existed at the beginning of the current plan year, according to Q&A-7.

The MFR for a plan year is the amount necessary to avoid a funding deficiency at the end of that year. If the required contribution is restricted by the full funding limitation of Section 412(c)(7), the limitation is the MFR for the plan year. The MFR is determined without regard to any credit balance as of the start of the plan year, under Q&A-6. Under Section 412(c)(10), the MFR for a plan year is satisfied as of the last day of that year if the required payment is made within the next 8½ months.

Applicable percentage. According to Q&A-4 and -5, the applicable percentage of the RAP that must be paid in each quarterly installment is 6.25% for plan years beginning in 1989, 12.5% for those beginning in 1990, 18.75% for those beginning in 1991, and 25% thereafter.

Q&A-8 states that if the MFR for the preceding plan year has been waived, the determination of 100% of the preceding year's MFR is made as if there had been no waiver. In addition, any amortization charges resulting from a funding waiver for an earlier plan year are included in the determination of the MFRs for the current and preceding plan years.

The computation of the RAP for the current plan year takes into account the use of the alternative minimum funding standard (of Section 412(g)) in either the current or preceding plan years, according to Q&A-9.

In general, according to Q&A-10, the amount of each quarterly installment for a plan year is determined by multiplying the RAP by the applicable percentage for the plan year. Each installment made during the plan year is credited with the appropriate amount of interest to the FSA from the contribution date to the end of the plan year. If an installment is paid early, interest credited for the period before such installment was due may reduce future installments for that plan year.

Designating contributions. An employer may designate whether contributions made during the 8½-month period following the end of a plan year are made for the current plan year or for the preceding plan year, under Q&A-11. Contributions may be designated for only one plan year, on Form 5500, Schedule B. If no designation is made, a contribution is treated as designated for the plan year in which it is made.

Q&A-12 states that an employer can treat all or a portion of a credit balance in a plan's FSA as a payment of a quarterly installment.

According to Q&A-14, the overpayment of a quarterly installment can be used to reduce the payment needed to satisfy a subsequent quarterly installment for the same plan year. Q&A-15 indicates that if the 1989 valuation for a plan indicates that the quarterly payments made for the 1989 plan year exceed the deductible amount for the 1989 plan year, the excess can be designated for the 1988 plan year if the payments were made within 8½ months after the 1988 plan year.

Q&A-16 provides that if part of a quarterly installment that has been paid is in excess of the deductible limits, it cannot be returned to the employer as a mistake of fact. Even though the first quarterly installment for any plan year is due 3½ months after the end of the preceding plan year and is based on the MFR for the preceding plan year, Q&A-17 indicates that the valuation for the preceding plan year need not be made final within such 3½-month period. □