

FAQs about Employees and Employee Benefits

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1. Introduction

This primer is an introduction to the basic laws of employee benefits. It is often assumed that there are legal impediments to employers providing benefits to phased retirees, part-time workers and the contingent workforce. From a benefits law perspective, this is really not true. By statute, self-employed workers are sometimes excluded from plans required to be employee-only but employers face few other prohibitions when designing their plans.

From an employer's perspective, there are far more impediments to excluding these workers from their benefit plans than including them. Tax law provides incentives to employers who sponsor plans and to workers who participate in them. But tax law also insists that this special treatment should not be available only to high-paid workers. So today's regulatory structure is intended to *compel* employers to include a substantial number of rank-and-file and lower-paid workers in their plans in exchange for favorable tax treatment for high-paid workers.

This primer illustrates this regulatory structure by focusing on the basic rules for eligibility and participation in the most common plans. It is in part an exercise in mapping the employee benefits universe. It is written from the perspective of an employer and highlights questions that an employer must answer when designing a particular plan. Those questions range from "who is an employee" to "how many low-paid workers must I include" to "what benefits may I offer and to whom?"

By providing a road map, this primer is also intended to illustrate the basic rules of employee benefit laws. These rules include some elementary rules about eligibility and participation that could be changed to mandate greater inclusion of phased retirees, part-time workers and the contingent workforce. But it is unlikely that such a broad-brush reform could be achieved. More likely avenues for change are the non-discrimination rules that apply to most employee benefits. These rules require employers to give more lower-paid employees more benefits than they otherwise might and more than the basic rules require. Harmonizing standards, tightening rules and tweaking definitions under these rules may be a more pragmatic approach to expanding benefit options to more employees.

The non-discrimination rules are admittedly difficult, complicated and often nonsensical. But it is not necessary or even desirable to attempt to master them. They are included for the purpose of illustrating the variety of tests, definitions and standards now in effect as part of this exercise in mapping the landscape of employee benefits plans.

2. Employee Benefits Basics

Q-1. What are “employee benefits”?

A-1. Employers typically provide their workers with a variety of benefits in addition to wages and salaries. These are commonly called “fringe benefits.” Fringe benefits include all types and sizes of benefits such as employee discounts, club memberships, employer-provided meals, educational assistance as well as pension and health plans. Under the general tax rule, workers are taxable on the fair market value of fringe benefits and employers may deduct their benefit costs every year, unless a specific tax statute provides otherwise. [IRC § 61(a) defines taxable income to workers and includes “compensation for services, including ... fringe benefits,” IRC § 162(a) permits employers a deduction for reasonable “salaries or other compensation for personal services,” and IRC § 132 excludes certain types of fringe benefits from taxation.]

“Employee benefits” are a special subset of fringe benefits. There is no single definition for this term but it typically refers to employer-sponsored plans that are subject to the Employee Retirement Income Security Act of 1974 (“ERISA”) and have special tax rules. ERISA contains technical definitions for the term “employee benefit plans” [ERISA § 3(3)].

Q-2. What laws apply to employee benefits?

A-2. There are three major laws: the Internal Revenue Code (“IRC”) [26 USC § 1 *et seq.*], ERISA [29 USC § 1001 *et seq.*], and the Age Discrimination in Employment Act (“ADEA”) [29 USC § 621 *et seq.*].

The IRC is the most important law because it determines how and when workers are taxed on employer-provided benefits. It also controls the ability of employers to take deductions for benefits provided to employees. It is the source of the non-discrimination rules that apply to many employee plans.

ERISA is the second most important law. It is partly a labor law. It sets some standards for plan participation and benefit requirements, imposes fiduciary responsibility on plan officials, and establishes rules for the enforcement of employee rights. It is also a tax law and contains several provisions that are incorporated into the IRC. It also includes special provisions for an insurance program for defined benefit pension plans, standards for continuation healthcare coverage (COBRA) and health plan portability and access rules (HIPPA).

The ADEA, as amended by the Older Workers Benefit Protection Act (P.L. 101-433), applies to employee benefit plans in theory but its impact is just beginning to be fleshed out by the courts. The ADEA, ERISA and the IRC also contain several duplicate provisions.

Social Security [42 USC § 301 *et seq.*] provides benefits such as retirement, disability, health

and life insurance that resemble employee benefits. Social Security, however, is not considered to be an employee benefit plan. It is instead an entitlement program that is mandatory, nearly universal, federally-regulated and financed by payroll taxes on employers and employees.

Q-3. Under ERISA, what is an employee benefit plan?

A-3. An employee benefit plan exists under ERISA if it is:

- a plan, fund or program
- maintained or established by an employer or an employee organization or both
- for the purpose of providing pension or welfare benefits
- to participants or beneficiaries.

For ERISA purposes, a plan must cover at least one “employee” [ERISA Reg. § 2510.3-3]. In order to have a “plan,” an employer must intend to create a plan and be involved in plan administration, among other factors. *See Donovan v. Dillingham*, 688 F.2d 1367 (1982). An employer who merely makes a plan available and implements employee payments through salary deductions has not established a plan under ERISA. For example, tax-sheltered annuities offered by educational institutions [ERISA Reg. § 2510.3-2(f)] or group insurance programs [ERISA Reg. § 2510.3-1(j)] are not ERISA plans if the employer doesn’t contribute and provides only minimal administrative support. The Supreme Court has also held in *Ft. Halifax Packing Co. v. Coyne*, 107 S. Ct. 2211 (1987) that an ERISA plan requires an on-going administrative scheme.

ERISA plans key off two concepts: being an employer and having employees. “Who is the employer” and “who is an employee” seem to be relatively easy questions to answer but benefits law continues to struggle with appropriate definitions for these concepts. Employers often invent new organizational structures and worker classifications designed to limit participation to favored employees. *See, for example, Vizcaino v. Microsoft*, 97 F.3d 187 (9th Cir. 1996). Regulatory authorities in turn develop complicated rules and regulations designed to prevent this.

Note: The discussion below highlights many of the different definitions used today but presenting all their nuances is beyond the scope of this primer.

Q-4. What is a “plan?”

A-4. In order to have a “plan,” an employer must intend to create a plan and be involved in plan administration, among other factors. *See Donovan v. Dillingham*, 688 F.2d 1367 (1982). An employer who merely makes a plan available and implements employee payments through salary deductions has not established a plan under ERISA. The Supreme Court has also held that an ERISA plan requires an on-going administrative scheme in *Ft. Halifax Packing Co. v. Coyne*, 107 S. Ct. 2211 (1987).

The common meaning of the term “plan” is a written document which describes the rules and procedures through which an employer provides one or more benefits to employees. Technically, the term “plan” is *not* synonymous with the plan document. It refers instead to a particular benefit

(or set of related benefits) and its funding, eligibility rules and participation requirements. A single plan document can include several component plans. For example, a defined contribution plan that is called a profit-sharing plan can be composed of 3 separate plans: one with across-the-board contributions for all eligible employees, one with employee contributions (a 401k plan); and one with matching contributions to 401k contributions. Each of these component plans must satisfy different rules and different testing requirements. In addition, for the non-discrimination testing procedures described below, one plan can be dis-aggregated into several plans or several plans can be aggregated into a single plan.

Q-5. Who is an employer or an employee organization?

A-5. ERISA § 3(5) defines an employer as “any person acting directly as an employer, or indirectly in the interest of an employer” and includes groups of employers. The IRC contains an elaborate set of rules and regulations called the “controlled group” rules that cast a wide net for employers within the complicated organizational structures of modern businesses. These rules include IRC §§ 414(a) (predecessor employers), 414(b) (controlled group of corporations), 414(c) (entities under common control), 414(m) (affiliated service groups), 414(n) (leased employees) and 414(r) (separate lines of business). These rules most commonly apply to retirement benefits but are increasingly being extended to other benefits as well.

ERISA § 3(4) defines an “employee organization” as a labor union or similar organization. The IRC frequently uses the term “collectively-bargained” to refer to plans sponsored by labor unions.

Q-6. Who is an “employee?”

A-6. An “employee” is any individual employed by an employer [ERISA § 3(6)]. In *Nationwide Insurance Co. v. Darden*, 112 S. Ct. 1344 (1992), the Supreme Court applied a common law agency test to the ERISA definition. In practice, this generally means that the 20-factor test found in Revenue Ruling 87-41 [1987-1 CB 296] is used to determine employee status.

Q-7. Who is a “participant?”

A-7. The term “participant” has several meanings. Under ERISA § (3)(7), a “participant” is any employee (present or former) that is or may become eligible for a benefit. The IRC has a number of different definitions for the term, depending on the context. The most common definition for tax purposes is 1) a participant who receives a benefit in any given year or 2) a former employee who is entitled to benefits either currently or in the future.

Q-8. What are the primary types of plans?

A-8. Under ERISA, a plan [ERISA § 3(3)] is either a “welfare plan” or a “pension plan” that covers at least one “employee” [ERISA Reg. § 2510.3-3].

Q-9. What is a “welfare plan?”

A-9. Under ERISA § 3(1), a welfare plan is a plan that provides benefits for:

- medical, surgical or hospital care
- sickness, accident, disability or death
- unemployment benefits
- vacation benefits
- apprenticeship or training programs
- day care centers
- scholarship funds (if funded)
- prepaid legal services
- holiday and severance pay plans.

ERISA Reg. § 2510.3-1 lists payroll and workplace practices that are NOT plans under ERISA, such as overtime and similar pay, certain types of sickness or absence pay, Christmas turkeys, recreation or dining facilities, and so on.

Q-10. What is a “pension plan?”

A-10. Under ERISA § 3(2)(A), a pension plan is a plan that:

- provides retirement income to employees, or
- results in the deferral of income until retirement or thereafter.

ERISA Reg. § 2510.3-2 excludes the following from the definition of a pension plan: severance pay and supplemental pay plans treated as welfare plans; bonus programs; and IRAs and tax-sheltered annuities not sponsored by an employer.

Q-11. What plans are exempt from ERISA?

A-11. Under ERISA § 4(b) and other sections, the following plans are generally exempt:

:

- plans sponsored by federal, state or local governments
- plans sponsored by churches
- workers’ compensation, unemployment compensation or disability insurance laws
- plans maintained outside the U.S. primarily for nonresident aliens
- unfunded executive compensation plans that provide additional benefits to executives and other high-paid employees.

Note: Even though these governmental, church and executive compensation plans are not subject to ERISA, IRC requirements continue to apply and must be observed in order to preserve tax-exempt treatment, where available, for plan participants.

3. Pension Plan Basics

Q-12. What laws govern pension plans?

A-12. The two primary laws are the IRC and ERISA, which share some provisions but have different responsibilities. Title 1 of ERISA governs reporting and disclosure requirements, fiduciary responsibility rules, and administrative remedies as well as civil and criminal enforcement procedures. It shares rules for eligibility for participation, vesting of benefits, forms of benefit payments and funding requirements with the IRC. The IRC establishes the rules by which pension plans are entitled to special tax treatment.

Note: For purposes of this project, it is useful to turn to ERISA for answers to questions about basic participation and benefit vesting requirements and to the IRC for other substantive issues.

Q-13. What is a “qualified” pension plan?

A-13. A qualified plan is a special creature of the IRC [IRC § 401 *et seq.*] If a pension plan satisfies IRC requirements, it receives special tax treatment. First, workers are not taxed on contributions made on their behalf or on benefits they accrue every year until they receive payments from the plan. Second, plan assets are not taxed on earnings. Third, employers can take an immediate deduction for amounts contributed. Any type of employer (for profit, non-profit, and governmental) can sponsor a qualified plan.

Q-14. Are all employer-sponsored pension plans qualified plans?

A-14. No. Under the IRC, there are other, special plan types for different types of employers. There are, for example, simplified plans based on IRAs under IRC § 408(k) largely for small employers. Non-profit and governmental employers can also sponsor plans that look a lot like qualified plans but are governed by different IRC provisions. For example, non-profit and public school employers can sponsor “403b plans,” also called “tax-sheltered annuities,” under IRC § 403(b). Governmental and non-profit employers have access to a similar form of plan under IRC § 457. A 403b plan with employer contributions is an ERISA plan but a 457 plan is not. All these plans essentially deliver the same tax treatment as qualified plans.

The rationale for having all these different plan types is that different types of employers (for-profit and non-profit, for example) are subject to different tax regimes under the IRC and should therefore have plans that suit their tax treatment. The law is currently moving toward rationalizing plan types and rules, but significant differences still remain.

Note: Qualified plans constitute the largest group of plans, so this primer will focus primarily on them in the discussion below. It is important to keep in mind, however, that some

employers have alternative plan choices with different rules for employee participation.

Q-15. Are there many types of pension plans?

A-15. Yes, but they generally fall into two basic categories: defined benefit (“db”) and defined contribution (“dc”) plans. In a traditional defined benefit plan, employees earn benefits based on their career earnings and years of service and receive retirement income in the form of a guaranteed income for life. In a defined contribution plan, employees receive contributions in a personal account and their benefit depends on the value of their account.

There are many different types of dc plans. The most popular form today is a 401k plan that permits employees to make their own contributions on a pre-tax basis. Employers may choose to make matching contributions to employees who contribute and/or across-the-board contributions to all employees. 403b and 457 plans are dc plans that also permit pre-tax contributions by employees. Traditional dbs are very similar, varying primarily by the type of benefits formula they contain. There are also “hybrid” db plans that resemble a dc plan while remaining subject to db rules, such as the notorious “cash balance” plan.

Note: Technically, under pre-ERISA IRC regulations, only a db plan and one type of dc plan called a money purchase pension plan are pension plans. This paper will, however, call all plans that provide retirement income “pension plans” to distinguish them from welfare plans.

Q-16. Can non-employees participate in a qualified plan?

A-16. No. IRC § 401(a) requires qualified plans to be for “the exclusive benefit of employees.” 403b plans are also limited to employees but 457 plans may include independent contractors.

Q-17. Who is eligible to participate in a pension plan?

A-17. ERISA sets minimum age and service standards for eligibility [ERISA § 202; IRC § 410(a)]. A plan is not required to have *any* eligibility rules but, if it does, it cannot require that employees be older than age 21 or complete more than one year of service, whichever is later. A year of service is generally 1,000 hours, and regulations under ERISA § 202 contain the rules for how hours of service of service are counted.

There are several exceptions to this rule. First, a tax-exempt educational institution may impose an age requirement of 26, provided that employees with at least 1 year of service are fully vested when they begin participation. Second, if a plan is *not* a 401k plan, an employer can impose a 2 year service requirement, also provided that employees are fully vested once they enter the plan.

Q-18. What are the rules about part-time workers in qualified plans?

A-18. Under ERISA, an employer may generally exclude employees who don’t meet

minimum age and service requirements from a pension plan. *See* Q-17. The IRC permits employers to establish additional standards for participation based on job classifications unless they are a subterfuge for excluding “part-time” and similar workers who meet ERISA’s minimum standards. Appendix A contains the 1994 IRS Directive on Part-Time Employees.

Q-19. What participation rules apply to qualified plans?

A-19. The eligibility standards set by ERISA are just a threshold requirement for qualified plans. More consequential are the non-discrimination requirements of the IRC. A fundamental principle for tax qualification is that a plan may not discriminate in favor of highly-compensated employees. The Tax Reform Act of 1986 and subsequent regulations created new objective tests for measuring discrimination in qualified plans. Those tests involve a two-step process. First, a plan must satisfy a “coverage” test by demonstrating that it does not favor highly-compensated employees in terms of plan participation [IRC § 410(b)]. Second, the plan must demonstrate that it is not providing disproportionate benefits to highly-compensated employees [IRC § 401(a)(4)].

Under IRC § 414(q), a “highly-compensated employee” (HCE) is generally one who is a 5% owner of the business or earned at least \$90,000 (in 2005, adjusted for inflation) a year in 2004. Employees who are not HCEs are called non-highly compensated employees (NHCEs).

Note: 401k plans have their own non-discrimination rules that are not described here.

Q-20. What are the coverage rules for qualified plans?

A-20. Briefly, unless a plan covers all employees, it must pass a coverage test that demonstrates that a sufficient number of NHCEs, given the number of HCEs, participate in the plan [IRC § 410(b)]. The relevant tests take into account all employees of the employer. “Employer” for this purpose means not only the employer sponsoring the plan being tested but all those with which it is affiliated under the controlled group rules.

There are two ways to pass. The first test is a “ratio-percentage” test. First, the employer calculates its total number of employees. Next, the employer excludes from that total the following categories of employees:

- all employees excludable under the minimum age and service rules of ERISA, unless the plan includes such employees, in which case it is tested as two plans, one just for otherwise excludable employees and one for other employees
- employees under a collective bargaining agreement
- non-resident aliens
- terminated employees who have not satisfied 500 hours of service in a plan that conditions benefits on employment on the last day of the plan year.

In the next step, the remaining employees are first characterized by income into HCEs and NHCEs and then are further subdivided by whether they benefit from the plan (receive a contribution or benefit accrual). Two ratios are computed: 1) the ratio of NHCEs who participate

in the plan to all NHCEs; and 2) an identical ratio for HCEs. If the result from dividing the first ratio by the second ratio is at least 70%, the plan passes the ratio-percentage test.

The second test is a “average benefit percentage” test available to plans that don’t pass the ratio-percentage test. In the first step, the plan must establish that it passes a “non-discriminatory classification test.” To do so, its eligibility rules must be based on bona fide business objectives (e.g., hourly versus salaried workers, specific job categories). Then, its ratio-percentage (calculated as described above) must satisfy a sliding compliance scale found in the regulations. In the second step, the “average benefit percentage” test, the plan must show that average employer-provided benefits received by NHCEs equals at least 70% of those received by HCEs.

Q-21. What are the tests for discriminatory benefits in qualified plans?

A-21. IRC § 401(a)(4) requires qualified plans to demonstrate that they do not discriminate in favor of HCEs in the contributions or benefits provided. Regulations provide a number of safe harbor formulas, such as providing benefits that are a uniform percentage of compensation for all participants, that automatically satisfy the test. Plans that don’t satisfy these rules must pass a very complicated, mathematical test called the “general test” to demonstrate that the benefits provided HCEs in comparison to those provided NHCEs do not exceed regulatory limits.

The general test measures the amount of benefits actually provided to HCEs and NHCEs. Then, “rate groups,” consisting of each HCE and all other participants with a benefit accrual equal or greater than each HCE are created. Each rate group is essentially treated as a mini-plan and must pass the coverage rules described in Q-19. The regulations include a number of techniques, such as Social Security integration and cross-testing (computing dc benefits as if the plan were a db and vice versa), that usually enable an employer to find a fit between its particular employee demographics - the relative concentration of high-paid workers and the richness of their benefits or contributions - and the requirements of the general test. Even if a plan’s demographics are so adverse that it is incapable of passing the general test, it might still satisfy a special circumstances provision if the IRS approves.

Note: If a plan fails to satisfy the non-discrimination rules, HCEs are immediately taxable on their vested accrued benefits [IRC § 402(b)(4)].

Q-22. What is the significance of the non-discrimination rules for plan participation?

A-22. A goal underlying benefits regulation is that employers should be required to include a sufficient number of NHCEs with similar benefits to justify the benefits offered each HCE. This sometimes requires employers to include more NHCEs in a plan than they otherwise might.

On the other hand, some employers have the ability to manipulate their employee demographics and certain testing techniques under the non-discrimination rules to give the illusion that NHCEs are receiving benefits that don’t really exist. The IRS has become aware of these abusive schemes and recently issued a directive, found in Appendix B, warning employers and

practitioners against their use.

Q-23. Do other types of pension plans have non-discrimination rules?

A-23. Instead of non-discrimination rules, simplified plans based on IRAs must cover almost all employees and provide benefits that are a uniform percentage of compensation under IRC § 408(k). Plans sponsored by governmental employers are generally exempt from all non-discrimination requirements other than those under their own governing statutes. 403(b) plans are theoretically subject to the same requirements as qualified plans but are currently operating under the less stringent standards found in Notice 89-23.

Q-24. Is there a pension alternative for employees without an employer-sponsored plan?

A-24. Yes. They can save on a pre-tax basis through an IRA [IRC § 408]. This enables them to contribute up to \$4,000 in 2005 as compared to up to \$14,000 through an employer-sponsored 401k plan.

4. Welfare Plan Basics

Q-25. Does ERISA set eligibility standards for welfare plans?

A-25. No. ERISA does not contain *any* minimum age and service rules for participation in welfare plans. Its primary function in this area is to provide definitions of covered benefits, impose reporting requirements and establish benefit claims and enforcement procedures.

Q-26. What role does the IRC play in welfare plans?

A-26. The IRC sets the rules for when employers may take a deduction for their welfare plan costs and when employees are taxed on the benefits they receive. In addition, the IRC has imposed non-discrimination rules on some welfare plans. Different types of welfare benefits are subject to different rules, although there are often similarities across benefit types. In addition, some non-discrimination rules are derived from pension plan rules. The primary welfare plans (and their non-discrimination rules) discussed in this primer are: accident and health plans; group-term life insurance plans; dependent care and educational assistance plans, and cafeteria plans, including flexible spending and health reimbursement arrangements. Health savings accounts are also described briefly.

Q-27. What are health plans?

A-27. An accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. It can be an umbrella plan for medical, dental, vision, mental health, long-term care, prescription drug and similar benefits. They can be insured, partially-insured or self-insured by an employer, and their costs can be paid by employers

or employees or some combination. An employer's contribution for coverage is not taxable to employees [IRC § 106] and benefits received from an accident or health plan are generally not taxable to employees [IRC § 105].

A-27. Which health plans are subject to IRC non-discrimination rules?

A-27. IRC § 105 imposes non-discrimination standards on accident and health plans but *only if* they are a self-insured medical reimbursement plan. If health benefits are provided under an insured plan, no non-discrimination rules apply.

Q-28. What are the non-discrimination rules of self-funded health plans?

A-28. A self-insured health plan is non-discriminatory only if 1) the plan doesn't discriminate in favor of HCEs as to eligibility to participate and 2) the benefits provided do not discriminate in favor of HCEs. If a plan fails these rules, HCEs are taxed on the benefits they receive generally determined as a proportion of reimbursements to other plan participants.

IRC § 105 generally uses the controlled group rules of pension plans for defining who is the employer for testing purposes but defines HCE differently. For health plan purposes, an HCE is

- 1 of the 5 highest paid officers
- a shareholder who owns more than 10% of the value of the stock of the employer
- among the highest paid 25% of all employees.

The non-discriminatory eligibility standard requires a plan to benefit 1) 70% of all employees, or 2) 80% of all employees who are eligible to benefit if 70% or more are eligible to benefit. If a plan can't satisfy that standard, it must demonstrate to the IRS that its eligibility classification does not discriminate in favor of HCEs using pension plan rules. For testing purposes, under IRC § 105(h)(3)(B), an employer may exclude workers who:

- have not completed 3 years of service
- have not attained age 25
- are part-time (working less than 25 hours a week) or seasonal (less than 7 months per year) employees
- are covered by a collective bargaining agreement
- are nonresident aliens with no income from U.S. sources.

Under the non-discriminatory benefits standard, all benefits available to HCEs must also be available to NHCEs.

Q-29. What are the non-discrimination rules for group-term life insurance?

A-29. Under IRC § 79, workers may exclude the cost of up to \$50,000 in coverage from income unless the plan fails a non-discrimination test. This benefit has the standard requirement that it may not discriminate in terms of eligibility to participate and may not provide discriminatory benefits. Life insurance plans, however, use the term "key employee" rather than HCE. In a plan

that fails, key employees must include in income their cost of coverage, defined as the greater of 1) the actual cost of the insurance, or 2) the costs under an IRS-provided table.

A key employee is any of the following:

- an officer (limited to the greater of 3 officers or 10% of all employees, up to 50 officers) with compensation greater than \$135,000 (in 2005)
- an owner of 5% or more of the employer
- an owner of 1% or more of the employer with compensation greater than \$150,000.

For eligibility purposes, life insurance plans must satisfy the following requirements:

- 70% of all employees benefit
- 85% of all employees who are participants are not key employees
- the plan benefits employees defined by a classification found by the IRS not to be discriminatory.

For testing purposes, the following employees may be excluded:

- employees who have not completed 3 years of service
- employees who are part-time (working less than 20 hours a week) or seasonal (less than 5 months per year) employees
- employees who are covered by a collective bargaining agreement
- employees who are nonresident aliens with no income from U.S. sources.

Under the non-discriminatory benefits standard, all benefits available to key employees must also be available to non-key employees.

Q-30. Are there similar non-discrimination rules for other welfare benefits?

A-30. Yes. Both dependent care and educational assistance programs are subject to non-discrimination rules. Under IRC § 129, a dependent care assistance program may pay employees up to \$5,000 each year for employment-related expenses for child care. The plan has the usual two-prong standard for discrimination. The first prong is met if the eligibility classifications in the plan are found by the IRS not to be discriminatory. The benefits standard is satisfied if the average benefit provided to NHCEs equals at least 55% of the average benefit provided to HCEs. Excludable employees under this test are 1) employees who haven't satisfied the ERISA test for pension plan participation (age 21 and 1 year of service) and 2) employees covered by a collective bargaining agreement.

Under IRC § 127, an employee may exclude from income up to \$5,250 a year for educational assistance. An educational assistance program may only cover employees who qualify under a classification found by the IRS not to be discriminatory in favor of HCEs or their dependents who are also employees. Excludable employees are those covered by a collective bargaining agreement.

Under both these plans, no more than a certain percentage (25% in dependent care and 5%

in educational assistance plans) of the benefits paid in any year may go to principal shareholders or owners (who own 5% or more of the employer). In addition, HCEs are taxable on the value of benefits received from any plan that fails the non-discrimination rules.

Q-31. What is a “cafeteria” plan?

A-31. Rather than provide benefits through separate plans, many employers prefer to offer their employees a choice among different benefit options through a single plan. IRC § 125 contains the rules for so-called cafeteria plans (also called a flexible benefit or flex plan) that give employees the opportunity to select their benefits from a menu selected by the employer. A cafeteria plan is also structured to give employees a choice between cash (a taxable benefit) and other taxable and nontaxable benefits. Under normal tax rules (the constructive receipt doctrine), employees given a choice between cash and non-taxable medical benefits would be taxed even if they selected non-taxable benefits. A plan satisfying the rules under IRC § 125 avoids this result.

A cafeteria plan can be very simple, merely offering employees the ability to pay their share of healthcare premiums with pre-tax dollars (also called a premium conversion plan), or it can have a very elaborate menu of benefits. Common benefits include health plans, group-term life insurance, accidental death and dismemberment insurance, long-term disability benefits, dependent care reimbursements, buying or selling vacation time, or health care expenses deductible under IRC § 213. Benefits may also include a group legal services plan, personal insurance such as car or homeowners insurance or disability or life insurance in excess of the non-taxable maximums. Only employees (former and present) may participate in a cafeteria plan, although spouses and dependents may receive benefits from the plan. For purposes of determining who is an employee, the controlled group rules apply.

Cafeteria plans must meet separate non-discrimination rules from those of their underlying benefits. Those rules have the standard prohibition against favoring HCEs in terms of eligibility or benefits. HCEs for this purpose are defined as:

- an officer of the employer
- a shareholder owning more than 5% of the voting power or value of all classes of stock of the employer
- a participant who is highly-compensated or
- a spouse or dependent of any of the above.

A plan satisfies the eligibility test if 1) it satisfies the non-discriminatory classification of the average benefit test for qualified plans and 2) does not require employees to complete more than 3 consecutive years of employment for eligibility and has a uniform length of service requirement for all employees.

The benefits test requires a cafeteria plan to make all benefits available to all participants. The plan must also demonstrate that the total benefits and non-taxable benefits attributable to HCEs (measured as a percentage of compensation) are not significantly higher than those attributable to NHCEs. There is also a special test for health benefits. They will not be considered discriminatory

if 1) total contributions for each participant equal 100% of the cost of coverage for the majority of similarly-situated HCEs or an amount at least equal to 75% of the cost of the most expensive coverage selected and 2) contributions or benefits are a uniform percentage of compensation.

The cafeteria plan rules include an additional discriminatory benefits rule for key employees. It limits their benefits to 25% of the total non-taxable benefits provided to all other participants.

If a cafeteria plan fails these tests, HCEs and key employees must include in income otherwise tax-free benefits they received.

Q-32. What are flexible spending arrangements and health reimbursement arrangements?

A-32. Flexible spending arrangements (“FSAs”) and health reimbursement arrangements (“HRAs”) are special accounts that may be part of a cafeteria plan. An FSA, typically funded by employees, provides employees with pre-tax dollars to pay for medical or dependent care expenses. An HRA is an employer-funded account that reimburses employees for medical expenses. Employer contributions and reimbursements are generally excludable from income. Both these accounts are subject to the discrimination rules for self-insured medical reimbursement plans under IRC § 105 described in Q-28.

Q-33. What are health savings accounts?

A-33. The recent Medicare bill created a new, individual-based rather than employer-based, health plan called a health savings accounts (HSA). These are the successors to the experimental Archer medical savings accounts previously available only to the self-employed or small employer. Although Archer accounts did not prove to be very popular, Congress decided to expand the concept for a broad-based market.

HSAs are essentially tax-sheltered, individual dc plans for health care combined with a high deductible insurance plan [IRC § 223]. Some employers have already begun transforming their traditional benefit plans by adopting a dc format and fixing the amount they contribute per employee to their plans. HSAs take this trend one step farther by transferring ownership of the account from the employer to the employee. Because HSAs are not a form of group health insurance, they are not ERISA plans. They may be offered as part of a cafeteria plan. HSAs also offer a number of attractive features to individuals, including generous tax benefits.

HSAs are subject to a comparability standard. If an employer contributes to an HSA, it must contribute an equal amount or equal percentage of the annual deductible limit of the high deductible plan for all employees. This rule is applied separately for part-time employees defined as those working less than 30 hours a week. If this rule is not satisfied, employers are subject to a 35% excise tax on the amount of actual contributions made.

Q-34. Is there a health care alternative for employees without an employer-sponsored plan?

A-34. Yes. HSAs are now available to anyone. The IRC also provides an itemized deduction for certain medical expenses, provided that the amount is over 7.5% of adjusted gross income, under IRC § 213.

5. ADEA Basics

Q-35. What role does the Age Discrimination in Employment Act (ADEA) play in employee benefits plans?

A-35. The ADEA prohibits employers with more than 20 employees from discriminating against any individual with respect to compensation or the terms, conditions, or privileges of employment because the individual is age 40 or over [ADEA § 623(a)]. The ADEA, ERISA and the IRC have some duplicate provisions, including a prohibition on reducing benefits because of age or ceasing benefit accruals or contributions because of age.

Q-36. How does the ADEA apply to employee benefits?

A-36. The ADEA contains a general prohibition against age-based discrimination in employee benefits but also permits the following [29 USC §§ 623(f) and (l)]:

- age-based cost-justified benefits reductions
- voluntary early retirement programs
- early retirement benefit subsidies in dbs
- payment of Social Security supplements in dbs
- reductions from severance benefits
- deductions or offsets from long-term disability benefits.

Note: Benefit reductions based on cost justifications do not apply to pension plans under EEOC Reg. § 1625.10(d). The EEOC Compliance Manual provides that this exception only applies to life insurance, health insurance and disability benefits.

Q-37. What effect has the ADEA had on employee benefits plans?

A-37. Among benefits practitioners, the ADEA has been viewed as largely a labor law rather than a benefits law. It does not exert much influence on benefit plans with the following exception. To the extent the ADEA expressly prohibits certain benefits practices, it has had a direct effect on plan design. For example, pension plans routinely used to stop participation at age 65. This is no longer permissible. The ADEA has had a similar effect on the benefit structure of disability and health plans.

Increasingly, however, the ADEA is assuming an important role in employee benefits litigation. Older workers are using the general prohibition against age discrimination as a weapon against perceived unfair practices. One case in point is the current controversy over cash balance

plans. Plaintiffs have successfully argued in several courts that these plans, which satisfy other ERISA and IRC requirements, violate the ADEA's prohibition against age discrimination as incorporated into ERISA and the IRC. *See Cooper v. The IBM Personal Pension Plan*, Civil No. 99-829-GPM (S.D. Ill. July 31, 2003).

6. Glossary

ADEA. Age Discrimination in Employment Act [29 USC §§ 621-634].

Average benefit test. Under IRC § 410(b), a test for non-discriminatory coverage for qualified plans that fail to satisfy the ratio-percentage test. It has two components: a non-discriminatory classification test and an average benefit percentage test. The classification test requires the plan to have eligibility rules based on bona fide business objectives (e.g., hourly versus salaried workers, specific job categories). Then, the plan's ratio-percentage (calculated as for the ratio-percentage test) must satisfy a sliding compliance scale based on percentages of highly and non-highly compensated employees. If the plan's coverage falls between safe and unsafe harbors, a facts and circumstances test is used to determine if the plan's classification is nondiscriminatory. [IRC Reg. § 1.410(b)-4(b)].

Under the average benefit percentage test, a plan must have an average benefit percentage for NHCEs equal to at least 70% of those received by HCEs. A benefit percentage is the amount of employer-provided benefits or contributions expressed as a percentage of compensation received by each employee from all plans of the employer. [IRC Reg. § 1.410(b)-5(b)].

Cafeteria plan. Under IRC § 125, a plan that enables an employer to offer employees a choice between cash and a menu of benefits.

Controlled group rules. The various rules under IRC §§ 414(a) (predecessor employers), 414(b) (controlled group of corporations), 414(c) (entities under common control), 414(m) (affiliated service groups), 414(n) (leased employees) and 414(r) (separate lines of business) used to identify employers for some benefit plan purposes.

Coverage test. The requirement under IRC § 410(b) that a qualified plan cover a sufficient percentage of NHCEs relative to the percentage of HCEs covered. *See also* ratio-percentage test and average benefit test.

Db. A defined benefit plan.

Dc. A defined contribution plan.

Defined benefit plan. In a traditional defined benefit plan, employees earn benefits based on their career earnings and years of service and receive retirement income in the form of a

guaranteed income for life.

Defined contribution plan. In a defined contribution plan, employees receive contributions to a personal account and their benefits are based on the accumulation in that account.

ERISA. The Employee Retirement Income Security Act of 1974. [29 USC §§ 1001 *et seq.*] *Note:* The USC section numbers do not correspond directly to those in the statute itself. For simplicity, this primer cites ERISA, not USC, section numbers.

Flexible spending account. An account in a health plan, derived from IRC § 105, that enables employees to pay for medical expenses on a pre-tax basis.

FSA. A flexible spending account.

General test. Under IRC § 401(a)(4), the test that qualified plans not based on design safe harbors must pass in order to demonstrate compliance with the non-discrimination in benefits standard.

HCE. A highly-compensated employee.

Health reimbursement account. An employer-funded account in a health plan that employees can use to pay for certain medical expenses.

Health savings account. A new, individual-based, health plan under IRC § 223.

Highly-compensated employee. A fundamental concept in IRC non-discrimination rules.

For pension plan, dependent care plan and educational assistance plan purposes, an HCE is generally, a employee who is a 5% owner of the business or, in 2005, earned at least \$90,000 (adjusted for inflation) a year in 2004 [IRC § 414(q)].

For health plan purposes, an HCE is an employee who is 1 of the 5 highest paid officers, a shareholder who owns more than 10% of the value of the stock of the employer, or among the highest paid 25% of all employees [IRC § 105(h)(5)].

For cafeteria plan purposes, an HCE is an officer, a shareholder who owns more than 5% of the value of the stock of the employer, an employee who is highly-compensated or a spouse or dependent of one of the above. The cafeteria plan regulations state that determining who is “highly-compensated” is a facts-and-circumstances decision.

HRA. Health reimbursement account.

HSA. Health saving account.

IRC. Internal Revenue Code [26 USC §§ 1 *et seq.*].

Key employee. For group-term life insurance and cafeteria plans, a key employee is an officer (limited to the greater of 3 officers or 10% of all employees, up to 50 officers) with compensation greater than \$130,000 (in 2004), an owner of 5% or more of the employer, or an owner of 1% or more of the employer with compensation greater than \$150,000. This definition is borrowed from the top-heavy rules for pension plans under IRC § 416 (not discussed in this primer).

NHCE. A non-highly compensated employee.

Non-discriminatory classification test. Under IRC § 410(b), the first prong of the average benefit test for qualified plans that fail to satisfy the ratio-percentage test. This test requires the plan to have eligibility rules based on bona fide business objectives (e.g., hourly versus salaried workers, specific job categories). Then, the plan's ratio-percentage (calculated as for the ratio-percentage test) must satisfy a sliding compliance scale based on percentages of highly and non-highly compensated employees. If the plan's coverage falls between safe and unsafe harbors, a facts and circumstances test is used to determine if the plan's classification is nondiscriminatory. [IRC Reg. § 1.410(b)-4(b)].

Non-highly compensated employee. An employee who is not an HCE.

Pension plan. Under ERISA, a plan designed to provide income after the termination of employment or other deferral of income to retirement. *See* Q-10.

Qualified plan. A pension plan that satisfies the applicable requirements of IRC § 401(a) *et seq.* and is therefore entitled to the special tax benefits described in Q-13.

Rate group. A concept used in non-discrimination testing for benefits under IRC § 401(a)(4). A rate group is a hypothetical plan composed of each HCE and all NHCEs and HCEs with equal or greater benefits.

Ratio-percentage test. Under IRC § 410(b), the primary test for non-discrimination in participation for qualified plans. Employees who are not excludable by statute are characterized as HCEs or NHCEs and then are further subdivided by whether they benefit from the plan (receive a contribution or benefit accrual). Two ratios are computed: 1) the ratio of NHCEs who participate in the plan to all NHCEs; and 2) an identical ratio for HCEs. If the result from dividing the first ratio by the second ratio is at least 70%, the plan passes the coverage test.

USC. U.S. Code.

Welfare plan. Under ERISA, certain health and related employee benefits that are not pension plans under ERISA. *See* Q-9.

7. Appendix A

IRS FIELD DIRECTIVE ON PLANS WITH CLASS EXCLUSIONS FOR PART-TIME EMPLOYEES

This field directive provides guidance regarding the exclusion of part-time employees under section 410 of the Internal Revenue Code. It has come to our attention that a number of plan sponsors exclude part-time employees (employees who work less than 40 hours per week) from plan participation, and justify the exclusion as an acceptable classification under section 410(b). It is our view, however, that regardless of whether the exclusion of part-time employees satisfies section 410(b), such exclusion violates section 410(a). Section 410(a) and section 410(b) impose independent requirements on plans, both of which must be satisfied in order for a plan to remain qualified.

Section 410(a) of the Code provides certain minimum participation standards that were introduced in the Employee Retirement Income Security Act of 1974 (“ERISA”). Section 410(a)(1) provides, in general, that a trust will not be qualified if the plan of which it is a part requires, as a condition of participation, that an employee complete a period of service with the employer maintaining the plan extending beyond the later of the date on which the employee attains the age of 21, or the date on which he completes one year of service (or two years of service in the case of a plan which satisfies section 410(a)(1)(B)(i)).

The term “year of service” is defined in general at section 410(a)(3)(A) as a 12-month period during which the employee has not less than 1,000 hours of service. Section 410(a)(3) also contains special definitions of year of service for certain industries. Neither the year of service requirement of section 410(a)(1), nor its definition, has been significantly changed since the passage of ERISA.

Section 410(b) of the Code provides certain minimum coverage requirements that were also introduced in ERISA, but were significantly amended by the Tax Reform Act of 1986 (“TRA '86”). Section 410(b) provides, in general, that a trust will not be qualified unless the plan of which it is a part benefits a minimum percentage of nonhighly compensated employees. One prong of the average benefit percentage test described in section 410(b)(2), as amended by TRA '86, provides that if a plan benefits a reasonable classification of employees set up by the employer that is not found to be discriminatory in favor of highly compensated employees, then the plan has, in part, satisfied section 410(b). (Of course, a plan need not demonstrate that it covers a reasonable classification of employees if it meets the ratio percentage test described in section 410(b)(1).) Prior to TRA '86, section 410(b) also incorporated a classification test at section 410(b)(1)(B).

Section 1.410(a)-3 of the Income Tax Regulations provides guidance on the minimum age and service conditions of section 410(a)(1) of the Code, including the interplay of these conditions with the classification test of section 410(b). Section 1.410(a)-3(d) provides that the minimum age and service rules of the Code and regulations do not preclude a plan from establishing conditions, other than conditions relating to age and service, which must be satisfied by plan participants. For example, such conditions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed in a specified job classification.

Section 1.410(a)-3(e)(1) of the regulation, however, provides that plan provisions may be treated as imposing age and service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement.

Section 1.410(a)-3(e)(2) of the regulations provides a number of examples illustrating this rule. In example (3), a plan which requires one year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The example states that the plan does not qualify because the provision could result in the exclusion by reason of a

minimum service requirement of an employee who has completed a year of service. The example further states that the plan would not qualify even though, after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

Even assuming that the exclusion from plan participation of a class of part-time employees (employees who work less than 40 hours per week) would not cause a plan to fail the coverage requirements of section 410(b) of the Code, the exclusion nonetheless imposes an indirect service requirement on plan participation that could exceed one year of service (or two years of service under section 410(a)(1)(B)(i)). A plan may not exclude any part-time employee where it is possible for that employee to complete one year of service (or two years of service under section 410(a)(1)(B)(i)). Accordingly, plans which exclude such employees violate section 410(a) and section 1.410(a)-3 of the regulations.

Sponsors of these plans may argue that, even if such a provision is not permitted for future years, the exclusion of a class of part-time employees is a reasonable good-faith interpretation of section 410(b) of the Code, as amended by TRA '86, during the transition period before the new section 410(b) regulations become effective. *See* section 1.410(b)-10(c) of the regulations. Because the exclusion of part-time employees violates section 410(a), however, rather than section 410(b), and section 410(a) was not significantly amended by TRA '86, sponsors may not avail themselves of the good-faith interpretation provisions of section 410(b). It should be noted, though, that a plan which has received a favorable determination letter on a document containing a provision excluding part-time employees from participation may be entitled to retroactive relief under section 7805(b).

8. Appendix B

IRS Memorandum, October 22, 2004.

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, DC 20224

Tax Exempt and Government Entities Division

October 22, 2004

MEMORANDUM FOR DIRECTOR, EP EXAMINATIONS DIRECTOR, EP DETERMINATIONS REDESIGN

FROM: Carol D. Gold Director, Employee Plans

SUBJECT: Short Service Employees and Other Meaningful Benefit Schemes and Abuses

Background

We have become aware of certain schemes which effectively limit the amounts payable under a retirement plan to a small number of highly compensated employees by limiting participation under the plan to highly compensated employees and to rank and file employees with short periods of service (such as periods of a few weeks or even a few days). These plans, in the form of defined contribution plans, defined benefit plans, or combinations of both, attempt to satisfy the requirements of various Code sections (e.g. sections 401(a)(4), 401(a)(26), and 410(b)) by allocating amounts to the sponsor's lowest paid employees which, while perhaps significant relative to the employee's compensation, are actually small in amount because of the employees' small amount of compensation. Thus, these plans provide little or no actual benefits to these employees.

The sponsors of these plans use plan designs and hiring practices that limit the nonhighly compensated employees who accrue benefits under the plan primarily to employees with very small amounts of compensation. By combining these elements, these sponsors contend that the lowest paid employees may be treated as benefiting under the plan thereby satisfying the Code's nondiscrimination rules. These sponsors further contend that the qualification requirements of the Code and the regulations are satisfied even though the dollar amounts actually accrued by the lowest paid employees are nominal and even though these employees may never vest in their benefit.

As discussed in this memorandum, these plans may violate the nondiscrimination requirements of the Code even though they ostensibly satisfy certain provisions in the nondiscrimination regulations. In addition, arrangements similar to those discussed in this memorandum may, in the case of defined benefit plans, raise related issues under section 401(a)(26). These related issues were discussed in a prior memorandum from Paul Shultz, dated June 6, 2002.

Law and Analysis

Section 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (within the meaning of section 414(q)). Section 1.401(a)(4)-1(a) of the regulations provides a plan must be nondiscriminatory both in form and in operation.

Section 1.401(a)(4)-1(a) also provides that the regulations under section 401(a)(4) set forth the exclusive rules for determining whether a plan satisfies section 401(a)(4), but §1.401(a)(4)-1(c)(2) provides that the provisions of §§1.401(a)(4)-1 through 1.401(a)(4)-13 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees.

The nondiscrimination rules of section 401(a)(4) and the regulations thereunder are designed to ensure that amounts paid under a plan are not provided to highly compensated employees in a discriminatory manner. A plan that uses plan formulas and/or hiring practices to provide substantial amounts to highly-compensated employees while severely limiting amounts payable to nonhighly compensated employees by targeting coverage to nonhighly compensated employees with short periods of service does not satisfy the nondiscrimination rules of section 401(a)(4) or the regulations.

For example, the nondiscrimination requirement is violated by a plan design that satisfies the nondiscrimination general test by using cross-testing under §1.401(a)(4)-8 where (1) the plan excludes most or all permanent nonhighly compensated employees, (2) the plan covers a group of nonhighly compensated employees who were hired temporarily for short periods of time, (3) the plan allocates a higher percentage of compensation to the accounts of the highly compensated employees than to those of the nonhighly compensated employees covered by the plan, and (4) the compensation earned by the nonhighly compensated employees covered by the plan is significantly less than the compensation earned by the nonhighly compensated employees not covered by the plan.

This plan design does not interpret §1.401(a)(4)-8 in a “reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees” as required by §1.401(a)(4)-1(c)(2) because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to nonhighly compensated employees hired temporarily for short periods of time.

The following is an example of a plan design that violates §1.401(a)(4)-1(c)(2):

Employer M is a corporation which is solely-owned by Individual A. Employer M is not part of a controlled group of corporations under §414(b), is not under common control with another trade or business under §414(c), is not part of an affiliated service group under §414(m), and has no leased employees under §414(n).

Employer M maintains Plan X, a defined contribution plan, intended to be qualified under §401(a). Plan X is the only plan maintained by Employer M. Under its terms, Plan X provides immediate participation and covers only the highly-compensated employees of Employer M and a group of nonhighly compensated employees defined by Plan X. Plan X provides that the highly-compensated employees receive an annual allocation of 20% of compensation (subject to the limits of §415). The other covered employees receive an allocation of 5% of compensation.

In 2003, Employer M employed 55 employees. These 55 employees included five highly-compensated employees. The remaining 50 employees included 15 employees who were employed on a permanent basis and whose annual compensation ranged from \$20,000 to \$50,000. These 15 employees were not included in the group of nonhighly compensated employees covered by Plan X. The other 35 employees were temporarily hired for short periods of time and were included in the group of nonhighly compensated employees covered by the plan. None of these 35 employees received compensation in excess of \$1000 in 2003 and they all received allocations under the plan of 5% of compensation. Plan X intended to satisfy the nondiscrimination in amount general test by using cross-testing under §1.401(a)(4)-8 of the regulations.

Plan X fails §1.401(a)(4)-1(c)(2) because it satisfies the nondiscrimination test of §1.401(a)(4)-8 by covering a group of nonhighly compensated employees who were hired temporarily for short periods of time and who received small amounts of compensation while at the same time it excludes all higher paid, permanent nonhighly compensated employees and allocates a higher percentage of compensation to the accounts of highly compensated employees than to those of the covered nonhighly compensated employees. This plan design does not interpret §1.401(a)(4)-8 in a “reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees” as required by §1.401(a)(4)-1(c)(2) because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to nonhighly compensated employees hired temporarily for short periods of time. The conclusion would be the same if the allocation rates were inflated through the use of an entry date for plan participation that occurs shortly before the end of the plan year in conjunction with plan provisions limiting compensation, for allocation purposes, to the period of participation.

Depending on the circumstances, the nondiscrimination requirement may also be violated in cases where one of the enumerated elements is not present. For example, the nondiscrimination rules may be violated even though the same percentage of compensation is allocated to the highly compensated and to the nonhighly compensated employees, where the nonhighly compensated employees covered by the plan are hired for short periods of time and there is no reasonable business reason for hiring these employees on a short-term basis.

In the absence of questionable hiring practices, a violation may also occur where the employer uses a plan design to limit benefits to a select group of highly compensated employees and to the lowest paid of the nonhighly compensated employees. The following is an example of such a plan design:

Employer M is a corporation which is solely-owned by Individual A. Employer M is not part of a controlled group of corporations under §414(b), is not under common control with another trade or business under §414(c), is not part of an affiliated service group under §414(m), and has no leased employees under §414(n).

Employer M maintains Plan X, a defined contribution plan, intended to be qualified under §401(a). Plan X is the only plan maintained by Employer M. Under its terms, Plan X provides immediate participation but covers only Individual A and the “Lowest paid group of employees.” The “Lowest paid group of employees” is defined to include the employees with the lowest compensation for the plan year and is limited to the minimum number of these employees needed to satisfy the coverage requirements of section 410(b). Plan X provides that Individual A receives an annual allocation of 20% of compensation (subject to the limits of §415). The other covered employees receive an allocation of 5% of compensation.

In 2003, Employer M employed 55 employees. These 55 employees included Individual A and four other highly-compensated employees. Under the terms of Plan X, Individual A received an allocation of 20% of compensation and the seven lowest paid employees of Employer M each received an allocation of 5% of compensation. Each of the lowest paid group of employees received an allocation of less than \$100. The remaining 43 nonhighly compensated employees and four highly compensated employees received no allocation under the plan. Plan X intends to satisfy the nondiscrimination in amount general test by using cross-testing under §1.401(a)(4)-8 of the regulations.

Plan X fails §1.401(a)(4)-1(c)(2) because it satisfies the nondiscrimination test of §1.401(a)(4)-8 by (1) covering a group of nonhighly compensated employees who received small amounts of compensation, (2) excluding all higher paid, nonhighly compensated employees and (3) allocating a higher percentage of compensation to the account of the sole shareholder of the employer. This plan design does not interpret §1.401(a)(4)-8 in a “reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees” as required by §1.401(a)(4)-1(c)(2) because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to the lowest paid group of nonhighly compensated employees.

The examples provided in this memorandum are not intended to limit the situations where a plan design may be found to be an unreasonable interpretation of the regulations under section 401(a)(4). Additional situations with similar facts may also violate the requirement of §1.401(a)(4)-1(c)(2) that the regulations under section 401(a)(4) must be interpreted in a reasonable manner. Also, additional factors may also be considered in determining whether the plan discriminates in favor of the highly compensated employees.

Conclusion

Section 401(a)(4) requires that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees. The regulations under 401(a)(4) set forth various objective criteria for determining whether the nondiscrimination rules of the Code are satisfied, but the regulations also provide that they must be interpreted in a reasonable manner consistent with the purpose of preventing this discrimination. Thus, the regulations cannot be interpreted to permit an unreasonable disparity in the benefits paid to highly compensated employees over those paid to nonhighly compensated employees.

In accordance with this memorandum the following actions should be taken regarding the arrangements identified here and other arrangements where the principles set forth here may be violated:

- Adverse determination letters should be issued with respect to plan designs similar to those identified in this memorandum as violating §1.401(a)(4)-1(c)(2).
- Other arrangements where employers use hiring practices and/or plan formulas to discriminate in favor of highly compensated employees and which may violate the nondiscrimination rules notwithstanding that the plans may otherwise appear to satisfy the regulations under section 401(a)(4) should be addressed on a case-by-case basis.
- If deemed appropriate, technical advice may be requested in accordance with the established procedures.