12. Nondiscrimination, Minimum Coverage, and Participation Requirements for Pension Plans

Introduction

Qualified pension plans have long been subject to statutory and regulatory requirements designed to ensure that the tax advantages would result in broad-based coverage of employees—as opposed to plans set up to benefit only the highly paid employees and/or managers of a firm. Although these requirements have met with various degrees of success, legislators sought to accelerate this progress and further broaden employee access to employment-based pension plans through various provisions of the Tax Reform Act of 1986 (TRA ’86). This chapter deals with three specific criteria that must be simultaneously satisfied for a plan to have tax-qualified status: nondiscrimination, minimum coverage, and minimum participation requirements. The regulations on the nondiscrimination rules, which provide a three-part test to ensure that contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees are discussed first. This is followed by an examination of the regulations on the minimum participation requirements and a discussion of the minimum coverage requirements that consider overall employee participation in pension plans.

Nondiscrimination Rules

Overview—Sec. 401(a)(4) of the Internal Revenue Code (IRC) provides that a plan is qualified only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. The regulations for sec. 401(a)(4) set forth three requirements a plan must meet to satisfy this condition:

- either the contributions or the benefits provided under the plan must be nondiscriminatory in terms of their amount;
- the benefits, rights, and features provided under the plan must be available to employees in the plan in a nondiscriminatory manner; and
- the effect of the plan in certain special circumstances (e.g., plan amendments, grants of past service credit, and plan terminations) must be nondiscriminatory.

Each of these requirements is explored in more detail in the following paragraphs.

Nondiscrimination in Amount of Contributions or Benefits—Although separate rules are provided for determining whether contributions and benefits are nondiscriminatory, it is generally permissible for a pension plan to satisfy this requirement by showing that either the contributions or the benefits are nondiscriminatory. An exception to this general rule applies to plans subject to sec. 401(k) or 401(m) and employee stock ownership plans (ESOPs). (For further discussion of 401(k) arrangements and ESOPs, see chapters 8 and 9, respectively.) In these cases, the plan must prove that contributions are nondiscriminatory.

Nondiscrimination in Amount of Contributions—The regulations for sec. 401(a)(4) provide two safe harbor tests for defined contribution plans. The first applies to a defined contribution plan with a uniform allocation formula that provides employees with uniform allocation rates. Permitted disparity that is explicitly taken into account under the allocation formula may be taken into account in applying this test. The second regulation permits a defined contribution plan with a uniform allocation formula weighted for age or service to satisfy the requirement if the average rate of allocation for highly compensated
employees under the plan does not exceed the average rate of allocation for nonhighly
compensated employees under the plan.

If a plan does not satisfy one of these safe harbor tests, the requirement will be met if no
highly compensated employee under the plan has an allocation rate exceeding that of any
nonhighly compensated employee under the plan. For the purpose of this calculation,
permitted disparity under sec. 401(l)—i.e., differences in rates that occur due to integration
with Social Security—may generally be taken into account by imputation. (For further
discussion of integrating pension plans with Social Security, see chapter 13.) Also,
considerable flexibility is provided to employers in applying this general test under the
grouping and restructuring tests. However, plans subject to sec. 401(k) or sec. 401(m) must
satisfy the special rules provided for them.

**Nondiscrimination in Amount of Benefits**—The regulations contain four safe
harbors under which a plan is considered nondiscriminatory with respect to the amount of
benefits. All require that the plan have a uniform benefit formula, that any subsidized early
retirement or joint and survivor benefit be provided on similar terms to substantially all
covered employees, that the formula base benefits on a nondiscriminatory definition of
compensation, and that the plan have a uniform retirement age for all employees.

Two safe harbors apply to unit credit plans that provide a benefit for each year of service
based on a fixed percentage of pay or a fixed dollar amount. The first is for plans that
provide for the accrual of these benefits on a unit credit basis, and the second is for plans
using the fractional accrual rule. The other two apply to flat benefit plans that satisfy the
fractional accrual rule. An example of such a plan is one that provides a benefit of 50
percent of compensation accrued evenly over all years of service or participation. Such a
plan satisfies the safe harbor only if the plan provides that the maximum flat benefit will be
accrued over a period of at least 25 years.

Those plans that do not satisfy any of the safe harbors must satisfy the general test for
nondiscrimination with respect to the amount of benefits. This is accomplished only if no
highly compensated employee has an accrual rate greater than that of any nonhighly
compensated employee. The disparity permitted under sec. 401(l) may be taken into account
by imputation for this purpose. The employer is generally required to determine accrual
rates with respect to both the normal form of benefit and the most valuable form of benefit.

**Nondiscriminatory Availability of Benefits, Rights, and Features**—Optional
forms of benefits, ancillary benefits, and other rights and features provided under the plan
must be nondiscriminatory. Special rules exist for acquisitions, mergers, and similar
transactions. An optional form of benefit is a distribution alternative that is available under
a plan, an early retirement benefit, or a retirement-type subsidy. Each optional form of
benefit must be currently available and effectively available to a nondiscriminatory
classification of employees. Current availability focuses on the availability of the option to
employees but assumes that certain conditions such as age or service under the plan’s terms
are currently satisfied. Effective availability examines whether actual availability of the
option, taking into account the ability of employees to satisfy age and service requirements,
substantially favors highly compensated employees.

Ancillary benefits include certain Social Security supplements, disability benefits,
ancillary life insurance and health insurance benefits, death benefits under a defined
contribution plan, preretirement death benefits under a defined benefit plan, and shut-down
benefits.

Other rights or features are defined as any right or feature applicable to employees
under the plan, other than a right or feature taken into account as part of an optional form
of benefit or ancillary benefit provided under the plan and other than a right or feature that
cannot reasonably be expected to be of more than insignificant value to an employee. For example, the following are specifically included in this definition:

- plan loan provisions;
- the right to direct investments;
- the right to a particular form of investment;
- the right to a particular class or type of employer securities;
- the right to make a particular rate of before-tax, after-tax, or matching contribution;
- the right to purchase additional retirement or ancillary benefits under the plan; and
- the right to make rollover contributions and transfers to and from the plan.

**Nondiscriminatory Effect of Plan in Special Circumstances**—Plan amendments and grants of past service credit must not have the effect of discrimination in favor of highly compensated employees. The regulations contain a safe harbor under which a grant of up to five years of past service credit is deemed to be nondiscriminatory. Restrictions on distributions are also prescribed to place a limit on the annual distributions received by the top-paid 25 employees. However, the distribution restrictions do not apply if the plan’s funding ratio is at least 110 percent (measured on a current liability basis) or if the benefit payable is less than 1 percent of the current liability.

**Employee Contributions**—Generally, benefits derived from employer contributions and benefits derived from employee contributions must separately satisfy the nondiscrimination requirements. The regulations provide rules relating to the determination of the employer-derived benefit in a defined benefit plan that also includes employee contributions not allocated to separate accounts. It also provides rules for determining whether employee contributions under a defined benefit plan are nondiscriminatory.

**Permitted Disparity**—The regulations allow the disparity permitted by sec. 401(l) to be taken into account in showing that the amount of contributions or benefits satisfies sec. 401(a)(4). In many cases, this merely requires inspection of the plan benefit or contribution formula, e.g., where a plan is using one of the safe harbor rules for showing nondiscrimination in the amount of contributions or benefits. These safe harbors require that the plan formula satisfy 401(l) in form. Thus, for example, a single defined contribution plan that takes permitted disparity into account under a uniform formula satisfies sec. 401(a)(4) with respect to the amount of contributions if the disparity under the formula satisfies sec. 401(l) and the regulations thereunder. Similarly, a single defined benefit plan or target benefit plan that takes permitted disparity into account under a uniform formula satisfies sec. 401(a)(4) with respect to the amount of benefits if the disparity under the formula satisfies sec. 401(l) and the regulations thereunder.

If a plan does not use the safe harbor rules, or if two or more plans are combined for purposes of sec. 401(a)(4), permitted disparity is taken into account by using specified formulas that determine an adjusted allocation or accrual rate that reflects the amount of permitted disparity that may be taken into account.

In the case of a defined contribution plan, the plan’s allocation rates are adjusted to take into account permitted disparity. This adjusted rate is used to determine whether the amount of contributions under the plan is nondiscriminatory under the general test and to apply the average benefit percentage test of sec. 410(b) (described later in this chapter). If an employee’s compensation does not exceed the taxable wage base in effect as of the beginning of the plan year, the employee’s adjusted allocation rate equals the sum of the employee’s accrual allocation rate and maximum allocation rate that the plan could have used under the permitted disparity rules. If an employee’s compensation exceeds the taxable wage base in effect as of the beginning of the plan year, the employee’s adjusted allocation rate is the lesser of two rates provided in sec. 1.401(a)(4)-7(b)(3).
The process for a defined benefit pension plan is similar, although covered compensation is used to dichotomize employees instead of the taxable wage base. (For a definition of covered compensation, see chapter 13 on integrating pension plans with Social Security.) In this case, if an employee's compensation does not exceed the employee's covered compensation as of the beginning of the plan year, the employee's adjusted benefit accrual rate is the sum of the employee's actual accrual rate and the maximum excess allowance under the permitted disparity rules. (For a description of these rules, see chapter 13 on integrating pension plans with Social Security.) If an employee's compensation exceeds his or her covered compensation as of the beginning of the plan year, the employee's adjusted benefit accrual rate is the lesser of two rates provided in sec. 1.401(a)(4)-7(c)(3).

Minimum Participation Requirements

**Overview**—The Small Business Job Protection Act of 1996 eliminated the current law requirement that a defined contribution plan such as a 401(k) plan must benefit at least 50 employees or 40 percent of all employees, whichever is less. In addition, with respect to defined benefit plans, the 40 percent rule is modified to require that the greater of two employees or 40 percent of all employees must benefit under the plan.

Minimum Coverage Requirements

**General Rule**—In general, a plan must satisfy one of two requirements under IRC sec. 410(b) for both active and former employees on one day in each quarter.

**Ratio Percentage Test**—Under this test, the percentage of the employer's nonhighly compensated employees benefiting under the plan must equal at least 70 percent of the percentage of the employer's highly compensated employees benefiting under the plan. For example, if a plan benefits 60 percent of the employer's highly compensated active employees and 35 percent of the employer's nonhighly compensated active employees, it fails this test because the plan's ratio percentage is less than 70 percent (35 percent/60 percent = 58.3 percent).

**Average Benefit Test**—This test has two parts, both of which must be satisfied. Under the first, the nondiscriminatory classification test, the plan is required to benefit a classification of employees that does not discriminate in favor of highly compensated employees. Under the second, the average benefit percentage test, the average benefit percentage of nonhighly compensated employees must equal at least 70 percent of the average benefit percentage of highly compensated employees.

**Nondiscriminatory Classification Test**—To satisfy the nondiscriminatory classification test under sec. 410(b), a plan must cover a classification of employees that is reasonable, reflecting a bona fide business classification such as salaried and hourly employees. Moreover, the plan must either

- benefit at least a safe harbor percentage of nonhighly compensated employees or
- pass a facts and circumstances test and benefit at least an unsafe harbor percentage of nonhighly compensated employees.

**Safe Harbor / Unsafe Harbor Tests**—Under these tests, the plan's ratio percentage must be at least equal to the safe (or unsafe) harbor percentage. Mathematically, this is the same test as the ratio percentage test explained earlier, but it substitutes the safe (or unsafe) harbor percentage for 70 percent. The safe (or unsafe) harbor percentages are based on the concentration percentage of all nonhighly compensated employees within the employer's work force. Table 12.1 illustrates the safe harbor and unsafe harbor percentages for specific concentrations of nonhighly compensated employees. This still leaves a gray area for a plan
if it has neither passed the safe harbor test nor failed the unsafe harbor test. In this case, it may be considered nondiscriminatory based on a review of all facts and circumstances.

**Facts and Circumstances Test**—The regulations indicate that the following factors, among others, may be considered in applying the facts and circumstances test:

- the employer's underlying business reasons for the classification;
- the percentage of the work force that benefits under the plan;
- whether the number of covered employees in each salary range is representative of the total number of employees in that salary range; and
- how close the classification comes to satisfying the safe harbor percentage.

**Other Factors That Affect Testing**

**Plans Deemed to Pass**—The following plans are deemed to satisfy the minimum coverage requirements:

- frozen plans (i.e., plans in which no employees are accruing additional benefits);
- plans of an employer that employs only highly compensated employees;
- plans that benefit only nonhighly compensated employees; and
- plans that benefit only union employees (unless more than a de minimis number of professionals are included).

**Excludable Employees**—In general, all active and former employees are taken into account in applying the minimum coverage tests except:

- employees who have not satisfied the plan’s minimum age and/or service requirements. (For further discussion of these requirements, see chapter 3 on ERISA.)
- nonunion employees who do not benefit under a plan because of a collective bargaining agreement (when testing a plan that benefits union employees);
- collective bargaining unit employees (when testing a noncollective bargaining unit plan);
- participants who fail to accrue a benefit or receive an allocation solely because of a minimum service requirement; and
- nonresident aliens with no U.S. source of income.

**Mandatory Disaggregation of Plans**—Certain single plans must be disaggregated into two or more separate plans, each of which must satisfy sec. 410(b). The following are examples.

- **Collectively Bargained Units**—The portion of a plan that benefits employees under a collective bargaining agreement and the portion of the plan that benefits nonunion employees must be treated as separate plans.
- **Employee Stock Ownership Plans**—For plan years after 1989, a plan with an ESOP and a non-ESOP feature is treated as two plans.
- **Sec. 401(k) and 401(m) Arrangements**—The portion of a plan that includes (1) a sec. 401(k) cash or deferred arrangement or (2) matching or employee contributions subject to sec. 401(m) rules are treated as separate plans. (For further discussion of 401(m) rules, see chapter 8 on 401(k) cash or deferred arrangements.)

**Aggregation of Plans**—For purposes of applying the ratio percentage test and nondiscriminatory classification test, two or more separate plans are permitted to be treated as a single plan. However, the aggregate plan would have to satisfy the nondiscriminatory benefit and contributions test of IRC sec. 401(a)(4). Also, an employer may not permissively aggregate plans that have been disaggregated on a mandatory basis (e.g., ESOPs and non-ESOPs, union plans, and nonunion plans). Generally, for purposes of the average benefit percentage test, all qualified plans of an employer, including qualified cash or deferred arrangements and matching or employee contributions subject to sec. 401(m), must be aggregated and treated as a single plan. However, union plans are tested separately from
nonunion plans. Also, the new regulations permit separate testing of defined contribution and defined benefit plans.

Multiemployer/Multiple Employer Plans—Each separate employer’s portion of a multiemployer plan that is maintained by more than one employer for nonbargained employees is tested separately. If one employer fails, the whole plan, for all employers, potentially could be disqualified. A multiemployer plan (a plan maintained by more than one employer for collectively bargained employees) is treated as one plan, and all participating employers are treated as one employer.

Former Employees—Former employees who currently benefit under the plan (e.g., are granted an ad hoc cost-of-living increase under a plan amendment) are tested separately from active employees. An employer may elect to disregard former employees who are not currently benefiting and who terminated prior to 1984 or more than 10 years before the year being tested. Under a special rule, if at least 10 former employees are currently benefiting under the plan and at least 60 percent of the former employees who are currently benefiting under the plan are nonhighly compensated, the plan will be deemed to pass with respect to former employees.

Compliance—A plan failing to meet the requirements of sec. 410(b) as previously described must be brought into retroactive compliance by the end of the applicable plan year. This may be accomplished either by extending coverage to a broader group of employees or modifying contribution allocations or benefit accruals.

1 The regulations provide detailed guidance concerning the calculation of the individual benefit percentages that are separately averaged for high paid and low paid employees. Benefit calculations are generally performed using the same actuarial techniques required by the nondiscrimination rules, with several important simplifications.

2 The concentration percentage is defined as the ratio of the nonhighly compensated employees to the employer’s total work force (minus any excludable employees), whether or not they are covered by the plan.

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