ASPA
Dedicated to the Private Pension System

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Contents

Operating a Qualified Plan? Know Your Responsibilities When It Comes to Plan Investments

by Pamela Zentko

SPONSORING A QUALIFIED RETIREMENT PLAN REPRESENTS A SUBSTANTIAL COMMITMENT ON THE PART OF THE PLAN SPONSOR. AS WE HAVE SEEN HIGHLIGHTED IN THE HEADLINES OF LATE, THE PLAN SPONSOR RETAINS THE OVERALL RESPONSIBILITY OF PROTECTING THE RIGHTS AND INTERESTS OF THE EMPLOYEES COVERED UNDER THE PLAN. ERISA IMPOSES CERTAIN OBLIGATIONS ON THE INDIVIDUALS OR ENTITIES THAT ARE RESPONSIBLE FOR THE ADMINISTRATION AND MANAGEMENT OF QUALIFIED RETIREMENT PLANS. THE LIABILITY FROM THESE OBLIGATIONS IS PERSONAL AND IS NOT ELIMINATED DUE TO PARTICIPANT DIRECTION OR THE HIRING OF OUTSIDE INVESTMENT MANAGERS. FAILURE TO FULFILL THESE OBLIGATIONS CAN RESULT IN EMPLOYEE ACTION AGAINST THE PLAN'S FIDUCIARIES, AND IN THE MOST SERIOUS OF CASES, CAN RESULT IN CRIMINAL SANCTIONS.

General Responsibility

In light of current economic conditions—including the volatility of the stock market, the critical need for private retirement savings to supplement Social Security, and current media attention to investments in company stock—it is now more important than ever for individuals responsible for the operation and investment of qualified retirement plans and their assets to understand their role and obligations to plans and their participants.

ERISA requires that the plan document include one or more named fiduciaries who will control and man-

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WASHINGTON UPDATE

President's Dividend Proposal Could Affect Small Business Retirement Plan Coverage

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by Brian H. Graff, Esq.

THE PRESIDENT BEGAN 2003 BY UNVEILING AN ALMOST $700 BILLION STIMULUS PACKAGE INTENDED TO JUMP-START THE ECONOMY. THE CENTERPIECE OF THIS PACKAGE IS A PROPOSAL TO GENERALLY EXCLUDE CORPORATE DIVIDENDS PAID FROM TAXABLE INCOME. SPECIFICALLY, UNDER THE PRESIDENT'S PROPOSAL, ALL DIVIDENDS THAT ARE PAID OUT OF CORPORATE EARNINGS THAT HAVE ALREADY BEEN FULLY TAXED AT THE CORPORATE LEVEL WOULD BE EXCLUDABLE FROM THE INCOME OF THE SHAREHOLDER WHO RECEIVES THEM. ALTERNATIVELY, THE PROPOSAL PROVIDES THAT IF THE COMPANY RETAINS ALREADY FULLY TAXED EARNINGS, THE SHAREHOLDER WILL BE ENTITLED TO A BASIS ADJUSTMENT TO REFLECT THE ALREADY FULLY TAXED RETAINED EARNINGS. AS OF THIS WRITING, THE ADMINISTRATION WAS STILL WORKING ON THE FINAL DETAILS FOR THE PROPOSAL. CERTAINLY, THERE ARE A NUMBER OF UNANSWERED QUESTIONS ABOUT THE MECHANICS.

In a general sense, the tax effect of the President's proposal is similar to the operation of a Roth IRA. Amounts are invested on an after-tax basis and earnings (already taxed at the corporate level) are tax-free. However, unlike a Roth IRA, there are no limits on the amounts that can be invested nor are there any restrictions or penalties on early distributions. Consequently, questions have been raised about the potential impact of the President's proposal on retirement savings, particularly savings by workers of our nations' small businesses.

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FROM THE EDITOR

New Year—New Reasons To Cheer!

by Chris L. Stroud, MSPA

I AM SITTING DOWN TO WRITE THIS EDITORIAL ON NEW YEAR'S DAY AS I SLOWLY RECOVER FROM THE HUSTLE AND BUSTLE OF THE HOLIDAYS, THE YEAR-END CRAZINESS, AND OF COURSE, NEW YEAR'S EVE. AS WE CELEBRATE THE DAWNING OF 2003, IT SEEMS AN APPROPRIATE TIME TO LET YOU KNOW SOME OF THE NEW THINGS ASPA HAS IN STORE FOR YOU IN 2003.

Let's start with *The ASPA Journal*—a subject near and dear to my heart! Beginning with this issue, you will find that the CE (Continuing Education) Quiz that accompanies each issue of *The ASPA Journal* will be worth two CE credit hours. It will still only cost $20 to submit the quiz, so you "shop-aholics" can think of it as a sort of "2 for 1" sale that lasts all year! (Don't forget—you can take *The ASPA Journal* CE quiz online, saving time and offering immediate pass/fail feedback.) Occasionally, we will run "bonus CE" articles, so watch for the new bonus CE symbol. You will find a "bonus CE" offering in this issue on "Nondiscrimination Testing." Each bonus CE article will cover a specific topic in depth, with a portion printed in *The ASPA Journal* and the remaining information available on the ASPA Web site, along with a Bonus CE Quiz. Another new graphic to watch for is our new "toolkit" symbol. An article displaying this symbol will be a basic overview, typically a "skill-builder" for the newer members or a "refresher" for the more seasoned veterans. All of these new features are a result of your great suggestions and comments, so keep those ideas coming!

Another big happening is the new look of the ASPA Web site. The many hours of time and planning by the ASPA staff and Technology Committee members have paid off, bringing you easier navigation and a fresh new look and feel. Simply click on "Contact ASPA" to send us your comments or suggestions while you are surfing the Web site, so we can continue to make the site even better. Special thanks to ASPA staff members Chip Chabot, Webmaster, Geoff Brehm, Information Services Manager, and Chris Jones, Information Services Coordinator, for the good work and long hours devoted to implementing the design and data conversion. Watch throughout the year for more exciting features!

Exciting things are happening in conferences, too. Due to the overwhelming success of the First Annual 401(k) Sales Summit last year, the Summit is here to stay and will be an annual event. The 2003 401(k) Sales Summit, scheduled for February 27–March 1, 2003, looks like it will be another whopping success! ASPA will be offering at least one more new conference this year, the ASPA/IRS Conference in Denver, CO, scheduled for September 11–12, 2003, and co-sponsored by the Western Pension & Benefits Conference. And, you can be sure that there will be more great webcasts on a variety of topics, including some "timeless topics," throughout the year.

The E&E (Education and Examination) Committee is finalizing the program restructuring. New legislation may be on the horizon, and our tireless GAC (Government Affairs Committee) and PAC (Political Action Committee) remain in the forefront to make sure that the key players are educated on issues that are relevant to ASPA and that our positions are known and our interests served. The ASPA ABCs continue to grow and offer a great way to network locally and regionally. These are just a few of the things you have to cheer about in the coming year.

I hope that 2003 brings lots of good cheer to each and every one of you. Best wishes for happiness, health, and prosperity throughout the coming year! ▲

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The purpose of ASPA is to educate pension actuaries, consultants, administrators, and other benefits professionals, and to preserve and enhance the private pension system as part of the development of a cohesive and coherent national retirement income policy.

ASPA members are retirement plan professionals in a highly diversified, technical, and regulated industry. ASPA is made up of individuals who have chosen to be among the most dedicated practicing in the profession, and who view retirement plan work as a career.

To submit comments or suggestions, send an e-mail to **theaspajournal@aspa.org**.

ASPA
4245 North Fairfax Drive
Suite 750
Arlington, Virginia 22203
Phone: (703) 516-9300
Fax: (703) 516-9308
E-mail: aspa@aspa.org
Web: **www.aspa.org**

Letters to the Editor

Correction to Sep–Oct 2002 457 article

Below is a correction to the article "Recent Developments and Proposed Regulations Make 457 Plans More Attractive" as it appeared on page 8 of the Sept–Oct 2002 issue of *The ASPA Journal*. The second paragraph of the Introduction should be revised by deleting the final sentence and replacing it with the following:

The current rules for 457 plans maintained by state and local government employers ("governmental plans") differ significantly from the rules governing 457 plans maintained by private tax-exempt employers ("private plans"). In this article, any reference to a "plan" or "457 plan" refers to a plan that satisfies the requirements for an eligible deferred compensation plan [Code Section 457(b)], unless the context indicates otherwise.

—David A. Pratt, APM

Thank You Speakers!

ASPA would like to thank David M. Burns, MSPA, CPC, QPA, who was inadvertently not listed in the November-December 2002 issue of *The ASPA Journal*, for his help in making the 2002 ASPA Annual Conference a huge success.

In Memoriam

J. William Cloer, FSPA
1929–2002

Lynn B. Witte
1951–2002

Welcome New Members

Welcome and congratulations to ASPA's new members and recent designees.

MSPA

Bernard Forseter
David Taylor

CPC

Suzanne Stewart

QPA

Lesley C. Alexander
James L. Carnes Jr.
Dennis D. Davis Jr.
Martin K. Falk
David M. Gray
Linda Johnson
LuAnne G. Kern
Jacqueline T. Kral
Robert H. Krane
Erin Lam
Anita L. Lein
Shelia L. McLaughlin
Dawn E. Moore
Domonique M. Peretti-Reynolds
Shannon R. Sietmann
Shauna M. Stanzel
Laura L. Swain
Carlos E. Tocabens
Cortney L. Trent
Benjamin Y. Wang
Eileen F. Whitmore
Mark A. Zajicek

QKA

Doreen C. Barrett
Jerome G. Bettner
Jon H. Beveridge
Ivy W. Birgani
Steven A. Blom
Gary S. Bowen
Shaun D. Bromley
Judith L. Burris
Paul W. Carmichael
Jason T. Chapman
Edward W. Chen
Janet L. Clough
Denise L. Coderre
Heather R. Cole
Laurie L. Dalton
Amy Lee Darnell
Carol Dubois
Betty L. Faul
Judy L. Forster
Daniel N. Fowler
Rebecca L. Froberg
Kacie Hargrave
Ami L. Hill
Gary M. Jones
Debra A. Kilham
Martha T. Kirkley
Doris Kopp
Yvonne J. Korloch
Sharon R. Kovacic
Mitchell A. Kurtz
Erin Lam
Valerie A. Lange
Anita L. Lein
Catherine L. Lister
Mark S. Lohbeck
Sarah E. Melius
Michelle P. Miller
Pete J. Nemann
R. Scott Nicholls
Cynthia M.D. Rabe
Jennifer L. Richter
Jeffrey S. Rudloff
Randall R. Shrake
Kathryn M. Suich
Jeffrey A. Swiantek
Cydney T. Thomson
David J. Turpin
Howard I. Uliss
Anita J. Vachon
Christie L. VanKuiken
Betsy C. Vincenti
Joy C. Wilkes
Rich L. Witzke
Michelle L. Wolf
Joyce E. Yaccarino
Winnie S. Yu

APM

Patrick J. Farzaroli
David Kitcoff
Akihiro Yabe

Affiliate

Sheila L. Akers
Holly Arrington
Karen E. Carney
Robert J. Darragh
Debra A. Davis
Ted Disabato
Ronald A. Harczak
Alexander W. Hargraus
Margo Juarez-Griffith
Kathryn J. Kennedy
Robert Joseph LeMay
Donald F. Markwardt
Max E. Redlich
Joseph H. Reynolds Jr.
Whitney N. Smith
Vicki L. Spittel
Michael N. Staples
Arasely Valdez

Thank You Exhibitors!

ASPA would like to thank the following exhibitors, who were inadvertently not listed in the November–December 2002 issue of *The ASPA Journal*, for their help in making the 2002 ASPA Annual Conference a huge success:

- Ameritrade Corporate Services
- The Guardian Life Insurance Companies of America
- Orbitex Retirement Services
- PENDOC
- Professional Practice Insurance Brokers
- RIGGS Bank, NA

The following exhibitor was inadvertantly not listed in the September–October 2002 issue of *The ASPA Journal* for their help in making the 2002 Summer Academy also a huge success:

- PenChecks, Inc.

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Washington Update

ASPA's Government Affairs Committee has already had meetings with senior officials at the Department of Treasury to discuss these concerns. While the President's proposal may arguably address reasonably sound tax policy concerns about making sure that corporate income is taxed only once, and at the level it is earned, it potentially could have an unintended, adverse impact on small business retirement plan coverage.

Retirement Savings in General

Since the President's announcement, the Department of Treasury has been vociferously asserting on Capitol Hill, in the media, and with interest groups that the dividend exclusion proposal does not disfavor retirement savings. The basis for their argument is that, assuming the same tax rates at the time of contribution and distribution, a deductible IRA and a Roth IRA are economically neutral. For example, assume a $1,000 contribution to a deductible IRA and a 5 percent rate of return. If it were withdrawn one year later, assuming a 40 percent tax rate and ignoring early withdrawal penalties, the taxpayer would net $630. If, instead, the same taxpayer contributed to a Roth IRA, the contribution would be $600. Assuming everything else is the same, after the first year, the taxpayer would again net $630. Given this economic neutrality, Treasury argues that because the President's proposal has a similar tax effect as the Roth IRA, it is at most equally neutral as compared with a deductible tax-favored retirement savings vehicle. In Treasury's view, tax-favored retirement savings vehicles remain more attractive because they inherently have more investment flexibility, similar to the President's proposal.

Contrasting views have been expressed suggesting that, if the President's proposal were enacted, the investment community would most certainly develop competitive products to take advantage of the new law. Further, unlike retirement savings vehicles, the investments made under the President's proposal would be advantaged since they would not be subject to limits of restrictions, or penalties upon early distribution. Regardless of your views, one thing is clear—the relative value of tax-favored retirement savings vehicles would be somewhat lessened if the President's proposal were enacted.

Effect on Small Business Retirement Plan Coverage

As many of you know too well, for many small business owners, the decision to establish a qualified retirement plan is particularly sensitive to the value of the tax incentives provided through the qualified plan rules. There is no question that the law provides qualified plans with valuable tax incentives—contributions to the plan are tax deductible and earnings are tax-deferred until distributed. However, qualified plans are also subject to stringent nondiscrimination rules that require small business owners to make contributions on behalf of their employees in order to make contributions on behalf of themselves. Given the valuable tax incentives accorded qualified plans, Congress determined it appropriate to impose these nondiscrimination requirements in order to provide rank-and-file workers with a fair share of retirement benefits.

Due to these nondiscrimination rules, for every dollar a small business owner wants to contribute to a qualified plan on his or her own behalf, he or she will generally have to spend a minimum of 30 to 40 cents on behalf of employees. This scenario assumes a fairly typical small business employee census, where the owners are older than most of the employees and where more aggressive nondiscrimination testing techniques, like cross-testing, are used. Other less aggressive techniques will result in even higher costs to the small business owner. This expenditure represents a combination of the implementation and administrative costs associated with a qualified plan, and the cost of covering the business' workers—a prerequisite to the owner's participation in the plan as required by the qualified plan nondiscrimination rules.

Given this added cost, the relative value of the tax incentives provided under the qualified plan rules is a critical element to the small business owner's decision to establish a retirement plan. Consequently, if a small business owner were able to save an equivalent amount in a non-plan tax-favored alternative without such added cost, such an alternative would significantly reduce the incentive of the small business owner to incur the responsibilities of contributing to a retirement plan for the small business' workers. An unlimited, uncapped exclusion from taxable income of qualifying dividends is just such an attractive alternative.

Further, the adverse effect of more attractive non-plan savings options is exacerbated when the more attractive alternative also comes with fewer (or without any) restrictions, like limits or early-withdrawal penalties. For example, consider a dental practice with two owners and 13 employees. The cost to the owner-dentists of a qualified plan for their practice is approximately $115,500—$80,000 in contributions on behalf of the two owner-dentists, $29,500 for the cost of contributions on behalf of the 13 employees, and $2,000 in administrative costs. Assuming the owner-dentists adopt the plan at age 50, make

the same contributions each year until retirement age (age 65), and an average annual rate of return for the plan of 7 percent, the two owner-dentists could each expect an after-tax lump sum benefit of $669,313 when they reach retirement age. However, if instead of contributing to the qualified plan, they purchased stock that paid dividends or retained earnings qualifying for the President's proposed income tax exclusion, their accumulated after-tax values at normal retirement age would exceed the qualified plan lump sum if the rate of earnings on the stock investment were as little as 3 percent. At 3 percent, the after-tax value would be $674,248. At an equivalent rate of return of 7 percent, the accumulated after-tax value at retirement age would be $932,855.[1] In other words, at that equivalent rate of return, it would cost each owner-dentist $250,000 or more to forego the dividend-paying stock investment in favor of contributing to a qualified plan for their employees.

With this math, many small business owners will likely choose the non-plan option consistent with the President's proposal and forego the necessity of making contributions on behalf of their small business employees. They may offer their employees a 401(k) plan, but such a plan would be funded solely with contributions made by the small business employees with no contributions, like matching contributions, made by the owners.

Tax and Social Policy Concerns

ASPA's Government Affairs Committee recognizes the tax policy arguments underlying the proposition that income should be taxed only once, and at the first source where it is earned. However, ASPA also joins the Administration and the Congress in its firm support for the *social policy* underlying incentives to encourage businesses—and particularly small businesses—to establish and fund qualified retirement savings plans for the workers employed by our nation's small businesses. In our discussions, the Department of Treasury has recognized the legitimacy of the concerns raised related to the potential impact of the President's proposal on small business retirement coverage.

Unfortunately, unless the President's proposal is modified, the tax policy that supports tax-free qualifying dividends will likely undercut the good social tax policy that incents small business owners to provide retirement coverage for their workers. Failure to modify the proposal that would exclude qualifying dividends from taxable income (or increase basis to reflect retained earnings) could make the employees of our country's small businesses potential losers. It is a heavy price to pay for theoretically sound tax policy.

There are alternatives to address the tax policy concerns surrounding the double taxation of corporate earnings that would not have the accompanying negative effect on small business retirement plan coverage. One example would be a deduction for dividends paid at the corporate level. ASPA's Government Affairs Committee discussed this and other alternatives during its meeting with the Treasury Department. However, Treasury made clear that they have considered and dismissed these alternatives and are not interested in reconsidering them. Treasury indicated these alternatives were either too expensive from a budgetary standpoint or that such alternatives were not politically viable because they provide tax reductions to corporations and not individual taxpayers.

From a political standpoint, Democrats, to date, have almost universally rejected the President's proposal. Further, a number of moderate Republican senators have raised concerns. It is quite possible that in its final form, the President's proposal could be scaled back. For example, the proposal could be revised to exclude only 50 percent of dividends from taxable income or an annual dollar cap (*e.g*, $1,000) of excluded dividends. In such cases, the potential impact on small business retirement plan coverage would be greatly ameliorated.

ASPA's Government Affairs Committee recognizes that there are many possible ways to approach a solution to this unintentional potential blow to small business retirement plan coverage. We will work closely with the Administration and Congress to devise a fair, sound, practical way to address this serious issue. In addition to changes to the President's proposal, the solution could also take the form of additional incentives for the small business owner to establish and contribute to a qualified plan or other types of incentives. Whatever the form of the solution, it is imperative that the President's proposal be structured so that it does not discourage small business owners from establishing and contributing to qualified retirement plans on behalf of their workers. ▲

[1] At 6 percent, the after-tax value would be $858,746, at 5 percent it would be $791,343, and at 4 percent it would be $730,031.

Brian H. Graff, Esq., is the Executive Director of ASPA. Before joining ASPA, Brian was legislation counsel to the US Congress Joint Committee on Taxation.

Benefit Calculation Basics

by Ken Vollmer, MSPA

DEFINED BENEFIT PLANS ARE MAKING A COMEBACK AND, AS A RESULT, PENSION ADMINISTRATORS WHO HAVE BECOME EXPERTS ON DEFINED CONTRIBUTION PLAN ADMINISTRATION MAY NEED TO BECOME FAMILIAR WITH DEFINED BENEFIT PLANS. THIS COMEBACK MAY NOT BE GOOD NEWS FOR THOSE ADMINISTRATORS WHO HAVE, FOR WHATEVER REASON, AVOIDED THE WORLD OF DEFINED BENEFIT PLANS.

For those of us who are familiar with defined benefit plans, the idea of a monthly benefit at retirement is one of the simplest concepts to grasp regarding defined benefit plans. Furthermore, it is unlikely that you could have a good understanding of the funding concepts of defined benefit plans without first understanding how the benefit is calculated. So, if you want to learn about defined benefit plans, a good place to start is to learn how to calculate a benefit.

The easiest way to understand how a benefit is calculated is from the participant's point of view. The benefit formula is usually designed to replace a participant's salary with a retirement income. That is, the defined benefit plan will provide a steady monthly income to the participant when they retire. This retirement income amount is usually based on the participant's total service and/or salary while employed.

The Benefit Formula

All defined benefit plans have a formula that is used to determine a participant's benefit payable at retirement. The most common benefit formulas are:

- Percent of Pay times Service
- Flat Percent of Pay
- Dollar times Service
- Unit Credit

Percent of Pay Times Service Formula

Under this type of formula, the participant's benefit at retirement is usually equal to the participant's completed years of service multiplied by a percentage of the average of the participant's highest salaries. The highest years of compensation are usually defined to be 3 or 5 consecutive years. This type of formula is also known as a final average pay formula.

Example

Using the following information:

- Benefit formula percentage = 2%
- Participant's years of service = 25
- Participant's highest 3 years of compensation = $55,000, $60,000, and $65,000

The participant's monthly benefit would be:

- 2% times 25 years times the average of $55,000, $60,000, and $65,000.
- = .02 x 25 x [(55,000 + $60,000 + $65,000)/3]/12 = $2,500 per month

Flat Percent of Pay Formula

Under this type of formula, the participant's benefit at retirement is usually equal to a specified percentage of his average salary.

Example

Using the following information:

- Benefit formula percentage = 60%
- Highest 3 years of compensation = $25,000, $30,000, and $35,000

The participant's monthly benefit would be:

- 60% times the average of $25,000, $30,000, and $35,000.
- = 0.6 x [(25,000 + $30,000 + $35,000)/3]/12 = $1,500 per month

Sometimes this amount is then reduced pro rata for the participant's years of service less than a specified amount. This reduction is calculated by multiplying the full benefit above by a fraction equal to the participant's completed years of service divided by the specified service amount. For instance, if the service required for the full benefit was 30 years in the example above and the participant had completed 20 years, the monthly benefit at retirement would be reduced to $1,000 (*i.e.*, 20/30 times $1,500).

Dollar Times Service Formula

Under this type of formula, the participant's benefit at retirement is usually equal to the participant's completed years of service multiplied by a specific dollar amount.

Example

Using the following information:

- Benefit formula dollar amount = $20
- Participant's years of service = 25

The participant's monthly benefit would be:

- = 25 x $20 = $500 per month

Unit Credit Formula

Under this type of formula, the participant usually accrues a piece of his benefit in each year that is equal to a percent of the pay earned in that year. The

Continued on page 27

Presidential Year in Review

by Craig P. Hoffman, APM

ANOTHER YEAR HAS PASSED, LEAVING US ALL A LITTLE BIT OLDER AND, HOPEFULLY, A LITTLE BIT WISER. FOR ME, THIS PAST YEAR WAS THE MOST REWARDING OF MY PROFESSIONAL LIFE BECAUSE I HAD THE HONOR OF SERVING AS ASPA'S PRESIDENT. THE MEMORIES AND FRIENDSHIPS FORGED AT ASPA OVER THESE LAST 12 MONTHS WILL BE CHERISHED FOR A LIFETIME. I SINCERELY APPRECIATE THE OPPORTUNITY I WAS GIVEN.

As any Past President of ASPA will attest, what makes ASPA successful is the hard work and dedication of our volunteers and staff. I never cease to be amazed at the passion for our organization and its mission that is exhibited by ASPA volunteers and staff. The accomplishments of this past year are a direct result of their efforts. I simply was lucky enough to be the one who received many of the compliments.

This year was particularly challenging. We began the year in the wake of the events of September 11, 2001. In addition, the economic recession was now very real and its impact on ASPA was uncertain. Our Board of Directors was very specific in directing the Executive Committee to keep a watchful eye on our revenues and expenses during the year to ensure we stayed on budget. Although the final numbers are not yet completed, it appears that 2002 will be very close to what we expected. Thanks to all who worked so hard to make it possible in very difficult times!

Exactly what did we do this past year? Plenty! However, to try and detail all of the activities of ASPA in a year-in-review summary goes well beyond the scope of this article. So instead, let me try to highlight just a few of the year's accomplishments.

Membership

Total membership has reached 4,920. (I had hoped we would reach 5,000 members in 2002, but a 7% growth rate during a recession isn't all bad!) We continue to enjoy a very high membership retention rate of 93%. We now have 13 ABCs, with the latest addition being the ASPA Benefits Council of Greater Cincinnati.

The extremely popular *ASPA ASAP*s (published by GAC) have been added as an e-mail service provided to ASPA members at no cost. (Time and again, surveys have shown that this service is highly valued by our members.)

Education and Examination

The E&E Task Force completed their work with a recommendation to the Board of Directors on restructuring several of the exams and subjects covered. As directed by the Board, the E&E Committee is now moving forward with that process.

Full grade reports (rather than only a pass/fail grade) for the C-2(DB) exam are now available at the Prometric exam site. This feature is expected to be extended to the C-1 and C-2(DC) exams in the spring.

Conferences

The 2002 Annual Conference was held for the first time at the Washington Hilton. Our new "home" allowed us to hold the largest conference in our history, with classroom seating in most sessions and an expanded exhibit area. Plans are underway for an even bigger and better program in 2003.

We held the first annual 401(k) Sales Summit in Scottsdale, AZ in February 2002. We had approximately 500 attendees and received rave reviews for the program and the speakers. The Conference Committee expects another sell-out this year.

In May, ASPA took on the co-sponsorship of another IRS conference, to be held annually in the Philadelphia/Baltimore area. We now jointly sponsor five conferences with the IRS. In addition, we are exploring ways to continue to expand this educational partnership in the future.

Government Affairs

Pension reform proposals in Congress, generated by the Enron debacle, became an important priority for GAC. Our Executive Director, Brian Graff, spent countless hours with legislators and their staffs discussing these proposals, to both educate and ensure no undue burdens were placed on private retirement plans. In the end, most of what had been proposed never became law. This issue, however, is sure to be high on the agenda of the 108th Congress and will require further diligence on our part.

The ASPA PAC continues to grow. Although relatively small by Washington standards, I am amazed at the positive effect a few dollars contributed at the right time can do for our cause. I urge all ASPA members to contribute to our PAC.

In the spring, both Scott Miller (now President of ASPA) and I had the opportunity to testify at two different hearings held by the House Ways and Means,

Oversight Subcommittee, on Enron-related pension matters. Needless to say, it was quite an experience (and I didn't have to plead the fifth amendment once!).

The other hard work from GAC, (*e.g.*, commenting on the many regulatory pronouncements that were issued, developing legislative proposals for the future, as well as producing and distributing 31 *ASPA ASAP*s) was handled with the high level of professionalism and proficiency that has become their norm.

The Board of Directors

I am happy to report that our Board of Directors meetings continue to focus more on strategic planning and less on simply hearing committee reports. In each of our three Board meetings during 2002, a significant amount of time was spent fleshing out our core values and core purpose. As we grow in both size and stature, these values will provide the standards that will guide us in shaping our future. I believe the time and effort invested in this process will be to our benefit.

Closing

I want to thank my Board of Directors and Executive Committee. Their counsel and support made my job much easier. (Note: "easy" is a relative term.) In addition, the ASPA National Office staff is second to none in their dedication to the job, and I personally appreciate their hard work this past year. Finally, I owe a special debt of thanks to our Managing Director, Jane Grimm, and our Executive Director, Brian Graff. No two individuals care more about ASPA than Jane and Brian. It was a privilege to work with these two consummate professionals. ▲

The ASPA PAC continues to grow. Although relatively small by Washington standards, I am amazed at the positive effect a few dollars contributed at the right time can do for our cause. I urge all ASPA members to contribute to our PAC.

Craig P. Hoffman, APM, JD, LLM, is vice president and general counsel of SunGard Corbel. Prior to Corbel, he was in private practice, specializing in the areas of taxation, ERISA, and employee benefits.

Bonus CE!

Nondiscrimination Testing

by Lawrence Grudzien

THIS ARTICLE IS INTENDED TO BE A "PRIMER" IN THE VARIOUS ISSUES RELATED TO NONDISCRIMINATION TESTING. PART 1 IS INCLUDED IN THIS ISSUE OF *THE ASPA JOURNAL*. THE REMAINING PARTS 2 AND 3 CAN BE FOUND ON THE ASPA WEB SITE AT WWW.ASPA.ORG/CONTED/NEWSLETTER-CE.HTM. A "BONUS CE QUIZ" WORTH 2 CREDITS, COVERING PARTS 2 AND 3 OF THE ARTICLE, CAN BE FOUND ON THE WEB SITE AT WWW.ASPA.ORG/CONTED/NEWSLETTER.HTM.

Part 1—Getting Started

Because of the complexity involved with discrimination testing under Internal Revenue Code Sections 401(k) and 401(m), most employers leave this task to their consultants or record keepers. However, it is important that an employer has a broad understanding of the process in order to review the quality of the work performed and protect itself in the event of an Internal Revenue Service (IRS) audit. To determine that a plan does not discriminate in favor of highly compensated employees, the IRS specifies the following:

- The number of highly compensated employees and non-highly compensated employees to be covered [Internal Revenue Code Section 410(b)]
- The maximum deferral percentage of salary deferral contributions that highly compensated employees can contribute [Internal Revenue Code Section 401(k)(3)]
- The maximum contribution percentage of employee after-tax contributions and employer matching contributions that can be contributed by and for a highly compensated employee [Internal Revenue Code Section 401(m)(2)]
- The total amount of contributions or benefits that can be contributed for or provided to highly compensated employees [Internal Revenue Code Section 401(a)(4)].

The Internal Revenue Code and its regulations also provide a complicated system of rules to remedy discriminatory contributions already made. If an employer does not follow these rules and a discriminatory contribution is not corrected, the employer's plan can be disqualified for the plan year and several previous plan years.

The entire area of nondiscrimination testing under Internal Revenue Code Sections 401(k) and 401(m) will be reviewed in three separate articles. In this article that follows, the background work that must be completed before the tests are conducted will be reviewed and discussed. This discussion includes the determination of which employees are highly compensated employees and the procedures for conducting coverage testing under Internal Revenue Code Section 410(b). Before any 401(k) or 401(m) testing is conducted, a plan sponsor's plan or plans must pass the coverage testing. In next month's article, the procedures for conducting actual deferral percentage testing under Internal Revenue Code Section 401(k)(3) will be reviewed and discussed. Over the last several years, there have been changes to these rules. The third article reviews the procedures for conducting the actual contribution percentage test under Internal Revenue Code Section 401(m)(2), the repealed multiple use of the alternative limitation test, and the design-based safe harbors under Internal Revenue Code Sections 401(k)(12) and 401(m)(11). Many employers are adopting the designed based safe harbors, but before adopting these safe harbors, an employer should review the cost of adoption and the additional notice requirements.

Determining Highly Compensated Employee Status

Basic Rules: Before conducting any of the nondiscrimination tests, an employer must determine which employees are highly compensated. Under Internal Revenue Code Section 414(q)(I), the term "highly compensated employee" means any employee who:

- Was a 5 percent or greater owner of the employer during the current year or the preceding year; or
- Received compensation from the employer in excess of $80,000 for the preceding year (indexed for inflation; the limit for 2002 and 2003 is $90,000); and
- If the employer so chooses, was in the top-paid group of employees for that preceding year.[1]

Note: The above dollar limitation is reduced proportionately for short plan years of fewer than 12 months. Only actual compensation is tested. The periodic rate of compensation for a part of a year is not "rated up" to a full 12-month annual rate of compensation.

An employer's highly compensated employee's status is determined based on the "applicable year" of the plan or other entity for which the determination is being

made (the "determination year") and the preceding 12-month period is the "look-back year". In general, the plan year is the "applicable year". In addition, an employer may make a calendar year election for a determination year. If this election is made, the calendar year beginning with or within the preceding 12-month period is the look-back year. This calendar year data election does not apply in determining whether the employer's employees are highly compensated employees on account of being 5% owners. Therefore, if an employee is a 5% owner in either the look-back year or the determination year, then the employee is a highly compensated employee, without regard to whether the employer makes a calendar year data election. If a plan year is also a calendar year, the calendar year data election will have no effect on the highly compensated employee determination.[2]

It is important to remember that the top-paid group election and the calendar year data election are independent of each other. An employer that makes one of the elections is not required to make the other. If an employer makes both of the elections, the look-back year in determining the top paid group must be the applicable calendar year.

If an employer makes the calendar year election for one plan, this election must apply to all plans and all members of the controlled or affiliated service group.

In addition, the employer's or plan administrator's ability to make this calendar year election must be provided for in the plan, but the procedure for making the election is not required to be set out in the plan itself.[3]

Determining Compensation Paid to Highly Compensated Employees: In determining the group of highly compensated employees, compensation is defined under Code Section 414(q)(4) as compensation under Internal Revenue Code Section 415(c)(3).

Treasury Regulations Section 1.415-2(d) allows four possible definitions of compensation:

- The general definition under Treasury Regulations Section 1.415-2(d)(1)(2) and (3);
- The modified definition under Treasury Regulations Section 1.415-2(d)(10);
- Wage reporting under Form W-2 under Treasury Regulations Section 1.415-2(d)(11)(i); and
- Tax withholding under Treasury Regulations Section 1.415-2(d)(11)(ii).[4]

In determining the amount of any highly compensated employee's compensation, no more than $200,000, indexed for inflation, can be considered for any determination year. The limit is $200,000 for 2002 and 2003. If a plan determines compensation for a period of time that contains fewer than 12 calendar months, then the annual compensation limit is prorated by the number of full months.[5]

To assist in determining which items of income are or are not included in one of the following definitions of compensation, a chart of these definitions of compensation is included at the end of this discussion.

Special Rules for Determining Highly Compensated Employees: In determining who is a highly compensated employee, the employer will need to keep in mind the following special rules and limitations.

For the purpose of determining the top 20 percent of employees who make up the top-paid group, the following employees can be excluded:

- Those who are under age 21;
- Those who have completed less than six months of service;
- Those who normally work less than 17½ hours per week;
- Those who are subject to a collective bargaining agreement;
- Those who are nonresident aliens without any U.S. Source income from the employer; and
- Those who do not work normally more than six months during any year.

Note: An employer can elect to apply exclusions by using a lower number for the six exclusions above.[6]

Controlled Group and Affiliated Service Group Rules: The determination of highly compensated employee status is always made on a controlled group or affiliated service group basis, even if the employer has elected to use the qualified separate line of business election under Internal Revenue Code Section 414(r).[7] If an employer operates qualified separate lines of business, it is permitted to apply certain minimum coverage requirements separately with respect to the employees of each qualified business. An employer is treated as operating qualified separate lines of business if it meets criteria under the regulations of Internal Revenue Code Section 414(r). This determination is important because related employers are treated as one employer under both the controlled group and affiliated service group rules.

General Testing Procedures

To conduct either the actual deferral percentage (ADP) test under Internal Revenue Code Section 401(k)(3) or the actual contribution percentage (ACP) test under Internal Revenue Code Section 401(m)(3), the employer must follow these seven necessary steps.

1. Conduct the minimum coverage test under Internal Revenue Code Section 410(b).

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Newest Additions to ASPA's Board of Directors

KERRY M. BOYCE, CPC, QPA, **SUE J. CHAMBERS**, FSPA, AND **JEFFREY C. CHANG**, APM, HAVE BEEN ELECTED TO ASPA'S BOARD OF DIRECTORS AND WILL SERVE THREE-YEAR TERMS FROM 2003–2005. **ROBERT M. RICHTER**, APM, AND **CAROL J. SKINNER,** QPA, WERE ELECTED TO FILL OPEN ONE-YEAR TERMS ON THE BOARD OF DIRECTORS.

Kerry M. Boyce, CPC, QPA, is CEO and sole shareholder of Boyce & Associates, Inc., in Scottsdale, AZ. Boyce & Associates' survival and growth is a testament to two truths: 1) Pick an obscure enough line of work and very few people will know if you're doing it right; and 2) Talk fast, smile a lot, exude confidence, and people will trust you and bring you business. Doing good work helps too!

Prior to forming Boyce & Associates, Kerry wandered aimlessly as an employee of many firms, performing the duties of bill collector, furniture and auto re-possessor, as well as pulling a three-year stint in the US Army (a great place to hide from reality). Kerry attended multiple colleges majoring in actuarial science and business administration, but never graduated from any of them. Truth be told, Kerry barely graduated from the fourth high school he attended. Kerry somehow got through the ASPA exams to earn the CPC and QPA designations.

Kerry is the current Chair of ASPA's Membership Committee which is proof that the "Peter Principle" works as well as ever. With the same skills mentioned above (fast talk, etc.), Kerry also weaseled his way onto ASPA's Technology and Marketing Committees as a way to qualify for more free trips and meals.

Kerry has been the featured speaker for numerous organizations including NIPA, WP&BC, the Institute of Management Accountants, the Arizona CPA Society, Golden Gate University, Arizona Employee Benefits Forum, and the Institute of Certified Financial Planners. Obviously these groups had no prior contact with each other or they would have sought a more engaging speaker.

In addition to being an avid golfer and a member of a men's performance chorus, Kerry's free time is spent primarily channel surfing and fantasizing about "how good things might have been if...."

Susan J. Chambers, FSPA, MAAA, EA, is the president of Chambers Benefit Group in Albuquerque, NM. She has over twenty years of experience in the pension actuarial field.

Sue is a Fellow of ASPA, a member of the American Academy of Actuaries, and an enrolled actuary, and a member of the ESOP Association. An ASPA member since 1994, Sue is chair of the Actuarial Subcommittee of ASPA's Education and Examination Committee.

Sue is also a member of the New Mexico Estate Planning Council and Employee Benefits Roundtable. She serves on the Community Fund Review Panel of United Way.

Sue graduated with a Bachelor of Science in Mathematics from Cleveland State University. She lives in Rio Rancho, NM, near Albuquerque, with her husband George, and two dalmatians, Murphy and Bingo.

Jeffrey C. Chang, APM, is a shareholder in the law firm of Chang, Ruthenberg & Long PC. Jeff specializes in profit sharing, pension plans, and deferred compensation matters. An ASPA member since 1989, Jeff serves as co-chair of ASPA's Government Affairs Committee (GAC).

Jeff founded the Sacramento Employee Benefits Roundtable, which is now the Sacramento chapter of the Western Pension and Benefits Conference. He has taught deferred compensation and qualified retirement plan courses in the Masters of Law program at McGeorge School of Law.

In the early 1990s, Jeff formed the Employee Benefits Committee of the State Bar Tax Section and served as its founding chair. He co-authored the *Business Owner's Retirement Plan Survival Guide*. In 2000, Jeff was inducted into the American College of Employee Benefits Counsel as a charter fellow.

Jeff received a BA in Economics from UC Berkeley in 1976 and a JD from UC Davis School of Law in 1979. Jeff lives in Granite Bay, CA near Sacramento with his wife, Linnell, and three children. In his spare time he enjoys playing tennis.

Robert M. Richter, APM, JD, LLM, is a vice president at SunGard Corbel Inc. in Jacksonville, FL. Robert began his career with SunGard Corbel in 1985, and has served as Director of the Technical Consulting Department since 1992. He is instrumental in authoring and supporting SunGard Corbel's retirement plan documents, as well as being co-author of the firm's Cafeteria (Section 125) plans.

Robert is well known in the industry as a frequent lecturer, both locally and nationally, on employee benefits. In addition, he is a contributing author to employee benefits publications. He has served on numerous committees within ASPA. Currently he is chair of both *The ASPA Journal* Committee and the Reporting and Disclosure and Plan Document Subcommittee of the Government Affairs Committee, and he is a member of the Education & Examination C-4 Subcommittee.

Robert received his BS degree in Business Administration with a concentration in finance from the University of Florida. He received his Juris Doctor (JD) from Florida State University and his Masters of Law in Taxation (LLM) from the University of Florida. He is a member of numerous associations including The Florida Bar, the American Bar Association, the Jacksonville Bar Association, the National Institute of Pension Administrators, the ABC of North Florida, and the Jacksonville Jewish Community Alliance (where he has served on the board of directors). He is currently a Webelos Cub Scout den leader and in his spare time, he enjoys spending time with his wife and four children.

Carol J. Skinner, QPA, currently serves as co-chair of the ASPA Benefits Council (ABC) Committee, has served as past president for the Atlanta ABC, and continues serving on the Atlanta ABC Board of Directors.

As the Atlanta Regional Pension Sales Manager for Securian Retirement Services, Carol is responsible for managing existing client relationships and generating new business sales through intermediaries in the Southeast. She markets both DB and DC plan designs offering either a single-provider "full service" or a partial "investment only" service package.

With over 22 years of experience focused on marketing and sales with a foundation in recordkeeping and administration, Carol has a broad perspective of the private retirement plan industry. Her past experiences include operational consulting to industry service providers, creating marketing alliances with associations, and providing in-house sales and technical training to insurance and brokerage field offices. Carol holds an NASD Series 7 & 63 license, in addition to Georgia Life Insurance and Variable Annuity licenses.

Aside from her work and volunteer activities with ASPA, she has a mini farm that includes four dogs, two cats, and two horses that she rides and trains. Carol also finds time to study Anthropology at Georgia State University in preparation for her "post-retirement career." She also knits baby blankets for local hospitals to give to unwed or indigent new mothers.

Stephen L. Dobrow, CPC, QPA, QKA, **Scott E. Hiltunen**, CPC, and **Chris L. Stroud**, MSPA, were elected to their second Board terms and will serve through 2005.

ASPA Benefits Councils Calendar of Events

Date	Location	Event	Speakers
February 20	Cleveland	DOL Correction Program	TBA
February 26	Delaware Valley	Cash Balance Plans-Emphasis on New Regulations	Tom Finnegan, MSPA
April 3	Western PA	Form 5500 Issues	Janice M. Wegesin, CPC, QPA
April 17	Cleveland	Legislative Update	TBA
June 11	Western PA	Compliance Issues	Bruce Ashton, APM
June 26	Cleveland	Successfully Negotiating with the IRS/DOL	TBA

Continued from page 1

Operating a Qualified Plan? Know Your Responsibilities When It Comes to Plan Investments

age the plan's operation and administration. Typically, plan administrators and trustees are named fiduciaries and most plans will identify the Employer or a Plan Committee as Plan Administrator. Any individuals with discretionary authority over plan assets or plan management are fiduciaries.

With limited exceptions, ERISA also requires that all assets in a qualified retirement plan be held in a trust controlled by one or more trustees. A plan **trustee** is generally an individual, or group of individuals, or an entity, such as a bank or trust company. The plan trustee is named in the plan's trust document. The purpose of the trustee is to manage and control the plan assets and coordinate their investment for the exclusive purpose of providing benefits to the plan's participants and their beneficiaries.

Section 403 of ERISA provides that the trustees of a plan must have the "exclusive authority and discretion to manage and control the assets of the plan." If a plan provides for co-trustees, assets will typically be jointly managed unless the co-trustees allocate their trustee responsibilities. For the most part, the trustee's responsibilities may not be allocated to other plan fiduciaries. There are, however, three exceptions to this rule. First, a plan may provide that the trustee is subject to the direction of a named fiduciary who is not a trustee, in which event the trustee is called a directed trustee. Second, a plan may permit the appointment of an investment manager with authority to manage, acquire, or dispose of plan assets. Finally, a plan trustee may follow the directions of plan participants if the plan and the directions comply with the requirements of ERISA Section 404(c).

In general, trustee responsibilities include any obligations to manage or control the assets of the plan, whether or not that responsibility is represented in a trust agreement or plan document. Trustee responsibilities are subject to the rules concerning ERISA fiduciary duties. Fiduciaries may be personally liable for any plan operation problems if they have knowledge of the problem, know it is being ignored, and take no action. Generally, however, fiduciary personal liability exists only for the component of plan administration for which the fiduciary is responsible.

Types of Trustees

Trustees fall into two main categories: **directed trustees** and **discretionary trustees**. Trustees subject to the direction of the named fiduciary are referred to as directed trustees. A directed trustee is generally a person who has custody of plan assets but does not have discretionary authority over the disposition or management of those assets. Usually a directed trustee acts on the instructions of a plan fiduciary, who does have such discretion. Directed trustees have limited liability because they are unable to exercise discretion over the administration or management of the plan, or over the investment of the assets. Although directed trustees generally have limited liability, they do have a fiduciary duty to determine whether or not the instructions they receive from the plan fiduciary are proper before they are carried out. Most trust companies that accept trusteeship of a plan operate in the capacity of a directed trustee.

A discretionary trustee has the sole authority to manage and control plan assets. Typically, this role is reserved for an investment manager; however, a discretionary trustee could be anyone with complete control over plan assets who is authorized to make investment decisions on the investments in the trust.

Most **corporate trustees** act as directed trustees. Having a corporate trustee helps the plan, since an institution specializing in these services performs the trustee's role and administrative functions. Additionally, fiduciary liability is broadly distributed, which may eliminate potential conflicts of interest, reducing the possibility of litigation under ERISA and making available the trustee's legal and financial resources to defend against litigation that may arise. Typically when corporate officers play multiple roles in the administration of qualified plans (sponsor, participant, administrator, and trustee), there is an increased potential for conflicts of interest. While a corporate trustee may cost as much as 1% of plan assets annually, a corporate trustee can act as a liaison between the plan sponsor and the plan assets, in addition to providing the benefits mentioned above.

Many smaller companies will appoint the company's owner or another executive to act as trustee. In these situations, often the trustees also act in other capacities, such as plan sponsor, plan administrator, or other fiduciary roles—not to mention plan participant. This "wearing of many hats" may appear to cause a conflict of interest among participants and their beneficiaries. It is important that responsible parties be well aware of any potential for conflict.

Other Responsible Parties

A **custodian** is not a trustee. A custodian has possession of plan assets, but generally lacks any discretionary authority over the disposition of those assets or the administration or management of the plan. Custodial accounts may be used instead of trusteed accounts, but the plan will still need to have a trustee. This plan trustee will have the responsibility for plan asset investment decisions, and thus the custodian merely retains custody of such assets. Most qualified plan assets are custodied through a mutual fund company, insurance company, or brokerage firm.

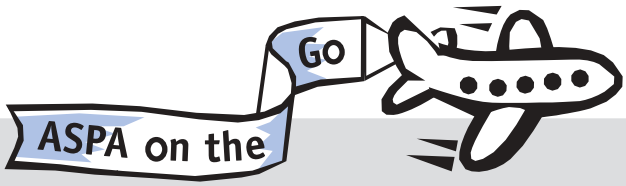
A plan may provide for the appointment of an **investment manager** with the authority to manage, acquire, or dispose of plan assets. An investment manager has the power to buy or sell plan assets, and must either be a registered investment advisor, a bank, or an insurance company licensed to do business in more than one state. If an investment manager is hired, the plan trustees may be relieved of their fiduciary responsibilities for the assets allocated to that investment manager, as long as the investment manager acknowledges its ERISA fiduciary status and responsibility in writing. Once the investment manager is properly appointed, the plan trustee no longer has the responsibility of managing the assets controlled by the investment manager and is not liable for the investment manager's acts or omissions, provided that the fiduciaries do the following: (1) prudently select the investment manager(s); (2) establish and implement appropriate investment guidelines; and (3) regularly monitor the manager to ensure that the guidelines are being followed.

In special circumstances the *trustees* may wish to hire an investment manager, and they must be sure the plan document specifically provides for the delegation of investment responsibility. The plan documents must clearly establish procedures that make it possible for plan trustees to allocate or delegate responsibilities to an investment manager. Otherwise, the trustees may not have removed themselves from investment responsibility. A procedure must subsequently be developed for the selection of an investment manager.

In order to meet one component of due diligence with respect to the selection and retention of an investment manager and the ensuing trust decisions, it is wise for the plan's fiduciaries to develop and utilize an investment policy statement. The investment policy statement serves as the guidebook for making fund selections and monitoring an investment's performance. The written policy should, at a minimum, address the following issues:

- The plan's goals and objectives
- The specific criteria for selecting investment managers, mutual funds, and other investments
- Guidelines on how funds will be monitored
- Standards as to what benchmarks will be used for review of investment performance
- Minimum acceptable investment returns
- A procedure to follow if a fund fails to meet investment expectations
- A policy with respect to fund manager changes
- An annual investment audit procedure
- Guidelines for the evaluation of plan expenses
- A participant education policy
- A record retention policy in order to prove compliance
- An outline of the roles and responsibilities of all parties including the plan sponsor, the trustee, the fund company, and all other fiduciaries and consultants.

Many fund companies offer boilerplate investment policy statement language. While this is a good starting point for drafting an investment policy statement, it is important that an investment policy statement be custom designed to reflect the personal investment philosophies of the plan's decision makers. The final result should be a document that is detailed enough to



As usual, ASPA's Government Affairs Committee (GAC) continues to work hard on issues of importance to ASPA members. As many of you know, in December 2002 GAC filed an *amicus* Memorandum of Law in response to the North Carolina State Bar's *assertion that retirement plan consulting constitutes the unauthorized practice of law.* ASPA made its position clear—the North Carolina Bar's current position should be withdrawn. You can read the complete (redacted) *amicus* memorandum at **http://www.aspa.org/pdf_files/govpdffiles/2002_ncbar.pdf.**

If the State Bar's position is upheld, these views may spread to other states. Many of you may recall that virtually the same restriction on retirement plan services was proposed in Florida several years ago. GAC was involved in that case, and in the end the Supreme Court of Florida agreed with ASPA's position that the Florida Bar lacked the legal authority to impose their proposed restriction on non-lawyer retirement plan services. We can assure you that GAC is working very hard to achieve the same result in North Carolina!

provide specific guidance, but not so restrictive that it is inflexible and impossible to follow. As market conditions change, it may be important to change the overall investment mix, so these adjustments would need to be easily implemented without amending the policy statement. As opposed to stating specific investment mixes, identifying a range that can withstand a shift in the market is more appropriate.

Demographics change, market conditions change, and often investments change in character over time. Both the plan's investment policy statement and the plan's investments should be reviewed annually or more frequently in light of such changes. This annual review will uncover areas in the investment policy that may need adjustment or further clarification, as well as identify investment alternatives that may need to be looked at more closely or perhaps eliminated or replaced. Nothing should get stagnant if this process is implemented.

Alternatively, a plan trustee may follow the directions of plan participants if the plan and the directions comply with the requirements of ERISA Section 404(c). If investments are directed by plan participants, trustees are not liable for investment decisions, but if the trustees choose the investments, they will be held to the same standards as any other investment manager. It is important that plan sponsors understand the ongoing responsibilities of ERISA 404(c) especially in two key areas: investment selection and information requirement. It is also important that those charged with the task of operating and administering the plan understand those fiduciary responsibilities that they retain, particularly when selecting plan investments.

Investments may change over time for many different reasons, sometimes when a fund manager changes and the fund changes as a reflection of the fund manager's personal investment style, or sometimes an investment gets too large and as a result, changes its core characteristics. Other times, the underlying investments may change as a result of corporate growth and transition. Because of these factors, it is essential that those charged with the task of selecting the investments offered monitor these investments to make sure that they are mirroring their intended purpose. An investment policy statement provides the benchmarks by which to make these evaluations.

Conclusion

Operating a qualified plan comes with many responsibilities and with the potential for liability. While the potential for fiduciary liability is mitigated through the use of independent professionals/institutions, it is not eliminated, and although participant direction is an attractive and popular feature, there is no such thing as complete protection. Finally, the importance of written policies and procedures on trustee and fiduciary responsibilities cannot be overlooked. ▲

Pamela Zentko, CFP, is a Retirement Plan Consultant for McKay Hochman. Pamela has more than three years of personal financial planning experience. Her areas of expertise include employee benefit planning, retirement planning, income tax planning, estate planning, and investments. In addition to holding her CFP, she also holds NASD Series 7 & 63 licenses and is currently working towards ASPA's CPC designation.

ASPA Announces the 2002 Educator's Award Winner

Joan addressing the 2002 ASPA Annual Conference upon receiving the 2002 Educator's Award.

At the 2002 ASPA Annual Conference, ASPA proudly recognized Joan A. Gucciardi, MSPA, CPC, as the recipient of the 2002 Educator's Award. Joan was selected by the ASPA Education and Examination Committee's divisional chairs.

Joan is a consulting actuary with Gucciardi Benefit Resources, Inc., a division of Summit Benefit & Actuarial Services, Inc. She received an Honors Bachelor of Science in Math from Marquette University. She has co-authored *The 401(k) Answer Book* (1992), *5500 Preparers Manual* (1993–2001), *The Pension Distribution Answer Book* (2002), and *The Plan Termination Answer Book* (2002). Joan is editor-in-chief of *The Journal of Pension Benefits* (Panel Publishers, 1993–present). Joan is a former vice president and current board member of ASPA and her professional designations include MSPA, MAAA, CPC, CLU, and ChFC. She is a former president of the Wisconsin Retirement Plan Professions, Ltd. and is on the board of the Bay View Community Center.

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Nondiscrimination Testing

2. Segregate employees in the plan or plans being tested into highly compensated groups and nonhighly compensated groups.
3. Determine the actual deferral percentage and the actual contribution percentage for each participant being tested by dividing each participant's salary deferral contributions for the ADP test and employer matching and employee after-tax contributions for the ACP test by the amount of his or her compensation. (For an eligible highly compensated or non-highly compensated employee who elects not to defer, the ADP or ACP is 0).
4. Determine the actual deferral percentage for the ADP test and the actual contribution percentage for the ACP test for the highly compensated employee group and the non-highly compensated employee group by adding together the individual actual deferral percentage for the ADP test and individual actual contribution percentage for the ACP test of each participant in each group and dividing it by the number of participants in the group.
5. Conduct the ADP test under Internal Revenue Code Section 401(k)(3) and the ACP test under Internal Revenue Code Section 401(m)(3) by determining whether the actual deferral percentage for the ADP test and the actual contribution percentage for the ACP for the highly compensated employee group is within one of the two limits set by the actual deferral percentage for the ADP test and the actual contribution percentage for the ACP test for the non-highly compensated employee group.
6. Conduct the multiple use test for years beginning before January 1, 2002.
7. Review correction procedures if either the actual deferral percentage test or the actual contribution percentage test does not pass or if the multiple use test does not pass for years beginning before January 1, 2002. These correction methods include the following:
   - Distributing excess salary deferral contributions or excess employer matching contributions and employee after-tax contributions from the accounts of highly compensated employees, adjusted for investment earnings or losses;
   - Recharacterizing excess salary deferral contributions as after-tax employee contributions for the ACP test;
   - Adding employer contributions to non-highly compensated employees for passing the ADP test or ACP test. These contributions must be 100 percent vested and subject to the same distribution rules as salary deferral contributions; and
   - Aggregating the plan with other plans sponsored on a controlled group basis and retesting.

Coverage Tests under Internal Revenue Code Section 410(b)

Introduction: Before conducting any of the nondiscrimination tests, an employer must first determine whether the plan or component plan being tested meets one of the two coverage tests under Internal Revenue Code Section 410(b). These coverage tests are the ratio percentage test and the average benefit test. There are some situations in which the plan is deemed to automatically satisfy these coverage tests. They include the following:

- Employers with only highly compensated employees;[8]
- Plans benefiting no highly compensated employees;[9]
- Plans benefiting collectively-bargained employees;[10] or
- Plans during a specified time period following certain business dispositions or acquisitions.[11]

Employees Benefiting: In conducting the minimum coverage tests under Internal Revenue Code Section 410(b), each test compares the employees actually benefiting under the plan with those who must be included in the coverage testing. With respect to salary deferral contributions, employer matching contributions, and employee after-tax contributions, an employee will be considered to benefit if he or she is eligible to make contributions in the case of salary deferral contributions and after-tax contributions and, in the case of employer matching contributions, if he or she is directly or indirectly eligible to receive an allocation of matching contributions (including matching contributions derived from forfeitures), even if he or she did not contribute. An employee will not be treated as being eligible to receive employer-matching contributions if he or she has not completed the required minimum service under the plan (*e.g.*, a 1,000 hour requirement or employed on the last day requirement).[12]

When determining the population of employees benefiting from the plan for a plan year, all active employees of an employer, other than excluded employees, are taken into account. The following employees or former employees can be excluded:

- Employees who have not satisfied the minimum age and service requirements, if any, indicated in the plan as a condition of participation;[13]

- Nonresident aliens who receive no earned income within the United States or whose US source income is excluded by a tax treaty;[14]
- A "collectively bargained employee," either not eligible for the plan (if the plan covers only non-collectively bargained employees) or under the mandatory disaggregated portion of the plan (if the plan covers both collectively bargained and non-collectively bargained employees);[15]
- Employees of a qualified separate line of business of an employer that is not being tested;[16]
- Participants who terminate employment during the plan year with 500 or fewer hours of service and who failed to accrue a contribution under the plan solely because they did not meet a minimum period of service requirement (for example, 1,000 hours of service or were not employed on the last day of the plan year);[17]
- A former employee who was an excluded employee under any of the above exclusions during the plan year. If such employee is treated by the employer as excluded under this rule, such former employee will not be taken into account even if benefiting.[18]

If an employer has adopted more liberal age and service requirements than allowed under Code Section 410(a)—less than age 21 and one year of service—it may treat its plan as two plans: one plan for the otherwise excludable (less than age 21 and one year of service and dual entry dates) and another plan for all the other employees who benefit under the plan. The otherwise "excludable employees" are treated as excluded employees in testing the plan for all the other employees. This testing can take place only if the plan for the otherwise excluded employees satisfies the minimum coverage requirements after excluding the following employees:

- Those employees who have satisfied the maximum age and service requirements allowed under Code Section 410(a);
- If the plan applies minimum age and service conditions that are lower than the maximum permissible age and service conditions, those employees who have not satisfied the lower age service requirements.[19]

Ratio Percentage Test: In this test, the percentage of non-highly compensated employees benefiting under the plan must be at least 70 percent of the percentage of highly compensated employees benefiting under the plan.[20] The test is conducted on a controlled group basis or an affiliated service group basis.[21] If an employer makes the qualified separate line of business election, the plan of each separate line of business must be tested both on a separate line of business basis and on an employer-wide basis.[22]

For example, XYZ Company has three divisions, X, Y, and Z, with a total of 1,000 employees, 15 of whom are highly compensated. Only the Y division established a 401(k) plan. Y has 300 eligible employees, six of whom are highly compensated. The percentage of non-highly compensated employees participating is 29.8 percent (294/985). The percentage of highly compensated employees benefiting is 40 percent (6 out of 15). Y's plan would meet the ratio percentage test because the ratio of the percentage of nonhighly compensated employees benefiting to the percentage of highly compensated employees benefiting is 74.5% (29.8/40). Therefore, the plan meets the minimum coverage requirements of Internal Revenue Code Section 410(b) by passing the ratio percentage test.

Average Benefit Test: If a plan does not meet the ratio percentage test, it must be tested under the average benefit test. Under this test, the employer must meet two separate nondiscrimination tests. First, the plan must benefit a classification of employees that the IRS finds not to be discriminatory in favor of highly compensated employees. Second, the average benefit percentage of the non-highly compensated employees must be at least 70 percent of the average benefit percentage of the highly compensated employees.[23]

A plan is deemed to meet the nondiscriminatory classification test only if the classification is both reasonable and nondiscriminatory. A classification is deemed reasonable if it reflects bona fide business criteria, such as salaried employees and hourly employees, rather than a classification designed to increase qualified plan disparities. This determination is made on a case-by-case basis.[24]

A classification is deemed nondiscriminatory if either it falls within an objective safe harbor for the plan year or if the plan falls between the objective safe harbor and objective unsafe harbor and satisfies a facts and circumstances test for the plan year.[25]

A plan will fall within this objective safe harbor if its "ratio percentage" equals or exceeds the employer's "safe harbor percentage."[26]

A plan's ratio percentage for a plan year is the percentage resulting from dividing the non-highly compensated employee benefiting percentage by the highly compensated employee benefiting percentage.

When conducting this test, the following definitions are important to know:

Non-Highly Compensated Employee Benefiting Percentage—The number of non-highly compensated employees of the employer benefiting under the plan expressed as a percentage of all non-excludable non-highly compensated employees.

Highly Compensated Employee Benefiting Percentage—The number of highly compensated employees benefiting under the plan expressed as a percentage of all nonexcludable highly compensated employees.[27]

Non-Highly Compensated Employee Concentration Percentage—The percentage of all employees who are not highly compensated employees. Excludable employees are not taken into account.

Safe Harbor Percentage—50 percent, reduced by 3/4 of a percentage point for each percentage point by which the non-highly compensated employee concentration percentage exceeds 60 percent.

Unsafe Harbor Percentage—40 percent, reduced by 3/4 of a percentage point for each percentage point by which the non-highly compensated employee compensation percentage exceeds 60 percent. However, in no case is the unsafe harbor less than 20 percent.[28]

For example, Employer A has 200 employees after applying the appropriate exclusions; 120 are non-highly compensated employees and 80 are highly compensated employees. The non-highly compensated employee concentration percentage is 60 percent (120/200).

Employer A maintains a plan that benefits 72 highly compensated employees. The highly compensated employee benefiting percentage is 90 percent (72/80). The safe harbor percentage is 50 percent and the unsafe harbor percentage is 40 percent (because 60 percent of the employer's work force consists of non-highly compensated employees).

If the plan benefits at least 45 percent (50 percent times 90 percent) of the non-highly compensated employees, or 54 employees, the classification is deemed within the safe harbor and considered nondiscriminatory.

If a plan's ratio percentage falls between the safe harbor and unsafe harbor, it may still be determined to be nondiscriminatory under a special facts and circumstances test contained in the final regulations.[29] This test is met if the classification is deemed not to be discriminatory based on all relevant facts and circumstances. For the purpose of this test, all the following facts and circumstances are considered relevant:

- The underlying business reason for the classification;
- The percentage of employees benefiting under the plan (the higher the percentage, the more likely the classification is to be nondiscriminatory);
- Whether the number of employees benefiting under the plan in each salary range is representative of employees in each salary range;
- The difference between the non-highly compensated employee benefiting percentage and the safe harbor percentage (the smaller the difference, the more likely the classification is to be nondiscriminatory); and
- The extent to which the plan's average benefit percentage exceeds 70 percent.[30]

The table below illustrates the safe harbor and unsafe harbor percentages, depending on the concentration or numbers of non-highly compensated employees.

Safe Harbor and Unsafe Harbor Percentages Table

Non-Highly Compensated Employee Concentration	Safe Harbor Percentage	Unsafe Harbor Percentage
0–60	50	40
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47	37
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44	34
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41	31
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38	28
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35	25
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32	22
85	31.25	21.25
86	30.50	20.50
87	29.75	20
88	29	20
89	28.25	20
90	27.50	20
91	26.75	20
92	26	20
93	25.25	20
94	24.50	20
95	23.75	20
96	23	20
97	22.25	20
98	21.50	20
99	20.75	20[31]

For example, Employer B has 10,000 employees after all of the applicable exclusions discussed above. Of the total, 9,600 are non-highly compensated employees and the remainder is highly compensated. The non-highly compensated employee concentration percentage is 96 percent (9,600/10,000).

Employer B maintains a plan that benefits 100 of the 400 highly compensated employees. How many non-highly compensated employees must benefit under the plan to meet the safe harbor or the facts and circumstances test? The highly compensated employee benefiting percentage is 25 percent (100/400). The plan's safe harbor percentage is 23 percent and the unsafe harbor percentage is 20 percent. If the plan will meet the safe harbor, it benefits at least 5.75 percent (23 percent times 25 percent) of the non-highly compensated employees or 552 employees.

If the plan benefits between 480 and 551 employees, it will meet the nondiscriminatory classification test if the facts and circumstances test is met.

If the plan benefits less than 5 percent (20 percent times 25 percent) of the non-highly compensated employees, or 480 employees, the classification falls below the unsafe harbor and is considered discriminatory.

If an employer cannot meet any of the above tests, then it should consider aggregating the plan with other plans for testing purposes.

Once the nondiscriminatory classification test is satisfied, the employer needs to determine whether its plan meets the requirements of the average benefit percentage test. This test is satisfied for a plan year only if the average benefit percentage is at least 70 percent.[32]

The average benefit percentage is the percentage determined by dividing the actual benefit percentage for non-highly compensated active employees by the actual benefit percentage for highly compensated active employees. The actual benefit percentage for a group of employees is the average of the benefit percentages calculated separately with respect to each employee in the group. For purposes of this test, all active employees not excluded are taken into consideration.[33]

In determining an employee's benefit percentage, the following steps must be followed:

1. Calculate the allocations contributed for each employee for all plans to be tested for the plan year.
2. Total each employee's accruals determined under step 1 and divide the total by the employee's compensation in accordance with Internal Revenue Code Section 414(s).[34]

In determining the employee's benefit percentages, the employer must remember the following considerations:

- The plans being tested and other plans that could be permissively aggregated (tested as a single plan) are taken into account;[35]
- Amounts are tested on the basis of plan years ending within the same calendar year;[36]
- Benefit percentages can be determined on either a benefit or contribution basis, but for any testing period, only one basis can be used;[37]
- Only employer provided contributions and benefits including salary deferral and employee matching contributions are taken into account while employee after-tax contributions and benefits derived from such contributions are not;[38] and
- The methods and options available for determining employee benefit percentages are the same methods and options that an aggregated plan will use under regulations of Internal Revenue Code Section 401(a)(4).[39]

For example, the Boyd Company has 50 employees. Of these, 5 are highly compensated. Boyd is divided into two divisions, A and B. Division A has 3 highly compensated employees and 20 non-highly compensated employees. Division B has 2 highly compensated employees and 25 non-highly compensated employees. Division A decides to establish a profit-sharing plan and contributes 5 percent of each employee's compensation. Assume that Division A passes the nondiscriminatory classification test. Does Division A's profit-sharing plan pass the average benefit test?

Calculate each employee's benefit percentage. For 3 highly compensated employees, it would be 5 percent. For 2 highly compensated employees, it would be 0. For 20 non-highly compensated employees, the benefit percentage would be 5 percent, and for 25 it would be 0.

Actual benefit percentage. The actual benefit percentage for the highly compensated employees is 3 percent. The actual benefit percentage for non-highly compensated employees is 2.2 percent.

Average benefit percentage. The average benefit percentage is 73 percent. This is determined by dividing 2.2 percent by 3 percent.

Therefore, Division A's plan would satisfy the average benefit percentage test because it exceeds the 70 percent standard.

Plan Aggregation and Disaggregation: The minimum coverage test under Internal Revenue Code Section 410(b) can be applied on a per plan basis, component plan basis, or aggregated plan basis. Treasury Regulations Section 1.410(b)-7(c) requires mandatory disaggregation (*i.e.*, certain elements of the plan must be tested separately) in the following cases:

- An employee stock ownership plan (ESOP) and the portion of the plan that is not an ESOP;
- The portion of a plan subject to Internal Revenue Code Section 401(k) (salary deferral contributions)

and the portion of the plan subject to Internal Revenue Code Section 401(m) (employee after-tax contributions and employer matching contributions);

- A portion of the plan benefiting employees who satisfy age and service conditions lower than the greatest permitted minimum age and service requirements permitted under Internal Revenue Code Section 410(b) where an employer has elected to apply the coverage rules separately to a portion of a plan that benefits only employees who satisfy age and service conditions that are lower than the greatest permissive minimum age and service conditions; and
- A portion of a plan that benefits a "disaggregation population" must be treated as a separate plan. The following categories of employees are considered separate disaggregation populations:
  - Employees of each qualified separate line of business;
  - Employees of each employer if the plan covers employees of more than one employer; and
  - Collectively bargaining employees and non-collectively bargaining employees if the plan covers both populations. Collectively bargaining employees covered under different collectively bargaining agreements are considered a separate disaggregation population.

For purposes of the ratio percentage test and the nondiscriminatory classification test, an employer may aggregate separate plans into one plan. If an employer does treat two or more separate plans as a single plan, the plans must be treated as a single plan for all purposes [Internal Revenue Code Sections 401(a)(4) and 410(b)].[40] An employer is only permitted to aggregate plans that have not been mandatorily disaggregated for the reasons above. Plans can only be aggregated if they have the same plan year.[41] Similarly, an employer cannot elect to aggregate two or more separate plans that would be disaggregated as discussed above if they were portions of the same plan. Therefore, to pass the ratio percentage test or the nondiscrimination classification test, the employer cannot aggregate a 401(k) plan feature with any other plan or any profit-sharing plan feature or 401(m) plan feature. However, it can be aggregated with another 401(k) plan feature.[42] Permissive aggregation is not available to an ESOP and another plan (including another ESOP) except where aggregation is permitted under Treasury Regulations Section 54 4975-11e.

For example, the ABBA Company has two subsidiaries, A and B, with no separate lines of business election. Subsidiary A maintains a profit-sharing plan with a 401(k) and 401(m) feature. Subsidiary B maintains a separate profit-sharing plan with a 401(k) and 401(m) feature. How many separate plans does the ABBA Company test under Internal Revenue Code Section 410(b)?

If ABBA chooses to aggregate, it could have three plans: (1) one that offers the profit-sharing features, (2) one that offers the 401(k) features, and (3) one that offers the 401(m) features. The profit-sharing, 401(k) and (m) features of each plan would be aggregated and treated as a separate plan. If ABBA chooses not to aggregate, it would have to test six separate plans.

If an employer elects to use permissive aggregation, a plan cannot be combined with two or more plans to form more than one single plan. For example, an employer maintains plans A, B, and C. The employer cannot elect to aggregate plans A and B and plans A and C to form two small plans, AB and AC. However, the employer may elect to aggregate plans A, B, and C to form plan ABC, plans AB and C, and plans AC and B, or plans A and BC.

In conducting the average benefit percentage test, the rules differ when it comes to aggregation from what was discussed above because the test seeks to account for all benefits and all contributions under an employer's plans. With certain exceptions, the employer is required to determine the average benefit percentage of all non-excludable employees under all retirement plans that the employer maintains on a controlled group or affiliated service group basis. The employer must test together all plans that could be permissively aggregated for ratio percentage and nondiscriminatory classification test purposes. In addition, the rule that states that plans must have the same plan years to be aggregated does not apply.[43]

An employer may not aggregate plans or portions of plans that were required to be disaggregated, as discussed above under Treasury Regulations Section l.410(b)-7(c), except for the following:

- ESOPs; and
- Salary reduction contributions under Internal Revenue Code Section 401(k), employee after-tax contributions, and employer matching contributions under Section 401(m).[44]

For example, the Acme Company has three subsidiaries, and it has no separate lines of business. Subsidiary A maintains a profit-sharing plan with a 401(k) feature, Subsidiary B maintains a money purchase plan, and Subsidiary C maintains a profit-sharing plan. For purposes of the average benefit percentage test, all of the above plans are treated as one plan to determine whether the actual benefit percentage of non-highly compensated employees is at least 70 percent of the actual benefit percentage of highly compensated employees.

In another example, the Andrew Company has four subsidiaries: 1, 2, 3, and 4. Subsidiary 1 has a defined benefit plan and a 401(k) plan. Subsidiary 2

has a money purchase plan and a profit-sharing plan. Subsidiary 3 has a profit-sharing plan with 401(k) and employer matching contributions. Subsidiary 4 has a defined benefit plan and ESOP with 401(k) features. In testing under Internal Revenue Code Section 4l0(b), how are the plans tested?

For the purposes of the ratio percentage test or the nondiscriminatory classification test, the Andrew Company has 10 separate plans to test:

- Company 1. (a) Defined benefit and (b) 40l(k) plan
- Company 2. (c) Money purchase plan and (d) profit-sharing plan
- Company 3. (e) Profit-sharing plan, (f) 40l(k) plan, and (g) employer matching plan
- Company 4. (h) Defined benefit plan, (i) ESOP, and (j) 40l(k) plan

If any or all of the above plans could not separately pass Internal Revenue Code 4l0(b), which of the above plans could be aggregated for the ratio percentage test and the nondiscriminatory classification test?

Theoretically, the Andrew Company could end up with the following two testing combinations: (These are not, however, the only combinations.)

- The first combination contains four groups of plans: a, d; b, f, and j; g; i.
- The second combination contains five groups of plans: a and h; c, d, and e; b, f, and j; g; i.

In combining plans, remember that Internal Revenue Code Section 401(a)(4) must be met as to the aggregated group as a whole or, if the aggregated group is restructured under Internal Revenue Code Section 401(a)(4), to each restructured component. Also, when conducting the average benefit percentage test, all plans are tested together, except in a few indicated situations.

Testing Methods to Satisfy Internal Revenue Code Section 410(b): A plan must satisfy Internal Revenue Code Section 410(b) for a plan year using one of the testing options described below. Whichever method is used, it must also be used to satisfy Internal Revenue Code Section 401(a)(4) for the plan year. Plan provisions and other relevant facts as of the last day of the plan year which establish those employees benefiting under the plan for the plan year are applied to the employees taken into account under the testing option used for the plan year. An employer is permitted to make any retroactive correction and treat it as effective on the last day of the plan year to meet the requirements of Internal Revenue Code Section 410(b) if the correction is completed within a period extending through the 15th day of the tenth month after the end of the plan year.[45]

A plan will be deemed to satisfy Internal Revenue Code Section 410(b) for a year if it satisfies the minimum coverage requirements:

- On each day of the plan year, taking into account only those employees or former employees who are employees or former employees on that day;[46]
- On at least one day of each quarter, taking into account only those employees or former employees who are employees or former employees on that day;[47] or

  Note: A plan that meets the coverage requirements under this option is considered to meet the requirements for the entire year.[48] To benefit from this rule, the plan's eligibility rules and benefit formula on each of the quarterly days must be reasonably representative of the coverage of the plan over the entire plan year.[49]
- On the last day of the plan year, taking into account all employees or former employees who were employees or former employees on any day during the plan year.[50]

  Note: This last method must be used in applying Internal Revenue Code Section 410(b) to a plan that contains salary deferral contributions and/or employee after-tax contributions and/or employer matching contributions and applying the average benefit percentage test.[51]

In addition, the IRS has simplified the above testing methods by allowing the employer to verify plan compliance under Internal Revenue Code Sections 410(b), 401(a)(4), 414(r), and certain provisions of Code Section 414(s), by looking at those employees on a given single day during the plan year, known as the "snap shot day." In order to use this day, it must be "reasonably representative" of the employer's work force and plan coverage throughout the plan year and generally must be consistent from plan year to plan year. Those employees taken into account for testing on the snap shot day are only the employees on that day and an employee's status on the snap shot day is the status that is relevant for the year (*i.e.*, collectively bargaining employees). Those employees covered on that day are considered covered for the year. This testing cannot be used for the nondiscrimination testing under Internal Revenue Code Section 401(k).

If an employer reasonably concludes that there are no significant changes subsequent to the test, for the two succeeding plan years the IRS will allow the employer to rely on tests confirming that the plan has satisfied the Internal Revenue Code Section 410(b) requirements for a plan year.[52]

Special Rules for Qualified Separate Lines of Business: If an employer is treated as operating qualified lines of business for a testing year, it may apply the requirements of Internal Revenue Code Section 410(b) separately for each business only if the employer does so for all of its plans, employees, and qualified separate lines of business.[53] An employer may apply the

requirements of Internal Revenue Code Section 410(b) on an employer-wide basis (rather than a qualified separate lines of business basis) for any plan that benefits at least 70% of the employer's non-excludable, non-highly compensated employees and satisfies the percentage test of Internal Revenue Code Section 410(b)(1)(A).[54]

If an employer does not sponsor an employer-wide plan, it can apply the requirements of Internal Revenue Code Section 410(b) separately for the employees of each qualified separate line of business. The employees of the qualified businesses are treated as if they are the only employees of the employer.[55] If an employer sponsors a plan in which more than one qualified separate line of business participates, the portion of the plan that benefits employees of one qualified business will be treated as separate from the portions of the same plan that benefit employees of the other businesses.[56]

If an employer applies Internal Revenue Code Section 410(b) separately for the employees of each qualified separate line of business for a testing year, a plan tested on a qualified separate line of business basis will satisfy that section only if:

- It satisfies the nondiscriminatory classification test under Internal Revenue Code Section 410(b)(5)(B) on an employer-wide basis; and
- It satisfies the requirements of Internal Revenue Code Section 410(b) on a qualified separate line of business basis.[57]

A plan satisfies the nondiscriminatory classification test under Internal Revenue Code Section 410(b) only if the plan satisfies either the ratio percentage test or the nondiscriminatory classification test on an employer-wide basis.[58] The plan need not be tested for the average benefit percentage test on an employer-wide basis.[59]

In testing a plan under the nondiscriminatory classification test on an employer-wide basis, the unsafe harbor percentage is reduced by five percentage points and is applied without regard to the requirement that the unsafe harbor percentage be not less than 20 percent, provided that the plan has a ratio percentage of at least 90% with respect to employees of the qualified separate line of business. Therefore, the unsafe harbor is treated as 35 percent (down from 40 percent), reduced by 3/4 of a percentage point for each whole percentage point by which the non-highly compensated employee concentration percentage exceeds 60 percent.[60]

If a plan satisfies the ratio percentage test on a qualified separate line of business basis at the 90 percent level but its ratio percentage on an employer-wide basis falls below the unsafe harbor percentage as amended in the previous paragraph, the plan is deemed to satisfy Internal Revenue Code Section 4l0(b)(5) on an employer-wide basis if on the basis of relevant facts and circumstances the plan benefits such employees as qualify under a classification of employees that does not discriminate in favor of highly compensated employees.[61]

If a plan does not satisfy (1) Internal Revenue Code Section 410(b)(5) on an employer-wide basis, (2) coverage on a qualified separate line of business basis, or (3) Internal Revenue Code Section 401(a)(4) on a qualified separate line of business basis, the plan (any plan of which it is a portion) fails to satisfy Internal Revenue Code Section 401(a) and is deemed discriminatory. However, this failure alone does not prevent the employer from being treated as operating qualified separate lines of business [unless the employer relies on benefits provided under the plan to satisfy the minimum benefit safe harbor under Treasury Regulations Section 1.414(r)-5(g)(2)].[62]

For example, Employer A operates two qualified separate lines of business, Line 1 and Line 2. Plan X benefits solely employees of Line 1 and Plan Y benefits only employees of Line 2. Employer A has 2,100 non-excludable employees of whom 100 are highly compensated. These employees are broken down as follows:

Line 1

50 highly compensated

1,900 non-highly compensated

Line 2

50 highly compensated

100 non-highly compensated

Under Plan X, 50 of the highly compensated employees and 1,300 of the non-highly compensated employees benefit. Under Plan Y, 50 of the highly compensated employees and 100 of the non-highly compensated employees benefit.

On an employer-wide basis, Plan X benefits 50 percent of Employer A's highly compensated employees (50 out of l00) and 65 percent of Employer A's non-highly compensated employees (1,300 out of 2,000). Plan X has a ratio percentage of 130 percent (65 percent ÷ 50 percent) and could satisfy Internal Revenue Code Section 410(b) under the ratio percentage list.

Because it does not cover 70 percent of employees on an employer-wide basis, Plan X must also comply with Internal Revenue Code Section 410(b) on a qualified

separate line of business basis. With a qualified separate line of business basis, Plan X benefits 100 percent of Line 1's highly compensated employees (50 out of 50) and 68 percent of Line 1's non-highly compensated employees (1,300 out 1,900). Plan X has a ratio percentage of 68 percent (68 ÷ 100 percent) and would not satisfy Section 410(b) under the ratio percentage test.

Plan X would pass the nondiscriminatory classification test because its ratio percentage (68 percent) is greater than Line 2's safe harbor percentage (22.25 percent). Line 2's non-highly compensated employees' concentration percentage is 97 percent.

On an employer-wide basis, Plan Y benefits 50 percent of Employer A's highly compensated employees (50 out of 100) and 5 percent of Employer A's non-highly compensated employees (100 out of 2,000). The Plan Y ratio percentage on an employer-wide basis is only 10 percent, but its ratio percentage on a qualified separate line of business basis is 100 percent.

Because it cannot comply with Internal Revenue Code Section 410(b) solely by complying with the ratio percentage test, Plan Y should be tested under the nondiscriminatory classification test. However, Plan Y fails to pass the nondiscriminatory classification test because its ratio percentage of 10 percent is less than the safe harbor percentage of 20 percent. Employer A's non-highly compensated employee's concentration percentage is 95 percent. Therefore, Plan Y does not satisfy Internal Revenue Code Section 410(b).

Conclusion

These first steps are important in conducting the actual deferral percentage test and the actual contribution percentage test, because without a proper determination of the controlled group members, highly compensated employees or coverage, any testing results that follow will be useless. Despite this importance, many providers do not apply the controlled group rules properly. Since the number of highly compensated employees for testing are determined on a controlled group basis, all testing results rest on this determination.

In addition, if an employer's plan has various levels of employer matching or non-elective contributions, each level of these contributions must meet the coverage tests individually. Employers with multiple plans also have to be concerned about passing the coverage tests. Certain plan features contained in plans must be tested separately. Any concentration of highly compensated employees in one plan or one plan feature will spell trouble for the coverage testing results. ▲

[1]Code § 414(q)(1)
[2]Note 97-45
[3]Note 97-45
[4]Code 414(q)(4)
[5]Code Section 401(a)(17)
[6]Code Section §414(q)(5)
[7]Code Section §414(q)(7)
[8]Code Section 410(b)(6)(E)
[9]Treas. Reg. §1.410(b)-2(b)(6)
[10]Treas. Reg. §1.410(b)-2(b)(2)
[11]Code §410(b)(6)(c)
[12]Treas. Reg. §1.410(b)-3(a)(2)(I)
[13]Code §410(b)(4)(B)
[14]Treas. Reg. §1.410(b)-6(c)
[15]Code §410(b)(3)(A)
[16]Code §410(b)(5)
[17]Treas. Reg. §1.410(b)-6(f)
[18]Treas. Reg. §1.410(b)-6(h)
[19]Treas. Reg. §1.410(b)-6(b)(3)
[20]Treas. Reg. §1.410(b)-2(b)(2)
[21]Treas. Reg. §1.410(b)-1(d)(8)
[22]Treas. Reg. §1.414(r)-8(b)
[23]Code §410(b)(2) and Treas. Reg. §1.410(b)-2(b)(3)
[24]Treas. Reg. §1.410(b)-4(b)
[25]Treas. Reg. §1.410(b)-4(c)
[26]Treas. Reg. §1.410(b)-4(c)(2)
[27]Treas. Reg. §1.410(b)-9
[28]Treas. Reg. §1.410(b)-4(c)(4)
[29]Treas. Reg. §1.410(b)-4(c)(3)(i)
[30]Treas. Reg. §1.410(b)-4(c)(ii)
[31]Treas. Reg. §1.410(b)-4(c)(3)(iv)
[32]Treas. Reg. §1.410(b)-5(a)
[33]Treas. Reg. §1.410(b)-5(c)
[34]Treas. Reg. §1.410(b)-5(d)
[35]Treas. Reg. §1.410(b)-5(d)(3)(i)
[36]Treas. Reg. §1.410(b)-5(d)(3)(ii)
[37]Treas. Reg. §1.410(b)-5(d)(4)
[38]Treas. Reg. §1.410(b)-5(d)(2)
[39]Treas. Reg. §1.410(b)-5(d)(5)
[40]Treas. Reg. §1.410(b)-7(d)(1)
[41]Treas. Reg. §1.410(b)-7(d)(5)
[42]Treas. Reg. §1.410(b)-7(d)(2)
[43]Treas. Reg. §1.410(b)-7(e)
[44]Treas. Reg. §1.410(b)-7(e)(1)
[45]Treas. Reg. §1.410(b)-8(a)(1)
[46]Treas. Reg. §1.410(b)-8(a)(2)
[47]Treas. Reg. §1.410-8(a)(3)
[48]Treas. Reg. §410(b)-8
[49]Treas. Reg. §1.410(b)-8(a)(3)
[50]Treas. Reg. §1.410(b)-8(a)(4)
[51]Treas. Reg. §1.410(b)-8(a)(1)
[52]Rev. Proc. 93-42
[53]Treas. Reg. §1.414(r)-1(c)(2)(i)
[54]Treas. Reg. §1.414(r)-1(c)(2)(ii)
[55]Treas. Reg. §1.414(r)-1(c)(1)
[56]Treas. Reg. §1.414(r)-7(c)(4)(ii)(A)
[57]Treas. Reg. §1.414(r)-8(b)(1)
[58]Treas. Reg. §1.414(r)-8(b)(1)(i)
[59]Treas. Reg. §1.414(r)-8(b)(2)
[60]Treas. Reg. §1.414(r)-8(b)(2)(iii)(B)
[61]Treas. Reg. §1.414(r)-8(b)(2)(iii)(B)
[62]Treas. Reg. §1.414(r)-8(d)(4)

See additional reference charts on pages 25– 26.

Lawrence Grudzien, JD, LLM, is an attorney practicing exclusively in the field of employee benefits. He has experience in dealing with qualified plan, health and welfare, fringe benefits, and executive compensation areas. Larry has more than 26 years of extensive practice advising on all aspects of employee benefit law, including drafting and reviewing individually designed and prototype retirement plans and performing due diligence on employee benefit issues for merger, acquisition, and outsourcing transactions. Larry is author of "Simplified Employee Survivor Manual" and co-author of "Designing & Administering 401(k) & Simple Retirement Plans," in addition to contributing to various other publications and speaking at national conferences. He is currently a technical advisor to two employee benefits Web sites, Technical Answer Group and Inside Benefits. Larry is an adjunct faculty member of John Marshall Law School's LLM program in Employee Benefits, a member of the Great Lakes Area TE/GE Council of the Internal Revenue Service, and a member of the Indiana and Illinois Bars.

Definitions of Compensation for Highly Compensated Employee Determination and for Determination of Compensation Under Internal Revenue Code Section 415(c)

Each definition includes elements marked "x" and omits the elements marked "—". These definitions are automatically nondiscriminatory for testing purposes.

Type of Item	1.415-2(d)(1), (2), and (3) General	1.415-2(d)(10) Modified 415	1.415-2(d)(11)(i) Wage Reporting	1.415-2(d)(11)(ii) Tax Withholding
Wages or salary	X	X	X	X
Self-employed income	X	—	X	X
Salesperson's commission	X	X	X	X
Percentage of profits	X	X	X	X
Insurance commissions on premiums	X	X	X	X
Premium pay	X	X	X	X
Tips	X	X	X	X
Bonuses or overtime	X	X	X	X
Taxable fringe benefits	X	X	X	X
Nonqualified stock option includable at grant	X	—	X	X
Restricted property under Internal Revenue Code Section 83(b) election	X	—	X	X
Long-term disability	X	—	X	X
Taxable medical reimbursements	X	—	X	X
Deductible moving expenses	—	—	—	—
Nondeductible moving expenses	X	—	X	X
Vesting of restricted stock or other property	—	—	X	X
Amounts realized at exercise of nonqualified stock option	—	—	X	X
Amounts realized from sale of qualified or incentive stock option	—	—	—	—
Foreign source income	X	X	X	X
Nontaxable fringe benefits	—	—	—	—
Elective contributions under Code §§125, 132(f), 401(k), 403(b), and 457	X	X	X	X
Employer contributions to deferred compensation plan	—	—	—	—
Nonqualified deferred compensation if paid while still an employee	—	—	X	X
Sick pay	X	—	X	X
Accountable expense reimbursements or allowances	—	—	—	—
Nonaccountable expense reimbursements or allowances	X	X	—	X
Taxable group term insurance premiums	X	X	X	X
Severance pay*	X	X	X	X

* Severance pay will be included if paid while an employee is still working for the employer.

Definitions of Compensation [Code Section 414(s)]

The definitions of compensation contained herein are used for the following purposes: ACP Test, ADP Test, permitted disparity, SEP contributions, Average Benefit Test under Internal Revenue Code Section 410(b), testing whether contributions are uniform for Internal Revenue Code §401(a)(5), and relationship of contributions or benefits to compensation for Internal Revenue Code §401(a)(4).

Type of Item	1.415-2(d)(1),(2), and (3) General	1.415-2(d)(10) Modified 415	1.415-2(d)(11)(i) Wage Reporting*	1.415-2(d)(11)(ii) Tax Withholding	1.414(s)-1(c)(3) Alternative	1.414(s)-1(d) Reasonable compensation
Wages or salary	X	X	X	X	X	X
Self-employed income	X	—	X	X	X	**
Salesperson's commission	X	X	X	X	X	**
Percentage of profits	X	X	X	X	X	**
Insurance commissions on premiums	X	X	X	X	X	**
Premium pay	X	X	X	X	X	**
Tips	X	X	X	X	X	**
Bonuses or overtime	X	X	X	X	X	**
Taxable fringe benefits	X	X	X	X	—	—
Nonqualified stock option includable at grant	X	—	X	X	***	**
Restricted property under Internal Revenue Code §83(b) election	X	—	X	X	X***	**
Long-term disability	X	—	X	X	—	**
Taxable medical reimbursements	X	—	X	X	***	**
Deductible moving expenses	—	—	—	—	—	—
Nondeductible moving expenses	X	—	X	X	—	**
Vesting of restricted stock or other property	—	—	X	X	***	—
Amounts realized at exercise of nonqualified stock option	—	—	X	X	X***	**
Amounts realized from sale of qualified or incentive stock option	—	—	—	—	—	—
Foreign source income	X	X	X	X	X	**
Nontaxable fringe benefits	—	—	—	—	—	—
Elective contributions under Code §§125, 132(f), 401(k), 403(b), and 457	X	X	X	X	X***	X***
Employer contributions to deferred compensation plan	—	—	—	—	—	—
Nonqualified deferred compensation if paid while still an employee	—	—	X	X	—	—
Sick pay	X	—	X	X	—	**
Accountable expense reimbursements or allowances	—	—	—	—	—	—
Nonaccountable expense reimbursements or allowances	X	X		X	—	**
Taxable group term insurance premiums	X	X	X	—	X	**
Severance pay	X	X	X	X	X	**

*This definition cannot be used to determine the earned income of self-employed employees.

**Any of these items of compensation can be excluded from this definition if certain nondiscrimination requirements are met by comparing it to any of the first four definitions of compensation.

***This definition can be used with any of the preceding four definitions. Items marked will depend on the definition used. Modifications for the first four definitions of compensation: Elective contributions to cafeteria plans, 401(k) plans, 403(b) plans, 457 plans, SEPs, and certain governmental plans can be excluded in the definition of compensation. The compensation of highly compensated employees can be modified to provide for the exclusion of additional items or tax deferred amounts (explained above) on a uniform basis from the definition.

Continued from page 7

Benefit Calculation Basics

retirement benefit is equal to the sum of each year's benefit that the participant earned before retirement.

Example

Using the following information:

- Benefit formula percentage = 2%
- Participant's years of service = 7
- Compensation earned in each year of service:
  - Year 1 – $10,000
  - Year 2 – $15,000
  - Year 3 – $17,000
  - Year 4 – $20,000
  - Year 5 – $22,000
  - Year 6 – $25,000
  - Year 7 – $30,000

Then the monthly benefit at retirement:

- = 1/12th of
- $10,000 x .02 +
- $15,000 x .02 +
- $17,000 x .02 +
- $20,000 x .02 +
- $22,000 x .02 +
- $25,000 x .02 +
- $30,000 x .02

  = $231.67 per month

Many people refer to this as a career average formula because you can get the same result by calculating the benefit as if it were a final average pay formula and averaging the participant's salary over their entire career. However, this is not true in all cases (*e.g.*, if the benefit formula changes in any year).

Integration with Social Security

Each one of the formulas above that are based on compensation can be integrated with Social Security. Usually, this involves splitting the benefit formula into two pieces: one percentage for compensation below the participant's covered compensation level and a different percentage for compensation above the participant's covered compensation level.

Covered compensation is similar to the concept of the taxable wage base in defined contribution plans. In fact, a participant's covered compensation is really just the average of their taxable wage bases over 35 years.

Integration Example—Percent of Pay Times Service Formula

Using the following information:

- Benefit formula percentage—below covered compensation = 1%
- Benefit formula percentage—above covered compensation = 1.5%
- Participant's years of service = 25
- Participant's average compensation = $90,000
- Participant's covered compensation = $60,000

The participant's monthly benefit would be:

- (1% times 25 years times $60,000) plus (1.5% times 25 years times $30,000)
- = [.01 x 25 x ($60,000/12)] + [.015 x 25 x ($30,000/12)] = $2,187.50 per month

The Accrued Benefit

The benefit formula can be used to determine the amount payable at normal retirement. But if the participant terminates employment before reaching normal retirement, only a portion of that amount will be payable to him at normal retirement.

Each year prior to the participant's normal retirement date he will accrue a portion of the benefit payable at normal retirement. Under most benefit formulas, the completed service can be applied directly to the benefit formula to get the amount of benefit accrued. In the case of a flat percent of pay formula, however, the accrued benefit must be multiplied by an "accrual fraction" to obtain an accrued benefit. This fraction is determined by multiplying the benefit by formula by a fraction equal to the participant's completed years of service (or participation) divided by the service (or participation) he would have had if he worked until his normal retirement date.

There are several rules regarding the accrual of benefits in defined benefit plans that are intended to protect participants. These rules need to be considered carefully when a plan is being designed, but they are beyond the scope of this article.

Note that vesting needs to be determined in a defined benefit plan just as it does in a defined contribution plan. A participant's accrued benefit may be partially vested or not vested at all.

Accrued Benefit Example—Flat Percent of Pay Formula with Accrual Fraction on Service

Using the following information:

- Benefit by formula = $1,000 per month
- Participant's completed years of service at termination = 10
- Years of service if the participant worked until normal retirement = 25

Then the monthly accrued benefit:

- = (10 / 25) x $1,000

  = $400 per month

Accrued Benefit Example—Percent of Pay Times Service Formula (no Accrual Fraction)

Using the following information:

- Benefit formula percentage = 2%
- Participant's completed years of service at termination = 10
- Highest 3 years of compensation = $25,000, $30,000, and $35,000

Then the monthly accrued benefit:

- = {.02 x 10 x [(25,000 + $30,000 + $35,000)/3]}/12 = $500 per month

Adjustments for Early and Late Commencements

Adjustments for Early Commencements

The participant may be able to commence payment of his benefit prior to the normal retirement date. Some plans allow all terminated vested participants to commence benefits before normal retirement and others require participants to meet certain requirements.

For example, a plan may stipulate that if a participant has at least 10 years of service at termination, he may commence his benefit as early as age 55. Such a plan will usually also provide that the benefit will be reduced for early commencement based on a given set of factors. If early commencement factors are not provided, the reduction is done using actuarial assumptions.

Many plans use different factors for deferred vested participants and those who have satisfied the plan's early retirement conditions on their date of termination.

Adjustments for Late Commencements

If a participant works beyond his normal retirement date, his benefit may be increased using simplified factors or actuarial rates to reflect the later commencement. If the participant's benefit by formula increases for any reason, such as a salary increase, the new benefit by formula must be compared to the actuarially increased amount at the end of each year and the greater amount is the participant's available accrued benefit.

Optional Forms of Payment

In most defined benefit plans, there are several forms of payment that the participant may choose from. Most small plans (and some large plans) allow participants to choose lump sum payments. All plans offer some kind of annuity option and most have several annuity options available to participants. Annuities are periodic (usually monthly) payments that cease after the participant and/or his beneficiary die or a specified time period elapses.

In all defined benefit plans, the married participant must be able to receive his benefit in the form of a qualified joint and survivor annuity (QJSA). A QJSA is an annuity that, when the participant dies, the spouse receives an annuity equal to 50 to 100 percent of the amount that was paid to the participant. If a participant in a defined benefit plan is married when his benefit payments commence and he elects to receive payment in a form other than a QJSA, his spouse must agree to his waiver of the QJSA. There are many rules regarding the timing of this waiver that go beyond the scope of this article.

Calculating Lump Sums

A lump sum is a single payment that is actuarially equivalent to the benefit that is calculated by the formula to determine the amount payable in periodic installments. This actuarial equivalence is based on interest and mortality. It is not necessary to discuss exactly how the actuarial equivalence works, but you should know that the lump sum would increase as the interest rate decreases and as mortality rates decrease.

The plan must define the assumptions to be used to calculate actuarial equivalence. In addition, IRC Section 417(e) requires that the lump sum is at least as much as it would be if the statutory interest and mortality rates (commonly referred to as GATT assumptions) were used. This means that two lump sum calculations must be done unless the plan assumptions are defined as the GATT assumptions.

The interest rate for the GATT assumptions is based on the 30-year Treasury rates (now published by the IRS). This rate usually changes every month but the plan may provide that the interest rate to be used for GATT lump sum calculations may stay the same for up to one year. This means that the interest rate to be used in GATT lump sum calculations will probably change at least once a year. It follows that the lump sum amounts will also change whenever the interest rate changes if the GATT assumptions provide for a higher lump sum than the plan assumptions. Furthermore, the anti-cutback rules do not apply to lump sums that decrease due to an increase in the GATT interest rate so a participant may actually lose out if there is a delay in payment for any reason and the GATT rate increases.

Example—Plan assumptions are different than GATT assumptions

Using the following information:

- Accrued benefit = $100 per month
- Normal retirement age = 65
- Participant's age at lump sum payment date = 25
- Plan interest and mortality = UP84 mortality and 7%
- GATT interest and mortality = GAR94 and 5.4%

Then the lump sum amount is calculated as follows:

- Plan actuarial equivalence factor = 5.5665 *
- Lump sum based on plan assumptions = $557
- GATT actuarial equivalence factor = 15.1937 *
- Lump sum based on GATT assumptions = $1,519
- Lump sum payable = $1,519

* Note that the actuarial equivalence factors are deferred from age 25 to 65 with interest and mortality.

Converting to Other Forms of Annuities

In most plans, it is assumed that the benefit that was calculated by formula will be paid monthly for the remainder of the participant's life (*i.e.*, a single life

annuity). This is referred to as the "normal form" of benefit. If the lump sum value is not greater than the small benefit cash out threshold (which can be as high as $5,000), the participant must receive his payment in the form of a lump sum. However, if the lump sum value is higher than the small benefit cash out threshold, the participant may choose any form of payment that the plan provides.

Since different types of annuities will be payable over different lengths of time or provide for survivor benefits, the amount of the benefit will vary so that the actuarial value of the different types of annuities will remain the same. Therefore, if a participant chooses a form of payment that is different than the "normal form" of payment, the benefit would be adjusted actuarially to account for the difference in the period for the payment of the benefit and any death benefit coverage.

Limits

There are a few statutory minimums and maximums that may apply to the benefit from a defined benefit plan. The definitions in this section are designed to give you an overview of these limits. Please be aware that there are additional details that have been omitted for the sake of brevity.

Top-Heavy Minimum

If the plan is top-heavy, the benefit payable at normal retirement must be at least as much as the top-heavy minimum. In general, the defined benefit top-heavy minimum is equal to 2% of average pay times the participant's top-heavy service (up to 10 years).

401(a)(17) Maximum Compensation

Prior to averaging the compensations for the benefit formula, the compensation in each year must be compared to the compensation limit. Thanks to EGTRRA, these limits are now $200,000 (up from $170,000) per year and they will increase each year based on inflation.

415(b) Maximum Benefit

After the benefit is determined by the benefit formula and adjusted for early/late commencement and form of payment, the benefit must be compared to the 415(b) limit. Thanks to EGTRRA, these limits are now $160,000 for benefits payable beginning at age 62 to 65 (up from $140,000 at the Social Security retirement age) per year and they will increase each year based on inflation.

The plan may impose its own limits in addition to the statutory limits, but the most restrictive limits must be used.

Cash Balance Plans

Cash balance plans are defined benefit plans made to look like defined contribution plans. Each participant has a "balance" which is communicated as his benefit under the plan. In the paragraph above regarding "calculating lump sums," we discussed the conversion of a benefit that is payable periodically to a single sum. In a cash balance plan, you already have the lump sum (*i.e.*, assuming the plan design complies with the safe harbor rules for cash balance plans). All you need to do is go backwards to get to a monthly benefit. In other words, divide the cash balance by an actuarial factor to get the monthly benefit at retirement.

There is an interesting twist to cash balance plans regarding the application of the minimum lump sum rules under IRC Section 417(e). Assuming that you must project a participant's cash balance to normal retirement using the same interest rate that is used to credit his account, it is likely that the minimum lump sum payable to the participant will be greater than his cash balance. This is known as the "whipsaw" effect. If the plan complies with the safe harbor rules for cash balance plans, this calculation is not necessary and the whipsaw effect will not occur. Unfortunately, the problem with the safe harbor is that it only allows the plan to provide for relatively low rate of interest for interest credit purposes.

The definitions in this section are designed to give you an overview of benefit calculations in cash balance plans. Once again, there are additional details that have been omitted for the sake of brevity.

Conclusion

As mentioned several times in this article, this is an overview of benefit calculations. Very few real life benefit calculations are so simple that the information in this article would be sufficient to determine a participant's benefit correctly. The CPC and MSPA designation study courses provided by ASPA are excellent resources for administrators to learn more about defined benefit plans. ▲

Ken Vollmer, MSPA, EA, MAAA, is a consulting actuary at Lorraine Dorsa and Associates, Inc. in Jacksonville Beach, FL, where he provides actuarial and administration services to plan sponsors, financial institutions, third party administrators, and other benefits professionals.

Before joining Lorraine Dorsa and Associates, Inc., Ken provided actuarial support to benefit outsourcing professionals and benefit professionals at large corporations. Ken also has an extensive background in designing and developing benefit calculation and valuation software.

Recap of the Agency Updates from the ASPA Annual Meeting

by Barry Kozak, MSPA

AS USUAL, ASPA NOT ONLY PROVIDED TIMELY AND RELEVANT EDUCATIONAL SESSIONS AT ITS ANNUAL MEETING IN WASHINGTON, DC, BUT ALSO PROVIDED ITS ANNUAL "STATE OF THE AGENCIES" REPORTS, AS WELL AS AN IRS QUESTION AND ANSWER SESSION. AGENCY SPEAKERS INCLUDED PAULETTE TINO, CHAIR OF THE JOINT BOARD FOR THE ENROLLMENT OF ACTUARIES; STEVE KANDARIAN, EXECUTIVE DIRECTOR OF THE PENSION BENEFIT GUARANTY CORPORATION; CAROL GOLD, DIRECTOR OF THE INTERNAL REVENUE SERVICE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION EMPLOYEE PLANS GROUP; WILLIAM SWEETNAM, BENEFITS TAX COUNSEL AT THE UNITED STATES DEPARTMENT OF TREASURY; AND ANN COMBS, ASSISTANT SECRETARY OF THE PENSION AND WELFARE BENEFITS ADMINISTRATION OF THE UNITED STATES DEPARTMENT OF LABOR. THE FOLLOWING REPRESENTS A SUMMARY OF THEIR COMMENTS.

Joint Board for the Enrollment of Actuaries

There are currently 4,178 active Enrolled Actuaries, and the Joint Board is running very well. Ms. Tino accepted a special award from ASPA on behalf of Roland Cross, who just retired from the Joint Board but was not able to attend the meeting.

The Pension Benefit Guaranty Corporation

The PBGC had been running at a surplus since 1996 due to high asset returns, increased variable premium rates, and no major bankruptcies. The surplus, which was around $8 billion, was at a high point in December 2001. However, because of poor asset performance, low interest rates, and a large number of terminations, the surplus has virtually been depleted. In fact, the PBGC covered 82,000 participants' promised benefits from the LTV Steel defined benefit plan and is expected to cover 190,000 new participants in 2002 and even more in 2003. In terms of market sectors, the airline industry is expected to run a $14 billion underfunding, and the steel industry is expected to run a $9 billion underfunding for normal benefits, plus an additional $4 billion in unfunded shutdown benefits.

The future outlook for defined benefit plans at the PBGC includes: looking at shutdown benefits [1975 guidance indicates that the PBGC will only insure such benefits if the plan shuts down before the employer does—and, therefore, Congress (rather than the PBGC) might need to fix the problem.]; looking at additional ways to prohibit underfunded plans from increasing pension promises; looking at overall transparency (A plan can appear fully funded based on FASB numbers, even though the plan is actually underfunded based on the PBGC's requirement to value annuities at the prevailing market rate.); and looking at ways for the PBGC to become a secured creditor in Chapter 11 bankruptcies. Right now, if an employer files for Chapter 11 bankruptcy, then any deficit in an underfunded plan becomes a liability for the PBGC, whereas any reversion from an overfunded plan goes into the bankruptcy estate.

Finally, Mr. Kandarian offered his immediate goals for the administration of the agency. First, he would like to continue making his agency more "stakeholder friendly" and user friendly. Second, he is looking at increasing its technological capacity and has hired Rick Hart as the PBGC Chief Technology Officer. Finally, he is interested in enhancing the way the PBGC manages customer relationships.

Internal Revenue Service Tax Exempt/ Government Entities Operating Division

Ms. Gold began by complimenting Charles Rosotti, IRS Commissioner, for his leadership in implementing the 1998 IRS Restructuring Act, especially in its structure of the TE/GE operating division. She reminded us that Mr. Rosotti's five-year term is about to end.

Ms. Gold described the IRS as a world-class financial servicing organization. In support of her description, she mentioned that the TE/GE division continues to work with employers and representatives by: being responsive with less burdensome guidance; ever-expanding and fine-tuning its EPCRS self-correction program; concentrating on its audits for non-compliers; and working with employers who do not yet sponsor retirement plans. According to Ms. Gold, her short-term goal is to increase all kinds of guidance. New Chief Counsel B. John Williams is stepping up the output of formal regulations, and the agency is providing informal guidance such as Frequently Asked Questions posted on the **www.irs.gov** Web site and the publication of the Employee Plans newsletter.

There are three basic components of the TE/GE: guidance, examinations, and outreach. As far as guidance, the future priorities include: restorative payments, Professional Employee Organizations (some guidance has already been issued), EPCRS self-correction (so far, the IRS has named four managers and support teams that will serve as local liaisons at four of the regional offices, and, additionally, the John Doe anonymous submission program has been extended), and possibilities for phased retirement programs (the IRS is actively soliciting comments on how to structure and regulate such potential programs). Additionally, the IRS continues to discuss the future of the Determination Letter program with practitioner groups such as ASPA.

As far as examinations and compliance are concerned, the IRS is continuing to refine their risk-assessment-by-industry-sector project and is looking into abuses in S-Corporation ESOPs. Additionally, the IRS is working with the Department of Labor on a non-filer initiative and will try to find plans that have not properly filed Forms 5500 where there is either a deduction on a corporate return or a request for a Determination Letter.

Finally, on education and outreach: senior IRS officers continue to appear at ASPA's and other conferences; the TE/GE continues to issue publications (such as the one about choosing the proper retirement plan, which was written for small business owners and non-retirement tax practitioners, and the new publication describing the mechanics, rules, and requirements of establishing a new retirement plan); TE/GE has developed an interactive CD-ROM which explains the EPCRS self-correction program; and TE/GE continues to ask practitioners to act as liaisons to the TE/GE (and are currently seeking out some new members).

US Department of Treasury (Benefits Policy)

Mr. Sweetnam began by thanking the members of ASPA and its Government Affairs Committee for their invaluable input into benefits policy discussions, and specifically thanked Brian Graff, Esq., ASPA's Executive Director, for his leadership. Mr. Sweetnam indicated that there are three main concerns of President Bush: getting good information to participants so that they can make good decisions; publishing clear and beneficial advice to the benefits community; and helping individuals so they have opportunities for adequate retirement income.

Regarding participants getting good advice, the proposed regulations for ERISA §204(h) / IRC §4980F notices for reductions in future rates of accruals were drafted to be a balanced approach between the demands of the benefit practitioners advocacy groups and the requests of the participant advocacy groups (and will be finalized in the near future); the proposed regulations for the relative value of various distribution options are similarly intended to represent a middle-of-the-road approach by mandating a comparison, but allowing the plan sponsor to determine how to make such a comparison; and the model notice (both in English and Spanish) that informs low-income and moderate-income individuals that they are entitled to a tax deduction for their 401(k) deferrals and traditional IRA contributions. (Bill likened this credit to a "government match.")

Mr. Sweetnam indicated that there are three main concerns of President Bush: getting good information to participants so that they can make good decisions; publishing clear and beneficial advice to the benefits community; and helping individuals so they have opportunities for adequate retirement income.

As far as clear rules for compliance: advance guidance was issued on consumer directed health plans and Health Reimbursement Arrangements so that the Treasury can hopefully guide the market place and provide compliance tools to "good" benefits practitioners (as Mr. Sweetnam raised his head and looked around the room at ASPA members); guidance was recently published to illustrate how the Age Discrimination in Employment Act impacts ERISA in designing and converting cash balance plans; guidance is forthcoming on the mechanics of calculating present values and lump sums (Treasury will re-examine Notice 96-8 and will update it, if necessary.); Treasury is starting to develop ideas on required guidance for the elimination of optional forms of benefits, early retirement benefits, and benefit-type subsidies in defined benefit plans and they are actively seeking input from ASPA members; and they will, in the near future, publish comprehensive guidance on the administration of 401(k) plans (which will consolidate all of the various pieces of guidance published throughout the years).

Finally, to encourage individuals to save for their own retirement: guidance on distributions in "substantially equal installments," which avoids the 10% premature distribution penalty tax under IRC §72(t), needs to be updated (as the existing provisions were drafted during a high stock market period. Treasury has published final regulations for required minimum distributions from defined contribution plans and

IRAs, but the guidance for distributions from defined benefit plans was only published in temporary form (and many comments were sent to Treasury indicating concern for the effective date); the proposed regulations governing the new catch-up deferrals allowed for individuals who have attained age 50 need to be published in final form (According to Mr. Sweetnam, they are aware that there is a lot of concern over the requirement that all employees of a controlled group of corporations must be offered the catch-up opportunity.); and regulations will be published soon regarding the "deemed IRAs" that were created by EGTRRA.

Pension and Welfare Benefits Administration of the US Department of Labor

Ms. Combs started by complimenting members of ASPA for providing invaluable expertise on employee benefits issues to members of Congress (a constant turnover of congressional staff necessitates ASPA's continued involvement in providing expert testimony as well as behind the scenes education to senators and representatives). Then Ms. Combs stated that although she would personally like to orchestrate the renaissance of defined benefit plans, the reality is that the PWBA needs to pay attention to, and devote its resources to, 401(k) and other defined contribution plans. The PWBA priorities have shifted due to current distress in the economy and the ongoing corporate scandals.

Ms. Combs explained some of their recently issued guidance. As mentioned by President Bush in one of his recent weekly radio addresses, the Department of Labor has issued an interim final rule on notices required for blackout periods in self-directed 401(k) plans. Such notices must state the business reasons for the blackout, the start and end of the blackout period, a description of participant rights, and strong advice for participants to review their personal investment goals and choices before the blackout period begins, and must generally be delivered at least 30 days before the blackout period begins. The DOL is currently working with the Securities Exchange Commission on issuing guidance on restrictions placed on insiders during a blackout period, and, until there is a legislative fix, the DOL is taking interim steps on allowing individual investment advice (such as the Sun America Advisory Opinion).

As far as her goals for the agency, Ms. Combs indicated that they want to establish a compliance support program, and that they want to work with the IRS to update its delinquent filer program and its fiduciary corrections program. Additionally, they will continue writing *amicus* briefs for corporate governance litigation cases when appropriate (such as their brief in the Enron case arguing that the case should not be dismissed, which can be found at **www.dol.gov/pwba**). ▲

Barry Kozak, MSPA, JD, LLM, EA, ChFC, is the Director of Academic Development for the Graduate Tax Law and Employee Benefits Programs at the John Marshall Law School and is an adjunct professor of law. Additionally, Barry is employed as a Legal Consultant at Chicago Consulting Actuaries, LLC. Barry serves on The ASPA Journal committee and is also a technical reviewer for the publication.

Register Now for Spring 2003 Examinations

The spring 2003 C-1, C-2(DB), and C-2(DC) examination window is May 1–June 30. The early registration deadline is March 31 and the final registration deadline is April 30. You may register online at **www.aspa.org** or submit an examination registration form. Examination registration forms are located in the *2003 Education and Examination Program Catalog* or may be downloaded from the ASPA Web site.

New for 2003, the C-3 examination will be administered at Prometric Testing Centers. The C-3 and C-4 examination date is May 21.

Welcome to www.ASPA.org, Version 4.0!

by Chris L. Stroud, MSPA

IN CASE YOU HAVE NOT HAD A CHANCE TO VISIT THE ASPA WEB SITE SINCE THE BEGINNING OF JANUARY, YOU HAVE MISSED A SIGNIFICANT CHANGE! ASPA INTRODUCED ITS LATEST REDESIGN OF THE ASPA WEB SITE IN EARLY JANUARY, MARKING THE FOURTH MAJOR UPDATE OF THE TOTAL SITE SINCE ITS INCEPTION.

www.ASPA.org started out very modestly in 1996, originally consisting of six Web pages that gave very basic (and unchanging) information about conferences, examinations, and government affairs, with a link that let you e-mail the National Office.

This latest version highlights just how far the Web site and the society have come in the six years since that first rollout. The Web site now includes over 1,400 separate web pages, occupies more than 500 MB of server space on two separate servers, and is tied into ASPA's database, enabling members and visitors to register for conferences and exams online and allowing members to update their personal information and search for other members. The Web site itself has an average of over 5,500 visitor sessions a week, a significant increase from the 600 weekly visitors the site had in 1996.

One of the most significant changes to the Web site, aside from the basic appearance, is the improvement of navigation. The main goal of the most recent redesign was to make navigation much easier for first time visitors trying to find something on the Web site, and to make the repeat user's session quicker by enabling them to jump sections easier. By incorporating a drop down menu that runs across the page underneath the logo and header, users can now directly access a wide range of pages before they even have to make that first mouse click. Simply move the mouse over the section you want to visit and a drop down menu will appear, listing the main pages within that section—some of which then display more detailed submenus.

Since the single greatest tool in Web site design is user feedback, steps were also taken to make submitting comments, suggestions, and recommendations easier. Now, from every page, visitors can click on "Contact ASPA" at the top of the page and open a Web page that enables the user to send messages directly to the various departments or to the Webmaster. Let ASPA know what you think of the redesign, point out a link that is not working, ask for more information regarding something you see on the Web page, comment or criticize something you see—all of this goes toward making the Web site more user friendly. These are just two issues addressed in the redesign. Also improved was Web page bookmarking—you can now bookmark individual pages. The previous design used browser frames, making Web page bookmarking ineffective. The Web site and the internal ASPA database interface integration was also improved, making online registration quicker to get to and easier to accomplish. The ASPA Web site will continue to evolve and improve. The comments and suggestions received will be reviewed by the National Office Web oversight group and future improvements will be planned or prioritized accordingly. Our crystal ball tells us that the future will bring the ability to pay dues online and hopefully to review your ASPA continuing education status online.

Take a moment to visit, or revisit, the ASPA Web site at **http://www.aspa.org**. Version 4.0 improves on an already proven design and makes visiting quicker and easier! ▲

Chris L. Stroud, MSPA, MAAA, EA, is President of Stroud Consulting Services, Inc., offering sales, management, and employee benefit consulting services to various firms, including SunGard Corbel. She currently serves on ASPA's Executive Committee and Board of Directors, chairs ASPA's Technology Committee, and is the Editor of The ASPA Journal*. Chris has spoken both locally and nationally on employee benefit topics.*

Delivering Quality Programs with Government Experts

ASPA, in conjunction with the Internal Revenue Service (IRS), will host five Employee Benefits Conferences in 2003.

2003 ASPA/IRS Conferences Schedule at a Glance

January 30–31, Los Angeles Benefits Conference, Universal City, CA

May 1–2, Great Lakes Area Employee Benefits Conference, Chicago, IL

May 13–14, Mid Atlantic Employee Benefits Conference, Philadelphia, PA

June 12, Northeast Area Employee Benefits Conference, Boston, MA, and
June 13, Northeast Area Employee Benefits Conference, White Plains, NY

September 11–12, Mountain States Employee Benefits Conference, Denver, CO
Cosponsored with the Western Pension & Benefits Conference

ASPA/IRS Conference Features

- Information on benefits regulations, litigation, enforcement, and compliance
- Interactive discussion on the latest pension issues with government agency experts representing the IRS, the US Department of Labor, the US Department of the Treasury, and other government agencies
- Government affairs updates and discussions with professionals from the private sector
- Networking with speakers, colleagues, and government representatives
- Tabletop exhibits showcasing the latest products and services available to the pension industry (at selected conferences)
- Continuing education credits* (ASPA members, attorneys, accountants, enrolled actuaries, enrolled agents, SOA Professional Development)

For more information, visit ASPA's Web site at **http://www.aspa.org/conf/index.htm**, or contact ASPA's meetings department at (703) 516-9300 or **meetings@aspa.org**.

*These conferences qualify for ASPA and Enrolled Actuary CE credits. The number of credits vary by program. For information for any other type of credit, visit our Web site at **http://www.aspa.org/conf/index.htm** or contact the Meetings Department at (703) 516-9300 or **meetings@aspa.org**.

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EVER WONDER WHY?

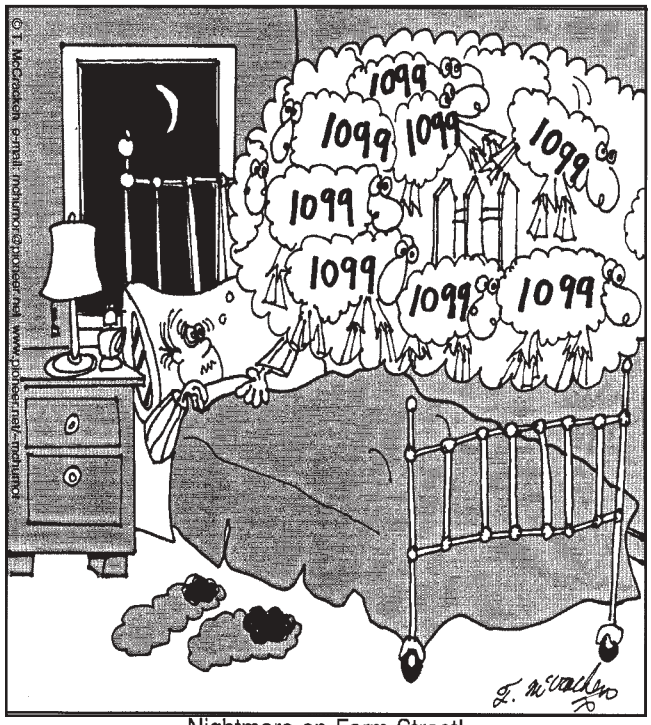
Why does a *slight* tax increase cost you $200, but a *substantial* tax cut saves you 30 cents?

If you think taxes are too high and the government intrudes too much into your life, be thankful we don't get all the government we pay for!

Don't think the government doesn't know what it's doing. First, it taxes liquor. Next, it makes the tax laws so complicated that people are driven to drink.

—Authors unknown

SIDE FUN



Nightmare on Form Street!

How To Put Laughter Into Your Life

We can all use a little more cheer in our day. Try the following advice:

FORCE YOURSELF TO LAUGH.

Look into the mirror and vow to make the person looking back at you laugh. Even if it's forced, you still get the health benefits!

REMEMBER THE FUNNY MOMENTS.

If there's something that makes you laugh, put it in your environment, so you're reminded regularly of that laughing moment.

BE AROUND PEOPLE WHO LAUGH.

Laughter *is* contagious.

MAKE OTHERS LAUGH.

A prop, such as a silly tie, can make others laugh, which, in turn, will make you laugh.

—Parade Magazine, April 24, 2002

WORD SCRAMBLE

Unscramble these four puzzles—one letter to each space—to reveal four pension-related words. Answers will be posted on the eASPA portion of ASPA's Web site at **https://router.aspa.org**. Login, go to Members Only>Newsletter, and look near the bottom.

BEAT LAX ○ __ ○__ ○ __ ○

MUM PIER __ ○○ __ __ ○○

MANY PETS __ ○○○ __ __ ○○

SON AL __ ○○○ __

BONUS: Arrange the circled letters to form the Mystery Answer as suggested by the cartoon.

Mystery Answer:

It was ○ "○○○○○○" ○○○○.

Why the consultant didn't need much time to explain the provisions to the Plan Sponsor.

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Calendar of Events

2003		ASPA CE Credit
Feb 27–Mar 1	401(k) Sales Summit Scottsdale, AZ	15
Mar 1	Grades for fall 2002 exams released	
Mar 27	IRS/ASPA Washington Update Webcast	2
Mar 29–Apr 31	EA-2(B) Exam Weekend course Los Angeles, CA	
Mar 31	Early registration deadline for spring examinations	
Apr 4–7	EA-2(B) Exam Weekend course Washington, DC	
Apr 5	Registration deadline for spring weekend courses	
Apr 10–12	EA-1 Exam Weekend course Chicago, IL	
Apr 13–16	EA-2(B) Exam Weekend course Chicago, IL	
Apr 30	Final Registration deadline for spring examinations	
May 1–2	Great Lakes Area Benefits Conference Chicago, IL	TBD
May 1–Jun 30	C-1, C-2(DB), C-2(DC) spring examination window	
May 13–14	Mid-Atlantic Benefits Conference Philadelphia, PA	16
Jun 12–13	Northeast Area Employee Benefits Conference Boston, MA & White Plains, NY	(each) 8
Jul 27–30	Summer Conference Irvine, CA	20
Sep 11–12	Mountain States Employee Benefits Conference, Denver, CO	16
Oct 26–29	Annual Conference Washington, DC	20

Did You Know?

Did you know that in an effort to raise public awareness of the need for comprehensive retirement planning, the National Retirement Planning Coalition (NRPC) selected the week of November 18 as National Retirement Planning Week? The NRPC is a group of prominent financial industry and advocacy organizations that was formed to educate Americans about the steps they need to take to ensure "retirement readiness."

You may have seen a series of public service announcements featuring former Senator Bob Dole, (R-KS) who was appointed as honorary chairperson of the NRPC. The announcements were part of an initiative to encourage Americans to seek professional financial retirement advice. Endorsed by President George W. Bush, this effort was the first national campaign to spotlight the critical importance of retirement planning.