

1988

Coverage Flexibility for Qualified Retirement Plans After the Tax Reform Act of 1986

Richard J. Kovach

Please take a moment to share how this work helps you [through this survey](#). Your feedback will be important as we plan further development of our repository.

Follow this and additional works at: <https://ideaexchange.uakron.edu/akrontaxjournal>

Part of the [Tax Law Commons](#)

Recommended Citation

Kovach, Richard J. (1988) "Coverage Flexibility for Qualified Retirement Plans After the Tax Reform Act of 1986," *Akron Tax Journal*: Vol. 5 , Article 5.

Available at: <https://ideaexchange.uakron.edu/akrontaxjournal/vol5/iss1/5>

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@UAkron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Tax Journal by an authorized administrator of IdeaExchange@UAkron. For more information, please contact mjon@uakron.edu, uapress@uakron.edu.

COVERAGE FLEXIBILITY FOR QUALIFIED RETIREMENT PLANS AFTER THE TAX REFORM ACT OF 1986

by
RICHARD J. KOVACH*

The Tax Reform Act of 1986¹ substantially changed the participation coverage criteria for qualified retirement plans. The purpose of this article is to set forth selected observations about the problems and opportunities that now exist² respecting planning for coverage exclusions under the Internal Revenue Code.³ Accordingly, this article will consider both surviving concepts from prior law and new rules that emerge from the 1986 Tax Act.

I. DETERMINING WHO ARE EMPLOYEES

A. *Common Law Employment Status*

Determining who are employees among all persons who render services to the sponsoring employer of a qualified retirement plan is usually viewed as a simple task, especially if no attempt has been made to manipulate arguable circumstances toward one side or the other of the common law definition of employment status.⁴ Attempts to manipulate the employment status of persons rendering services frequently occur, however, in a variety of contexts relating, for example, to imposition of employment taxes⁵ or duties under local laws such as state statutes known as "prevailing wage" enactments.⁶

Failed attempts to manipulate employment status can affect the qualifica-

*Professor of Law, The University of Akron School of Law; A.B. Oberlin College, 1970; J.D. Harvard Law School, 1974.

¹Pub. L. No. 99-514, 100 Stat. 2085 (1986).

²Some aspects of coverage regulation survive from pre-1986 law, and other aspects arise as a result of Pub. L. No. 99-514, effective for plan years beginning after December 31, 1988.

³This and all subsequent references to the Internal Revenue Code refer to the Internal Revenue Code of 1986, except where expressly noted otherwise. Subsequent textual references will be expressed in the form "Section _____."

⁴As used in numerous tax cases and revenue rulings, the common law definition of employment status determines whether there exists for the recipient of services a right to control the activities of the individuals whose status is in issue, not only as to results to be accomplished by the work but also as to the means and methods to be used for accomplishing the results. See *ALSCO Storm Windows, Inc. v. United States*, 311 F.2d 341 (9th Cir. 1962). Many authorities relying on this standard set forth a non-exhaustive list of employment status facts and circumstances that are accumulated and weighed in particular situations. For example, consideration may be given to whether the provider of services supplied his or her own tools or equipment, worked assigned hours, or exclusively provided services to only one recipient.

⁵Avoidance of state and federal employment taxes is perhaps the most common context in which the employment status issue is raised. For a discussion of federal legislative developments in the last ten years affecting the determination of whether a worker is an independent contractor or employee, see Solomon and Schlesinger, "Section 1706: Where it Came From and Where it is Going," 66 *Taxes* 50-55 (January, 1988).

⁶For example, Ohio Revised Code Section 4115.04 requires employers who construct public improvements to pay their employees the same wages as prevailing in the locale for workers under collective bargaining agreements. Of course, the employment status issue is also critically important to the tort law doctrine of respondeat superior.

tion of a deferred compensation plan in at least three ways, each relating to the basic requirement of I.R.C. Section 401(a) that a qualified plan benefit the *employees* of an employer. First, if persons are assumed to be non-employees, and therefore are not covered by the plan, insufficient coverage may result under Section 410 or Section 401(a)(26), or both. Second, if persons allowed to participate in the plan are regarded as non-employees for purposes unrelated to the plan and such status is consistently applied for plan purposes, the exclusive benefit rule of I.R.C. Section 401(a)(2) may be violated.⁷ Third, a person arguably receiving compensation as an employee for services rendered to an employer may improperly establish a Keogh plan on the theory that compensation is paid for independent, non-employment services.⁸

Any employer who has had an opportunity to predicate an important tax or non-tax result upon a determination of common law employment status would realize that such status could serve as a flexible and potentially boundless means to define coverage exclusions for qualified plans. Thus, even before one were to take advantage of the statutory and individually designed exclusions permitted under Section 410, he or she might consider the coverage effects of changing, if possible, the employment status of various persons otherwise regarded as employees.

Of course, the same technical problems encountered in employment tax and local law situations can occur respecting employment status determinations for employee benefit plan purposes. Above all it should be borne in mind that determinations of employment status involve a "facts and circumstances" test and not a "black or white" mechanical rule, despite attempts by the Internal Revenue Service to resolve hypothetical employment status disputes in the facile format typical of revenue rulings and other similar administrative promulgations directed toward the issue.⁹

Employment status disputes tend to be as highly litigable as valuation disputes. These two tax issues are highly litigable usually because so much depends upon the outcome of the dispute and because the outcome is often predicated upon a great many situational factors. No single situational factor is determinative of the outcome and the aggregate of the factors may be viewed

⁷ Specifically, the plan may inadvertently benefit persons who are not employees or the beneficiaries of employees.

⁸ See *Pulver v. Commissioner*, 51 T.C.M. (P-H) 82,437 (1982), which was decided in favor of the taxpayer, a professional engineer who did independent consulting work for his employer outside his regular job and thus was allowed to maintain his own qualified plan respecting the consulting income.

⁹ Any commercial tax service will provide numerous citations to IRS rulings addressing the issue. Most rulings find in favor of employment status by referring to general indications of control by the recipient of services while ignoring other facts and circumstances that may differentiate the workers in question from other workers who admittedly are employees. It should be remembered that IRS rulings offer little or no authority in a litigated employment status dispute and that juries in particular may allow considerably more leeway for employment status designations than does the IRS.

subjectively to a large degree.¹⁰ Consequently, all attempts to convert employees into independent providers of services involve a substantial amount of risk if business is basically carried on as usual, even if the service personnel make formal declarations of their “independent” status and are in some ways actually treated differently than before their metamorphosis.¹¹

But the employment status problem can arise even if certain persons have been consistently treated as non-employees from the outset of their service. Consultants, “outside” salespersons, and part-time, temporary, and “casual” workers are frequently among those whose status as non-employees can be disputed, even though the affected parties never thought of themselves as having an employment relationship. Sometimes the dispute arises not as a result of intended manipulations but because of a naive failure to appreciate the full implications of a particular service relationship.¹²

Advisors who design qualified plan coverage exclusions may want to ask themselves three key questions in view of the potential volatility of employment status determinations: Which existing employment status determinations at least *arguably* could be viewed as incorrect, given a fair review of all relevant facts and circumstances? Having identified the number of arguable ambiguous determinations, which of such are most and least ultimately defensible? Assuming the least defensible determinations are eventually found in error, have the plan’s coverage exclusions been designed with a sufficient margin of error to account for the potentially erroneous determinations?¹³

More aggressive advisors who actually desire to manipulate service statuses so as to effect a first tier of de facto coverage exclusions will obviously rely much on their skills at risk-benefit analysis. Because of the litigable nature of employment status issues, their task, difficult but not impossible, takes at least as much nerve as knowledge and foresight in setting up favorable facts and circumstances under the large body of authorities that treat the issue.¹⁴

¹⁰In jury trials, litigants arguing in favor of non-employment status should seek jury instructions that refer to “independent providers of services” and not “independent contractors,” since the word “contractor” may connote a level of activity and sophistication of enterprise that does not necessarily fit every independent worker.

¹¹Many employers share the mistaken belief that an employee becomes an independent provider of services simply by signing a “boilerplated” services contract. Such contracts may enumerate various indicia of independence not in fact observed. For instance, contractually, the worker may have flexibility of work hours or the ability to substitute services but never actually exercise such “rights” because the recipient of the services would find such unacceptable in practice.

¹²The degree of control necessary for a finding of employee status may be lower when applied to professionals than when applied to non-professionals. See *James v. Commissioner*, 25 T.C. 1296 (1956).

¹³For example, if an employer has three workers, designated as independent but arguably not independent, it may want to design its plan coverage to include more persons than the statutory minimums, assuming the three workers potentially designated as independent could not otherwise be statutorily excluded by reason of age, service, or union status.

¹⁴As stated in note 9, *supra*, the practitioner should not consider IRS rulings as being particularly authoritative. IRS rulings tend to reflect an IRS bias toward finding that an employment status exists. For planning purposes conforming with the facts and circumstances illustrated in favorable rulings may provide the practitioner with a rough “safe harbor,” departures from which may be considered with care.

B. *Controlled Group Employees*

Aside from taking the position that particular providers of services are not employees, the sponsor of a qualified plan might wish to assert that the persons in question, although employees, are the employees of another employer and thus not to be covered under the sponsored plan. Sections 414(b), (c), and (m) rather precisely limit the efficacy of such assertions when related employers are involved.

In contrast to the common law employment status test, the controlled group and affiliated service group employment rules offer relatively concrete standards for determining which employees will be deemed constructively employed by a particular employer.¹⁵ The main problem with these rules, and perhaps the reason why they are sometimes overlooked when plan coverage decisions are made, is their complexity. For example, practitioners who have dealt with the constructive ownership rules of Section 267,¹⁶ Section 318,¹⁷ and Section 544¹⁸ must uneasily deal with yet another separate and intricate set of such rules under the Treasury Regulations for Section 414.¹⁹

In addition to distinct constructive ownership rules, Section 414 and its Regulations form a conglomeration of other concepts borrowed from elsewhere in the Internal Revenue code. Thus, the controlled group stock ownership standards are directly borrowed, with modifications, from Section 1563,²⁰ partnership ownership is determined with reference to either profits or capital interests,²¹ trust and estate ownership percentages may have to be actuarially determined using concepts developed under Section 2031,²² and certain ownership interests are totally excluded in determining control under Sections 414(b) and (c).²³

Attempts to categorize all potential mechanical determinations under Sections 414(b), (c), and (m) would lead to a checklist that could hardly be described as a ready reference. Yet, anyone who has submitted an application for a qualified plan determination letter knows (or should know) that these provisions cannot be ignored.²⁴ Consequently, the best approach for dealing with the controlled

¹⁵To illustrate, § 414(b) borrows the 80 percent of voting control standard defined in § 1563(a)(1) to define a parent-subsidiary group of controlled corporations.

¹⁶I.R.C. § 267 governs allowability of losses, expenses, and interest respecting transactions between related taxpayers.

¹⁷I.R.C. § 318 deals with constructive ownership of stock for the purpose of determining the federal tax consequences of corporate distributions and adjustments.

¹⁸I.R.C. § 544 provides rules for determining stock ownership for the purpose of determining whether a corporation is a personal holding company under § 542.

¹⁹Treas. Reg. § 1.414(c)-4.

²⁰See *supra* note 15. The original function of § 1563 is to provide definitions pertinent to the § 1561 limitations on certain multiple tax benefits that would otherwise be available on an unrestricted basis to controlled corporations.

²¹Treas. Reg. § 1.414(c)-2(b)(2)(i)(c).

²²Treas. Reg. § 1.414(c)-2(b)(2)(ii).

²³Treas. Reg. § 1.414(c)-3.

²⁴IRS Form 5300, "Application for Determination for Defined Benefit Plan" and IRS Form 5301, "Application

and affiliated group rules may be to diagram thoroughly all ownership relationships traceable via entities, blood, or marriage from a plan sponsor to any other employer, and then check the particulars of such relationships against the Section 414 Regulations.

In the event additional employers are to be considered under these rules, the next inquiry should determine how close the ownership relationships are to the minimum relationships needed to invoke Sections 414(b), (c), or (m). If a particular relationship is close to the minimum controlled group standard, the employer may want to consider a preliminary altering of the ownership relationship in a manner consistent with other potentially applicable non-plan considerations. For example, if an employer is otherwise to be included for coverage computation purposes as a result of an 82% ownership relationship with a corporate parent under Section 414(b),²⁵ the parent may wish to consider selling enough stock to remove the subsidiary from the controlled group. If the proposed sale of stock would not have offending tax or non-tax consequences²⁶ that would outweigh the value of avoiding Section 414(b), it would, of course, serve as a potential means to effect a de facto coverage exclusion respecting the parent's qualified plans.

C. *Leased Employees*

Code Section 414(n) again forces an employer to reconsider its contention that particular providers of services, although employees, are employees of another employer and thus not to be covered under the sponsored plan. Even though the sponsoring employer may have no ownership relationship with the leasing employer, employees of the leasing employer, known technically as "leased employees"²⁷ will be treated under Section 414(n) for coverage purposes²⁸ as employees of the sponsoring employer. However, these rules are inoperative if the leasing employer provides a required level of qualified plan coverage for such employees²⁹ and leased employees do not provide more than 20% of the

for Determination for Defined Contribution Plan" simply ask (at line 10), "Is the employer a member of a controlled group of corporations or a group of trades or businesses under common control?" One wonders how many employer representatives submitting these forms answer "no" without thoroughly examining the employer's ownership relationships under § 414(b) and (c). Obviously, misinformation respecting this question can void a qualified plan's IRS determination letter.

²⁵The minimum standard for controlled group status here is 80% ownership of voting control. See *supra* note 15.

²⁶For example, falling below 80% control would prevent the subsidiary from later effecting a nonrecognition liquidation under § 332.

²⁷The definition of a "leased employee" is contained in § 414(n)(2), which requires an agreement with a "leasing organization," substantially full-time services for a period of at least one year, and services of a type historically performed by employees in the business field of the recipient of the services.

²⁸I.R.C. § 414(n)(3) applies the leased employee concept to several other I.R.C. employee benefits provisions, in addition to § 410, but does not refer to § 401(a)(26). See Part III of this article.

²⁹I.R.C. § 414(n)(5)(B) mandates use of a money purchase pension plan with a nonintegrated employer contribution rate for each participant of at least 10 percent of compensation. The plan must also provide immediate participation and vesting.

non-highly compensated work force of the employer that hires the leased services.³⁰

Like the provisions of Sections 414(b), (c), and (m), Section 414(n) operates as a trap for negligent or unaware planners. Many employers frequently use leased employees for business reasons unconnected with the effect of such practice on qualified plan coverage requirements.³¹ Planners who wish to grab an easily available handle on the Section 414(n) issue respecting existing arrangements will no doubt refer first to the portion of the leased employee definition that eliminates persons who have not performed services for the recipient employer on a substantially full-time basis for a period of at least one year.³² If the planner believes that certain persons have met the leased employee definition, he or she should, of course, analyze the safe harbor exception for the potential relief it affords.³³ Of course, even if particular providers of services are found to be leased employees, they do not necessarily have to be included in any qualified plan of the recipient employer. Such persons must, however, be properly counted and allowably outside plan coverage under Section 410, as with non-leased employees similarly excluded.

Some planners may want to go beyond existing leased employee arrangements to the deliberate creation of leased employee statuses in order to effect a de facto coverage exclusion. They will no doubt focus their attention first on the "20% of nonhighly compensated workforce standard" given in Section 414(n)(5)(A), since it presents an objectively determined legal limit.³⁴ Also, the requirement that the leasing organization provide a substantially funded money purchase pension plan³⁵ imposes a rather practical cost limitation, since the recipient employer will ultimately bear the economic burden of all costs connected with leased employees, presumably in addition to paying a "profit" to the leasing organization. Has Congress calculated the burdens imposed by the safe harbor exception carefully enough to remove the incentive to use leased employees to create a de facto coverage exclusion in all cases? In considering defined benefit plans, cutbacks in Section 415 allowances³⁶ coupled with the 20% of nonhighly compensated workforce limitation, suggest that professional employers with small plans need no longer inquire into the use of coverage motivated leased employee arrangements. Employers with larger plans must

³⁰I.R.C. § 414(n)(5)(A)(ii).

³¹Leased employees often fill temporary positions or satisfy an employer's needs for casual, specialty, and short-term replacement workers.

³²I.R.C. § 414(n)(2)(B). Detailed guidance for applying the leased employee rules and definitions may be obtained from Proposed Regulations § 1.414(n).

³³See *supra* notes 29 and 30 and accompanying text.

³⁴I.R.C. § 414(n) did not include this requirement prior to the 1986 Tax Act.

³⁵See *supra* note 29.

³⁶I.R.C. § 415(b)(5) now provides reductions in permitted benefit levels based on *years of participation* (under ten years) rather than years of service, as was the case prior to the 1986 Tax Act.

regard the issue as involving the weighing of what may be at best marginal cost savings per employee³⁷ against any possible administrative burdens resulting from a bifurcated, leased and non-leased status workforce.

If indeed employee leasing has been killed as a coverage exclusion planning opportunity, we are left, as seems increasingly to be the case under the Internal Revenue Code, with a "plugged loophole" that serves no further function than as a potential trap for unwary practitioners. In this case the unwary would include employers who regularly use leased employees for legitimate business reasons.³⁸

II. STATUTORY COVERAGE EXCLUSIONS

A. Age and Service Exclusions

Internal Revenue Code Section 410(a) continues to allow employers to take advantage of unrestrained exclusions that affect employees who are under age twenty-one, or have not yet completed one year of service.³⁹ Actually, Section 410(a)(1)(B) permits the use of a two years of service exclusion standard⁴⁰ if a participant is granted 100% vesting upon entering the plan. Given the various administrative complications that frequently accompany the use of vesting schedules,⁴¹ as well as cutbacks in permitted vesting limitations from the 1986 Tax Act, more employers should consider use of the two-year service exclusion.

The problem, in general, with age and service exclusions is that they provide a somewhat transitory and ungovernable basis for limiting coverage costs. At any given time prior to implementation of a qualified retirement plan a clear view of the impact (savings) of age and service exclusions exists, but once a plan has been in operation for a few years, only termination of service will keep most employees from fulfilling the age and service standards. In many situations this results only in deferred, not permanently avoided, plan coverage costs. Any proposed attempts to manipulate employment statuses so as to maximize the usefulness of age and coverage exclusions must be carefully considered in light of the impact of such attempts on the plan's continued qualification

³⁷Theoretically, marginal savings per employee could be substantial in the aggregate depending on the substantiality of the employer's normal plan contributions in comparison with the total overhead and profit "load" of the leasing arrangement.

³⁸For those who are "wary" but have difficulty applying the § 414(n) rules and definitions, the effect of the provision may be to restrict informally full use of discretionary coverage exclusions so as to allow an appropriate margin of error. See note 13, *supra*.

³⁹Since a year of service is defined in § 410(a)(3)(A) as a 12-month period during which an employee has not less than 1,000 hours of service, accurate counting of service hours is critical for employers who rely on the one year of service rule to exclude part-time employees from plan participation.

⁴⁰The two year standard (formerly three years) is effective for plan years beginning after December 31, 1988 under the 1986 Tax Act.

⁴¹For example, it is often quite difficult to determine when a partial plan termination has occurred. However, if cessation of service by a group of employees does result in a partial termination, a plan will lose its qualification status unless all accrued benefits are made non-forfeitable for partially terminated employees, regardless of their position on the plan's vesting schedule. I.R.C. § 411(d)(3).

and the employer's or plan officials' compliance with their obligations⁴² under the Employee Retirement Income Security Act (ERISA).⁴³

Similarly, the qualified plan itself, the Regulations under Section 410 remind us, must not be drafted with individually designed exclusions having an indirect effect of age or service exclusions more restrictive than Section 410(a) permits. Thus, a plan cannot require an employee, as a condition for participation, to serve a specified number of years in a status that could result in the employee's attaining an age beyond 21 years or service beyond the one or two year requirement.⁴⁴

B. *Union Status Exclusion*

Code Section 410(b)(3) lists three additional statutory exclusions, including the often-used exclusion for employees covered by a collective bargaining agreement resulting from good faith bargaining that includes the subject of retirement benefits.⁴⁵ To prevent manipulation of the union exclusion by means of the creation of sham arrangements for collective bargaining, the 1986 Tax Act amended Section 7701(a)(46) to specify that a collective bargaining agreement must be a "bona fide" agreement between "bona fide" employee representatives and one or more employers. Thus, deliberate creation of a "friendly" or controlled union to avoid coverage obligations under a qualified retirement plan is not a planning alternative.

Legitimate reliance on the union exclusion can, however, still create a compliance problem. Since the exclusion is expressly predicated upon the existence of a collective bargaining agreement, the exclusion is jeopardized in situations involving extended negotiations of new or renewed agreements following the expiration of a former collective bargaining agreement. If a group of excluded workers is left on the job for some period "without a contract," the requirement of Section 401(a)(6) that the coverage rules of Section 410 be met on at least one day in each quarter may be violated if meeting Section 410 depends upon fulfillment of the union exclusion.

III. INTERNAL REVENUE CODE SECTION 401(a)(26)

Code Section 401(a)(26), beginning with plan years after December 31,

⁴²The exclusive benefit rule of § 401(a)(2) or the nondiscrimination rule of § 401(n)(4) would likely be violated if an employer deliberately fired certain employees prior to their attaining age 21 in order to avoid having to cover them in a qualified plan.

⁴³Would the actions of the employer in the immediately preceding note be tantamount to a deliberate denial of ERISA rights so as to subject the responsible individuals to the criminal penalties of ERISA § 501? ERISA § 510 also makes it unlawful for an employer to interfere with an employee's ERISA rights by discharging the employee.

⁴⁴Treas. Reg. § 1.410(a)-3(e)(2) gives an example of such an impermissible exclusion involving a plan requiring as a condition of participation that each employee have had a driver's license for at least 15 years. Such a provision will be treated as a prohibited age requirement.

⁴⁵I.R.C. § 410(b)(3)(A).

1988, operates as an ultimate limitation upon individually designed plan exclusions. After taking into account the statutory exclusions of Section 410(a) and (b), Section 401(a)(26) requires that a qualified plan benefit the lesser of 50 employees or 40% or more of all employees of the sponsoring employer.

This minimum coverage requirement must be met "on each day of the plan year,"⁴⁶ in contrast with the requirement of Section 401(a)(6) that the Section 410 coverage standards be met on at least one day in each quarter. Consequently, planners who design allowable non-statutory coverage exclusions so as to barely meet the Section 401(a)(26) requirement will be working with a narrow "margin of error" that permits virtually no corrective response time in situations involving a shift in personnel that results in a sudden widening of the excluded group of employees in relation to the covered group.⁴⁷

A specific employer's susceptibility to such calamitous shifts in personnel can be gauged only by carefully examining the employer's past personnel patterns while considering the potential effect of any forecasted or planned business growth or contraction circumstances that may alter past and present patterns. If an employer wishes to maximize plan coverage exclusions as permitted by Section 401(a)(26), it must be prepared to alter coverage levels as necessary to prevent plan disqualification when personnel changes occur.⁴⁸ To the extent the employer views the monitoring and alteration of coverage levels to be too administratively burdensome, it will choose to define coverage exclusions with a requisite "buffer zone" that allows for normal (predictable) personnel changes.

IV. INTERNAL REVENUE CODE SECTION 410(b)

A. *Mechanical Tests*

Like Section 401(a)(26), Section 410(b) imposes "minimum coverage requirements" as a condition for plan qualification. Thus, a qualified plan must concurrently comply with two sets of limitations that affect the scope of permitted coverage exclusions. Whereas Section 401(a)(26) imposes only one mechanically formulated limitation, Section 410(b) permits alternative compliance with any one of four coverage limitations. Two of these limitations, contained in Section 410(b)(1)(A) and (B)⁴⁹ are, like Section 401(a)(26),

⁴⁶I.R.C. § 401(a)(26)(A).

⁴⁷For instance, the covered employees might belong to a division that is contracting while the excluded employees are in a division that is expanding. Relief from the § 410(b) requirements may be granted for a "transition period" (that may exceed one year) in situations involving workers who become or cease to be members of a controlled group of employers as defined in § 414. See § 410(b)(6)(C).

⁴⁸Drafted coverage definitions might include a clause that permits some defined expansion of coverage to address such personnel shifts without the need to amend the plan. For example, the coverage definition might include a particular grouping of employees *plus* such additional workers from other groupings as are needed to fulfill designated statutory coverage criteria from time to time. The additional workers needed would be selected in some objective, nondiscriminatory manner.

⁴⁹All § 410(b) coverage tests rely on a coverage concept that requires inclusion of rank and file employees in direct relation to the extent the plan benefits "highly compensated employees" as defined in § 414(q).

mechanically expressed, and therefore operate as rather easily determinable safe harbor coverage rules.

The main difference between these two mechanical limitations for purposes of designing coverage exclusions relates to the effect of including varying numbers of highly compensated employees in a plan. Under Section 410(b)(1)(A), a plan must cover, after statutory exclusions, at least 70% of employees who are not highly compensated employees, *regardless* of the number of highly compensated employees covered. Under Section 410(b)(1)(B), the number of employees mandatorily covered who are not highly compensated employees will vary directly with the number of highly compensated employees included in the plan.

By using Section 410(b)(1)(B), an employer can "leverage" the exclusion of certain highly compensated employees so as to exclude potentially great numbers of employees who are not highly compensated employees. For example, if, after statutory exclusions, there remain four highly compensated employees and one hundred employees who are not highly compensated, designing a plan's coverage exclusions to eliminate even one highly compensated employee will reduce mandatory coverage of employees who are not highly compensated from seventy to fifty-three employees.⁵⁰ By contrast, reliance on the Section 410(b)(1)(A) limitation would require coverage of seventy employees who are not highly compensated employees in any event.

B. *Classification Based Tests*

Employers who desire coverage exclusion flexibility beyond that available with the Section 410(b)(1)(A) and (B) tests will want to consider the "average benefit percentage" test of Section 410(b)(2) and the "line of business exception" of Section 410(b)(5). The former test permits employers with two or more qualified plans to consider, in effect, the comparability⁵¹ of disparate plans while ignoring, to a degree, the extent of coverage existing under any one plan in favor of an overall view of benefits provided for rank and file employees under all plans in comparison with the extent highly compensated employees are benefited under all plans.⁵² The line of business rule also permits a potential widening of coverage exclusions, based solely upon legitimate organizational and operational distinctions adopted by an employer.⁵³

⁵⁰ Eliminating two highly compensated employees would reduce coverage of employees who are not highly compensated to thirty-five employees. Eliminating three highly compensated (perhaps leaving only the "boss" covered among the four executives) would reduce coverage of rank and file workers to twenty-five employees.

⁵¹ See Rev. Rul. 81-202, 1981-2 C.B. 93.

⁵² Under I.R.C. § 410(b)(2)(A)(ii), the "average benefit percentage" for rank and file employees must be at least 70% of that for highly compensated employees.

⁵³ I.R.C. § 414(r) sets forth definitions and rules for the determination of separate lines of business, which are effectively treated as separate employers for purposes of the § 410(b) coverage tests. To establish a separate line of business, a minimum of fifty employees is required. I.R.C. § 414(r)(1) states: "For purposes of sections 89 and 410(b), an employer shall be treated as operating separate lines of business during

Both Section 410(b)(2) and Section 410(b)(5) require that a plan benefit such employees as qualify under a classification set up by the employer and found by the Treasury not to be discriminatory in favor of highly compensated employees.⁵⁴ All but very recent practitioners will recognize the "classification" concept derived under Section 410(b)(1)(B) as it existed under the Internal Revenue Code of 1954.⁵⁵ As under former law, many practitioners working with the newest version of Section 410(b) will tend to avoid using the "classification" standard for designing coverage exclusions, since the blend of rules that purportedly define a nondiscriminatory classification of employees remain somewhat confusing and vulnerable to subjective interpretation.⁵⁶

To be sure, many other practitioners, adept at convincing their IRS determination letter examiners that their plans cover nondiscriminatory classifications of employees, will continue to reduce employer coverage costs by struggling with what amounts to a very complicated facts and circumstances test.⁵⁷ The greatest problem with the "classification" standard is not the procuring of an initial determination letter. The greatest problem is the continuous, periodic monitoring of coverage that must immediately proceed from a plan's adoption under a less than definite and (generally poorly understood) set of rules. Those who feel uneasy and ill-equipped to monitor the coverage effect of shifting personnel patterns under the mechanical tests of Section 410(b)(1)(A) and (B) will not be overjoyed to undertake such responsibility respecting coverage exclusions adopted in reliance on the average benefit percentage test or the line-

any year if the employer for bona fide business reasons operates separate lines of business." Since the separate lines of business must be "operated" by the employer, apparently § 410(b)(5) has no effect on the controlled group employer rules of § 414(b) and (c). It seems anomalous that one employer might be able to treat two divisions as separate employers for plan coverage purposes while not being able to so regard an entirely separate (and not totally owned in common) business entity.

⁵⁴I.R.C. § 410(b)(2)(A)(i); I.R.C. § 410(b)(5)(B).

⁵⁵I.R.C. § 410(b)(1)(B) prior to the 1986 Tax Act changes requires a plan to benefit "such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated."

⁵⁶The Conference Agreement for the 1986 Tax Act states that the classification test ". . . is to be applied on the basis of the facts and circumstances of each case, including the difference between the coverage percentages of the highly compensated employees and the other employees, the percentage of total employees covered, and the difference between the compensation of the covered employees and the compensation of the excluded employees." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-413(1986). No further guidance is given by Congress to assist in the settings of standards respecting the differences deemed critical.

⁵⁷Like all facts and circumstances tests under tax law, there really is no limit to the number and nature of considerations that will influence a final result under the "classification" criteria. Theoretically, only the practitioner's imagination limits his or her arguments in favor of a nondiscriminatory coverage finding in a particular situation. For example, if a classification is in doubt upon examination, it could be asserted that while the *number* of highly compensated employees covered is arguably a bit too high, one should also compare the highly compensated employees covered with those not covered. If such a comparison yielded disparities in ownership interests, compensation levels, and managerial control that make the covered highly compensated employees as a group appear "less highly compensated" than the noncovered elite, presumably such disparities would be an additional factor for the examiner to consider. No doubt the increasing use of nonqualified deferred compensation arrangements for top executives will, for some employers, result in such potential coverage disparities among highly compensated employees.

of-business exception.⁵⁸

V. COVERAGE EXCLUSION SELECTION FACTORS

A. *Technical Considerations*

One approach to designing coverage exclusions would consider the potential administrative problems of particular exclusions in view of the various legal limitations previously discussed. If a coverage exclusion will be too difficult to monitor and thus too dangerous a threat to a plan's qualified status, any perceived cost savings or other advantage will be outweighed by a potential tax disaster.

In balancing risk against benefit in this manner, the planner will want to be wary of Section 402(b), which provides that a plan losing its qualification due to a violation of Section 410(b) will have its trust continue to be treated as tax exempt only with respect to participants who are *not* highly compensated employees.⁵⁹ Participants who are highly compensated employees, by contrast, will face income recognition respecting their entire vested accrued benefit (less employee contributions), not just vested employer contributions allocated to them in a disqualification year.⁶⁰ This tax consequence makes Section 410(b) violations, in many situations, far more serious than other qualification violations under Section 401(a), including violations of the minimum coverage standard of Section 401(a)(26).⁶¹ In particular, this disparity in tax treatment upon disqualification may make plan administrators quite nervous about coverage exclusions based upon the "classification" tests of Section 410(b). No doubt some plan administrators will conclude that dealing with "risky" coverage exclusions is unduly burdensome.⁶²

Of course, a plan administrator must similarly be concerned about the effect of specific coverage exclusions upon legal rights and duties existing independently of the plan's qualification status. For example, a selected coverage exclusion should not interfere with other contractual undertakings of the employer, such

⁵⁸ Attorneys and other practitioners who urge adoption of a "classification" coverage approach should either undertake the necessary monitoring themselves or educate others, such as "in-house" personnel, to do so. At the outset such advisers should discuss with their clients both the importance of such monitoring and the administrative burdens and costs of such. The latter topic may properly be raised in the context of an explanation of how and to what extent adoption of a "classification" participation standard would save coverage costs.

⁵⁹ I.R.C. § 402(b)(2)(A).

⁶⁰ Under § 402(b)(1) *all* participants would face income recognition respecting vested employer contributions allocated in a disqualification year.

⁶¹ As noted in Section III., I.R.C. § 401(a)(26) must be complied with on each day of the plan year and thus could potentially create a greater disqualification threat than § 410(b), which need be satisfied on only one day in each quarter.

⁶² Employee benefits personnel may have enough to be concerned with by way of less discretionary tax risks, such as those now imposed respecting health plan continuation coverage under § 162(k). Similar to the approach taken under I.R.C. Section 402(b), § 106(b) tags highly compensated employees for income recognition when an employer fails to meet the continuing coverage requirements of § 162(k).

as employment contracts or collective bargaining agreements. And, a coverage exclusion must not violate applicable non-tax laws, such as labor relations statutes, nondiscrimination laws, or constitutional prohibitions.⁶³ All plan administrators should agree that they have a large enough burden avoiding penalties and litigation under pension and tax law, without having to worry about claims based on other laws.

B. *Coverage Costs*

Any employer will be willing to undertake a considerable administrative burden if the resulting cost savings are significant enough. Thus, before a planner dismisses “risky” coverage exclusions, such as those based upon “classification” standards, an attempt should be made to calculate the ostensible coverage cost increases that result from selection of exclusions deemed safer or less administratively burdensome.⁶⁴

Protracted actual costs of implementing a qualified retirement plan may be quite difficult to ascertain, not solely because of uncertainty respecting the employer’s future personnel structure, but also because of potential cost offsets that may be available. For example, consider the situation of an employer that is having difficulty staffing its night shifts as a result of setting too low a pay differential for night work. One solution to this problem would be to increase the direct pay rate for night workers to the minimum level necessary to attract and keep sufficient numbers of late shift workers. Another solution — one that might attract workers most concerned about their retirement income security — would be to implement a qualified deferred compensation plan⁶⁵ that covers only night shift employees plus certain selected highly compensated employees. This latter solution would generate coverage costs but such would otherwise have been offset by a direct pay increase that would have been necessary in any event. If excluding day shift workers in favor of night shift workers results in coverage compliance deemed too dangerously close⁶⁶ to the Section 410 or 401(a)(26) minimums, the costs attendant to any proposed expansion of coverage could accordingly be quantified and viewed as true additional costs not necessarily subject to offset.

Actually, in considering cost offsets, the employer should take stock of its

⁶³Obviously, a plan must not contain coverage exclusions based on factors like an employee’s sex, race, religion, union activities, or exercise of rights under the Employee Retirement Income Security Act of 1974.

⁶⁴The new, more limited vesting schedule choices under § 411 resulting from the 1986 Tax Act must be considered in calculating coverage costs projected into the future.

⁶⁵Adopting a qualified profit sharing plan would afford the employer sufficient contributions flexibility to determine by experiment the “minimum” economic incentive needed to retain the desired personnel placements. Whereas employees may be willing to accept fluctuating profit sharing plan contributions, direct pay raises, once given, are difficult to adjust downward without affecting employee morale. This fact of life is no doubt attributable to an employee’s tendency to rely fully upon current pay to maintain his or her adopted standard of living and financial commitments.

⁶⁶The planner would want to consider historical fluctuations in night shift staffing before deciding what coverage level comfortably complies with the statutory minimums.

entire compensation package, which is likely to involve other components in addition to "paycheck" compensation.⁶⁷ If a qualified deferred compensation plan clearly expands the compensation package without affecting its other components, then the costs of such expansion can be reasonably quantified based upon the best available projections respecting the employer's personnel needs. But, in viewing a proposed retirement plan in the context of total compensation, the employer will want to consider the possibility that the deferred compensation plan may be able to serve as a substitute for all or part of another component, or other components, in the compensation package. Indeed, the deferred compensation plan may not actually result in a *reduction* of other pay or benefit levels but may substitute, as illustrated above, for planned or proposed *expansions* of such pay or benefit levels.⁶⁸

The concept of minimizing the true costs of a retirement plan by searching the whole compensation package for offsets may be particularly attractive for employers that have implemented nondeferred profit sharing programs or similar bonus-type award structures that frequently take the place of across the board annual raises.⁶⁹ Many employers find that using annual bonuses or profit share awards gives the employer some means to control personnel costs while creating potential performance incentives that may lead to overall productivity. In many cases it would not be a difficult step to substitute the tax favored benefits of a qualified deferred compensation plan for some portion of year-end employee bonuses otherwise determined in the employer's discretion or pursuant to a formula that could be credibly modified by the employer.

If the employer carefully considers all potential plan cost offsets, it may find that a qualified retirement plan will involve less expense than otherwise imagined. This being the case, the employer may correspondingly feel less compelled to squeeze every dollar possible out of the coverage limitations set by the Internal Revenue Code, especially if to do so creates potential compliance problems for the plan.⁷⁰

C. *Incentives and Disincentives*

In many instances selection of coverage exclusions sends a message to both the excluded and included employees. If the message is one of reward for the included employees and hope for the excluded employees, employee morale

⁶⁷Employers tend increasingly to communicate to employees that their "pay" is really a "compensation package" that often contains several items, including even the employer's contribution to the Social Security system.

⁶⁸But the employer might want to consider strong employee preferences for particular compensation package configurations, as frequently expressed in collective bargaining negotiations.

⁶⁹Often an employer will "freeze" basic wage and salary rates while granting the equivalent of raises in the form of year-end awards that may fluctuate downward. The observation made at note 65, *supra*, applies as well here.

⁷⁰Cost conscious employers will still want to consider available cost savings features of qualified plans like Social Security integration and vesting schedules.

may be enhanced, or at least not adversely affected. If the message is one of favoritism and exploitation, the unofficial political structure of the workplace may change for the worse. Such potential effects may play a subjective but important role in the selection of coverage exclusions. Once an employer or its advisors have a good idea whether and to what extent cost savings and administrative burdens should influence coverage exclusion choices, actual selection of covered and non-covered employees can commence pursuant to a variety of considerations.

At the outset existing organizational distinctions between groups of employees should be identified: hourly/salaried, technical or skilled/nonskilled, day shift/evening shift, management/clerical, etc. Other distinguishing features should also be noted, such as workplace locations, divisional designations, product line differences, job classification variations, and the like. Since the coverage rules under the Code outside the statutory exclusions do not suggest any particular basis for determining coverage exclusions⁷¹ as long as minimum coverage numbers are observed, the employer is free to match any existing grouping of employees against such minimum coverage numbers to create yet another identifying feature that serves to further define such groupings. Selecting for coverage particular groupings of employees who have demonstrated above average performances on the job, especially performances that have been long term and capable of objective measurement, will no doubt augment an employer's overall system for rewarding productivity.

Special attention may have to be given to highly compensated employees in this regard. Since the various Section 410(b) tests proportionately link coverage of non-highly compensated employees with coverage of highly compensated employees, generally speaking, coverage exclusions may expand to the extent highly compensated employees are excluded from a qualified plan. As noted, the exclusion of even one highly compensated employee from the plan of a small employer will often have a substantial impact on the number of rank and file employees that must be covered under the Section 410(b)(1)(B) test.⁷²

Unfortunately, excluding key executives from a qualified plan may affect an employer's ability to retain and maintain the morale of such employees. Fortunately, however, an employer can usually find a way to provide alternative incentives for key executives, often at a total cost that is lower when compared to the effect of including such personnel in a qualified retirement plan. Obviously, stock incentive plans and nonqualified deferred compensation arrangements⁷³ can play a significant role in satisfying excluded highly compensated

⁷¹Of course, the distinction between highly compensated employees and nonhighly compensated employees must be observed.

⁷²See note 50, *supra*, and accompanying text.

⁷³Nonqualified "Rabbi Trust" plans have become popular. These plans permit a degree of funding that may make an executive feel more secure about a nonqualified deferred compensation arrangement and thus less desirous of participating in a qualified plan.

employees.

One alternative to using coverage selection as a reward for high performance is to design a system for profit sharing plan contribution allocations that reflects objectively determined performance criteria. Under such a system, few coverage exclusions would be needed to distinguish mediocre performance groups from those exhibiting above average performance, since performance levels could be directly reflected in the participants' relative sharing in plan contributions.⁷⁴ A nondiscriminatory contribution allocation formula based on "performance points," or the like, would have the advantage of permitting annual determinations of merit for individuals, rather than groups of individuals. By contrast, using coverage inclusions and exclusions as incentives or disincentives tends to be an "all or nothing" tool, since once plan participation is granted, such typically inures until an employee terminates service.⁷⁵

Nonetheless, it would be possible, and for some employers perhaps desirable, to use plan coverage itself as an initial incentive to promote group performance. Once coverage status was attained, employees might still be subject to further incentives via an appropriate contribution allocation formula. Thus, coverage exclusions could operate in conjunction with the plan's contribution allocation formula as a kind of "double incentive" system.

VI. CONCLUSION

Despite changes in the 1986 Tax Act intended to broaden employee participation in qualified retirement plans, the coverage requirements for qualification are still a long way from mandating total employee participation. Employers not wanting individually designed coverage exclusions must still be acutely aware of various technical distinctions, including those affecting a worker's basic status as an employee, that might become qualification pitfalls after a plan's implementation. For employers wishing to take advantage of permitted discretionary coverage exclusions, a great deal of creative planning is still available to effect potential cost savings while implementing personnel goals and policies.

⁷⁴Care must be taken to prevent such an allocation formula from operating in a discriminatory manner in violation of § 401(a)(4). See *Auner v. United States*, 440 F.2d 516 (7th Cir. 1971).

⁷⁵As long as a proper number of nonhighly compensated employees are covered under the statutory tests, there appears to be no reason why a plan could not adopt coverage definitions based on performance criteria alone, as established from time to time. Some employees would "float" in and out of coverage status, depending upon their fulfillment of the designated performance criteria for a given period. The practical effect would be to grant or deny contribution allocations in whole for particular employees in particular plan years, something like an "all or nothing," merit-based contribution allocation formula would operate in a plan containing static coverage definitions.