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COPING WITH THE REDUCED LIMITATION ON “COMPENSATION” USED UNDER QUALIFIED RETIREMENT PLANS

BARRY J. BIDJARANO*

On August 10, 1993, Congress enacted the Omnibus Budget Reconciliation Act of 1993 (“OBRA”),¹ which includes a series of provisions² that will have an impact on the way retirement benefits are provided to highly compensated individuals,³ and indirectly, to nonhighly compensated individuals. Not since the passage of the Employee Retirement Income Security Act of 1974⁴ (“ERISA”) has the balance between “funded” and “pay-as-you-go” retirement plans been so affected.⁵

Generally, OBRA limits the amount of annual “compensation” that may be considered under a qualified retirement plan or annuity for purposes of determining the amount of a participant’s contributions or benefit accrual under the plan. In addition, OBRA limits the amount of annual compensation for purposes of deter-

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³ For purposes of this Article, “highly compensated individual” means any individual having annual earnings from an “employer” greater than the annual compensation limit in effect under I.R.C. § 401(a)(17) (1988 & Supp. V 1993) ($150,000 for 1994), and whose contribution or benefit accruals under a qualified retirement plan are thereby affected. “Employer” refers to the expanded definition of the term found in I.R.C. § 414(b), (c), (m), (o) (1988) which includes as a single employer: members of a controlled group of corporations, trades or businesses (whether or not incorporated) that are under common control, and members of an affiliated service group.


⁵ Kay G. Finley & Merritt A. Gardner, Note, The Pension Reform Act of 1974: Brave New World of Retirement Security, 27 U. Fla. L. Rev. 1044 (1975). “Funded plans provide for the gradual accumulation of assets, generally in a trust, to meet future demands. On the other hand, unfunded plans are operated on a ‘pay as you go’ basis whereby the employer contributes only those benefits actually due and makes no provision for future liabilities.” Id. at 1048 (citations omitted).
mining whether a participant’s contribution or benefit accrual is
nondiscriminatory. Generally effective with plan years beginning
in 1994, retirement benefits and contributions for highly compen-
sated individuals will be accumulated under qualified plans based
on compensation of $150,000 (reduced from $235,840 in 1993),6
and the annual compensation limitation will be increased for in-
fation only in increments of $10,000.

Although a relatively minor change in the law, OBRA will
have a diverse, and probably unintended, effect upon the design of
both funded and unfunded retirement arrangements. The author
presumes that employers and employees will not simply accept
the new limitations placed upon their retirement “treasure chest,”
but will actively renegotiate existing arrangements and derive
better total compensation packages in order to retain and attract
the individuals perceived as necessary for the success of the busi-
ness venture—whether it be the chief executive officer of a major
company or the head surgeon of a major hospital.7 This Article
places into perspective the impact of the new compensation limit
on qualified retirement benefits and explores alternative qualified
plan design options currently being considered by employers and
their consultants.

I. BACKGROUND

Before ERISA, a requirement that contributions and benefit
accruals not discriminate in favor of officers, shareholders, super-
visors, and highly compensated employees (the so-called “prohib-
ited group”)8 indirectly imposed the only limit on the amount of
annual contributions or benefit accruals that could be promised
under a qualified retirement plan. “Overly restrictive” partici-
ipation standards, however, resulted in inadequate coverage and
undermined this nondiscrimination requirement.9 Employees, for
example, could be and were arbitrarily excluded from plan partici-

6 I.R.C. § 401(a)(17) (1988) (limiting compensation to $200,000 adjusted by cost-
of-living under § 415(d) (prior to 1993 amendment)).
7 See Michael A. Oberst, A Perspective of the Qualified Plan Tax Subsidy, 32
BUFF. L. REV. 603, 615 (1983) (“In closely held companies, where many or all of the
highly paid employees are also stockholders in the company, there obviously is an
acute interest in establishing a qualified plan benefitting these employee-
stockholders.”).
4670, 4678.
pation by reason of age, or subjected to extended waiting periods. Likewise, the absence of a requirement that retirement benefits become nonforfeitable, i.e., "vested," over a specified period of time led to a preponderance of unfunded, pay-as-you-go plans and added to the discriminatory practices often followed outside the plan.

ERISA added the requirements that qualified retirement plans be embodied in a written plan, that the written plan provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and ERISA, that pension plans be subject to minimum funding requirements, that benefits attributable to employer contributions become vested under specified vesting schedules, and that plan assets be held in an inalienable trust or by an insurance company. In addition, ERISA added minimum participation and coverage requirements generally providing that individuals may not be excluded from participating in the plan solely by reason of age, and that participants covered under the plan had to be representative of a classification of employees found by the Secretary not to discriminate in favor of the prohibited group. Finally, ERISA enacted various incentives under the Internal Revenue Code for employers to establish and maintain qualified retirement plans. As a result, the amount of assets accumulated under qualified retirement plans has grown steadily.

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11 See id. ("[E]mployees do not acquire vested rights until they have accumulated a fairly long period of service with the firm ... As a result, even employees with substantial periods of service may lose retirement benefits on separation from employment.").
12 Cf. id. at 4672, 4679 (stating that significant number of pension plans are not adequately funded).
14 Id. § 1102(b)(1).
15 Id. § 1082; I.R.C. § 412 (1988).
16 I.R.C. § 411(a)(2) (1988) (added by ERISA § 1012(a), establishing requirement that employer contributions to qualified retirement plans be fully vested on attainment of normal retirement age and become vested generally over one of three alternative vesting standards referred to as "5 to 15 year graded," "10-year cliff," and "rule of 45").
Providing tax incentives for the establishment and maintenance of qualified retirement plans has been justified on the ground that it furthers the public policy goal of generally providing employees with fair and meaningful retirement savings.\(^{20}\) Notwithstanding this public policy, and even after the passage of ERISA, the tax incentives provided to employers for maintaining qualified retirement plans have been the focus of scrutiny.\(^{21}\) One


\(^{21}\) See Michael J. Graetz, The Troubled Marriage of Retirement Security and Tax Policies, 135 U. PA. L. Rev. 851, 861 (1987). Tax incentives linked to qualified retirement plans have been criticized for failing to adhere to principles of "tax justice"; that is, that "tax burdens be correlated with people's ability to pay." Id. "The revenue loss attributable to private pensions has been estimated to benefit high-income workers disproportionately, and the distribution of benefits from private pension plans is skewed in the same direction." Id. at 876.

Congress has attempted to alter the tax incentives in a more equitable manner. For example, § 235(a) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324, 505 generally amended I.R.C. § 415 to reduce the then applicable dollar limit on contributions and benefits under qualified retirement plans, 403(b) annuities, and simplified employee pensions ("SEPs") from $45,475 to $30,000 for defined-contribution plans and from $136,425 to $90,000 for defined-benefit plans.

Reflecting upon Congress' reasons for making these changes, the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Blue Book"), prepared by the Joint Committee On Taxation, provides:

Congress recognized the importance of tax incentives in creating a strong pension system. At the same time, however, Congress believed it was necessary to provide more appropriate limitations on contributions and benefits to prevent excessive accumulations of tax-deferred funds by high-income people.


Section 240 of Pub. L. No. 97-248, added Internal Revenue Code § 416(d) to limit the amount of compensation taken into account under a "top-heavy plan" to $200,000 (indexed). The 1982 Blue Book provides insight into Congress' reasons for making these changes:

Congress believed that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise. Similarly, Congress believed that the rules needed to assure that the tax incentives available under qualified plans are not abused should generally apply without regard to whether the employer maintaining the plan is incorporated or unincorporated.

Congress concluded that the level of tax incentives should be the same for all employers who maintain qualified plans, with the exception of employers whose plans focus more than 90 percent of their benefits on key employees. In the case of these plans, a lower level of tax incentives was considered adequate.
reason for the scrutiny is that allowing sizable tax deductions and
tax-deferred trust accumulations is inconsistent with a general policy goal aimed at reducing the nation’s increasing budget deficit.\textsuperscript{22}

Limiting the amount of compensation considered for purposes of determining contributions and benefit accruals under qualified retirement plans may be viewed as consistent with the first mentioned policy goal of retirement security to the extent it causes larger (and thus fairer) contributions or benefit accruals to be made on behalf of non-highly compensated individuals.\textsuperscript{23} This could be the result, for example, if an employer desires to maintain the pre-OBRA 1993 level of contributions or benefit accruals provided under its qualified retirement plan to highly compensated individuals. If instead such contributions or benefit accruals are allowed to decline, greater tax revenues would be generated for the government to apply against the budget deficit. Alternatively, the “annual compensation limit” could have a negative impact on the policy goal that fair and meaningful retirement savings be provided to employees in general, if it causes employers to terminate qualified retirement plans and to establish discriminatory pay-as-you-go plans. The rise and fall of the annual compensation limit is illustrated in Exhibit I.

What appears more likely to occur is that some employers will allow the contributions or benefit accruals on behalf of highly com-

\begin{itemize}
\item In the case of plans under which more than 60 percent of the benefits are focused on key employees, Congress concluded that special rules are needed to assure that the rank-and-file employees would receive the benefits that the tax incentives were provided to encourage.
\begin{quote}
\textit{Id.} at 308-09.
\end{quote}
\item \textsuperscript{22} See Finley & Gardner, supra note 5, at 1054 (“[T]he primary function of taxes is to raise revenue.”).
\item \textsuperscript{23} In reflecting upon Congress’ reasons for extending the annual compensation limit from “top-hat plans” to all qualified retirement plans in the Tax Reform Act of 1986, The General Explanation of the Revenue Provisions of the Reform Act of 1986 (the “1986 Blue Book”), prepared by the Joint Committee On Taxation, provides:
\begin{quote}
Congress intended that the Secretary will prescribe rules to effectuate the intent of the $200,000 limit on includable compensation. The purpose of the limitation is to ensure that reductions in the maximum contributions or benefits do not reduce the contributions or benefits of low- and middle-income employees. Congress concluded that it would be inconsistent with this intent to permit plans to define compensation in such a manner that the $200,000 limit has little effect on highly compensated employees, while adversely affecting low- and middle-income employees.
\end{quote}
\begin{quote}
\end{quote}
\end{itemize}
pensated individuals to decline, while other employers will attempt to maintain the status quo through creative plan design changes or by simply making up the retirement savings lost under the qualified plan by means of an unfunded, pay-as-you-go arrangement. To the extent that lost benefits are replaced through plan redesign, the policy goal of providing benefits that are more fair to nonhighly compensated employees is not furthered. Interestingly, the pay-as-you-go solution may be consistent with both policy goals mentioned above since it addresses concerns over the growing budget deficit; it should result in more immediate tax revenues, and it addresses the fairness of benefits provided to highly compensated individuals under qualified retirement plans.

**EXHIBIT I**

--- **PAST ANNUAL COMPENSATION LIMITS** ---

<table>
<thead>
<tr>
<th>Year</th>
<th>Limit</th>
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</thead>
<tbody>
<tr>
<td>1974</td>
<td>No Limit</td>
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<tr>
<td>1984</td>
<td>$200,000 (Top-Heavy Plans Only)</td>
</tr>
<tr>
<td>1989</td>
<td>$200,000 (All Plans)</td>
</tr>
<tr>
<td>1990</td>
<td>$209,200</td>
</tr>
<tr>
<td>1991</td>
<td>$222,220</td>
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<td>1992</td>
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<tr>
<td>1993</td>
<td>$235,840</td>
</tr>
<tr>
<td>1994</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

**II. OVERVIEW OF THE NEW $150,000 LIMITATION**

**A. In General**

Internal Revenue Code ("IRC") section 401(a)(17)(A), as amended, is effective for plan years beginning after December 31, 1993, and provides:

**In General**—A trust shall not constitute a qualified trust under this section unless, under the plan of which such trust is a part, the annual compensation of each employee taken into account under the plan for any year does not exceed $150,000. In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term "family" shall include only the spouse of the employee and any lineal descendants of the employee who have not attained age 19 before the close of the year.  

--- Footnote ---

By amendment, the $150,000 limitation also applies to compensation taken into account under simplified employee pensions ("SEPs")\textsuperscript{25} and Voluntary Employees Beneficiary Associations ("VEBAs") for purposes of applying the nondiscriminatory benefit requirements of IRC section 505(b)(7) to welfare benefit plans forming part of the VEBA.\textsuperscript{26} By reference, the $150,000 limitation applies to compensation taken into account under IRC section 403(a) qualified annuity plans\textsuperscript{27} and nonelective section 403(b) annuity plans.\textsuperscript{28}

Recently issued Treasury Regulations under section 401(a)(17) clarify that the requirements of section 401(a)(17) apply to the "plan,"\textsuperscript{29} that section 401(a)(17) provides an annual compensation limit for each employee under a qualified plan\textsuperscript{30} and that the limit applies to a qualified plan not only for purposes of determining allocations (in a defined-contribution plan) and benefit accruals (in a defined-benefit plan), but also for purposes of applying the various nondiscrimination rules under the IRC.\textsuperscript{31} The regulations also clarify that the "for any year" language refers to the plan year and that compensation is determined for the plan year or other consecutive twelve-month period used under the plan for determining compensation on which allocations or benefit accruals are based.\textsuperscript{32} The annual compensation limit that applies is the limit in effect for the calendar year in which, or with which,

\textsuperscript{25} Id. §§ 408(k)(3)(C), (k)(6)(D)(ii), (k)(8).

\textsuperscript{26} Id. § 505(b)(7).

\textsuperscript{27} Id. § 403(a) (1988).

\textsuperscript{28} Id. § 403(b)(12)(A)(i) (1988) provides that "with respect to contributions not made pursuant to a salary reduction agreement, such plan meets the requirements of paragraphs (4), (5), (17) and (26) of Section 401(a) . . . . in the same manner as if such plan were described in section 401(a)." The reference to § 401(a)(17) is not contained in I.R.C. § 403(b)(12)(A)(ii) with respect to salary reduction contributions. Also, unless the special election under § 415(c)(4)(D) is made, it appears that § 401(a)(17) has no applicability for purposes of determining the exclusion allowance under § 403(b)(2) for a § 403(b) annuity.

\textsuperscript{29} Treas. Reg. § 1.401(a)(17)-1 (amended 1994). Section 1.401(a)(17)-1(a)(1) provides that "in order to be a qualified plan, a plan must satisfy section 401(a)(17)." Section 1.401(a)(17)-1(b)(1) provides that "[a] plan does not satisfy section 401(a)(17) unless it provides that the compensation taken into account for any employee in determining plan allocations or benefit accruals for any plan year is limited to the annual compensation limit."

\textsuperscript{30} Id. § 1.401(a)(17)-1(a)(1).

\textsuperscript{31} Id. For purposes of this rule, section 1.401(a)(17)-1(b)(1) provides that allocations and benefit accruals under a plan include all benefits provided under the plan, including ancillary benefits.

\textsuperscript{32} Id. § 1.401(a)(17)-1(b)(3)(ii).
the plan year or twelve-month period begins. If allocations or benefit accruals for a plan year are based on compensation for a period of less than twelve months, then the otherwise applicable annual compensation limit must be reduced in the same proportion as the reduction in the twelve-month period.\(^3\) The annual compensation limit is not required to be reduced merely because compensation for purposes of allocations or benefit accruals is limited to the portion of a plan year for which an employee is a participant in the plan, or is covered under the plan, provided that allocations or benefit accruals are otherwise determined using compensation for a period of at least twelve months.\(^4\)

IRC section 401(a)(17)(B), as amended, is effective for plan years beginning after December 31, 1993, and provides:

Cost-Of-Living Adjustment.—

(i) In General.—If, for any calendar year after 1994, the excess (if any) of—

(I) $150,000, increased by the cost-of-living adjustment for the calendar year, over (II) the dollar amount in effect under subparagraph (A) for taxable years beginning in the calendar year, is equal to or greater than $10,000, then the $150,000 amount under subparagraph (A) (as previously adjusted under this subparagraph) for any taxable year beginning in any subsequent calendar year shall be increased by the amount of such excess, rounded to the next lowest multiple of $10,000.

(ii) Cost-Of-Living Adjustment.—The cost-of-living adjustment for any calendar year shall be the adjustment made under section 415(d) for such calendar year, except that the base period for purposes of section 415(d)(1)(A) shall be the calendar quarter beginning October 1, 1993.\(^5\)

The Treasury Regulations clarify that each increase in the annual compensation limit is effective as of January 1 of a calendar year and applies to any plan year beginning in that calendar year.\(^6\) If a plan, for example, has a plan year beginning July 1,
1994, and ending June 30, 1995, the annual compensation limit in effect on January 1, 1994 ($150,000) applies to the plan for the entire plan year. In addition, the regulations clarify that the annual compensation limit in effect for a plan year applies only to the compensation for that plan year. Any increase to the annual compensation limit may not be considered for a prior plan year, even if compensation for a prior plan year is considered for purposes of determining the current year’s allocation or benefit accrual.\textsuperscript{37} Further, the amount of annual compensation for any plan year beginning prior to the effective date that may be used for determining allocations or benefit accruals in a plan year beginning on or after the effective date is limited to the annual compensation limit in effect for the first plan year beginning on or after the effective date, which is generally $150,000.\textsuperscript{38}

\section*{B. Nondiscrimination in Allocations or Benefit Accruals}

The regulations clarify that for purposes of applying the annual compensation limit for testing nondiscrimination under the plan, "compensation" means the compensation used in applying the applicable nondiscrimination rule.\textsuperscript{39} Further, for purposes of applying an applicable nondiscrimination rule with respect to a plan, the annual compensation limit applies separately to each plan or group of plans treated as a single plan for testing purposes.\textsuperscript{40}

The annual compensation limit is applied to the compensation for the plan year to which the nondiscrimination requirement relates. If the nondiscrimination requirement relates to the plan year, then the annual compensation limit that applies is the limit in effect for the calendar year in which, or with which, the plan year begins. If the nondiscrimination requirement applies to a consecutive twelve-month period other than the plan year, then the annual compensation limit is the limit in effect for the calendar year in which, or with which, that twelve-month period begins. If the nondiscrimination requirement is applied to a period

\begin{itemize}
\item \textsuperscript{37} Id. § 1.401(a)(17)-1(b)(2).
\item \textsuperscript{38} Id.
\item \textsuperscript{39} Id. § 1.401(a)(17)-1(c)(1). Applicable nondiscrimination rules include Code sections 401(a)(4), 401(a)(5), 401(l), 401(k)(3), 401(m)(2), 403(b)(12), 404(a)(2), and 410(b)(2). The annual compensation limit also applies in determining whether an alternative definition of compensation impermissibly discriminates under Code section 414(a)(3).
\item \textsuperscript{40} Id. § 1.401(a)(17)-1(c)(3).
\end{itemize}
of less than twelve months, then the otherwise applicable annual compensation limit must be reduced in the same proportion as the reduction in the twelve-month period. The annual compensation limit is not required to be reduced merely because compensation for purposes of the nondiscrimination requirement is limited to the portion of a plan year for which an employee is a participant in the plan or is covered under the plan.\textsuperscript{41}

C. Effective Dates

As originally enacted as part of the Tax Reform Act of 1986,\textsuperscript{42} IRC section 401(a)(17) applies to a plan as of the first plan year beginning after December 31, 1988. Later effective dates were provided for governmental plans\textsuperscript{43} and for collectively bargained plans.\textsuperscript{44}

As amended by OBRA, IRC section 401(a)(17) applies to a plan as of the first plan year beginning after December 31, 1993.\textsuperscript{45}

Later effective dates are provided for both governmental plans\textsuperscript{46}

\textsuperscript{41}Treas. Reg. § 1.401(a)(17)-1(c)(4) (amended 1994) provides that the rules in paragraph (b)(3) of this section, see text accompanying notes 32-34, regarding the application of the limit to a plan year apply for purposes of paragraph (c).


\textsuperscript{43}The delayed effective date for governmental plans is the OBRA effective date for governmental plans. See infra note 46. See generally Treas. Reg. § 1.401(a)(17)-1(d)(1)(i) (as amended in 1994); I.R.S. Notice 92-36, 1992-2 C.B. 364.

\textsuperscript{44}Tax Reform Act of 1986 § 1106(i)(5)(B). I.R.C. § 401(a)(17) is effective for plans maintained pursuant to collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, on the first day of the first plan year beginning on or after the earlier of (A) January 1, 1991, or (B) the latest of (i) January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension, or renegotiation occurring after February 28, 1986). See generally Treas. Reg. § 1.401(a)(17)-1(d)(1)(ii) (amended 1994).


\textsuperscript{46}Id. § 401 note (effective date of 1993 amendment). A governmental plan is defined by I.R.C. § 414(d) generally as “a plan established and maintained for its employees by the Government of the United States, by the Government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.” I.R.C. § 401(a)(17), as amended by OBRA, applies to governmental plans for plan years beginning after December 31, 1995, or, if after December 31, 1995, plan years beginning more than ninety days after the opening of the first legislative session, if that body does not meet continuously. Treas. Reg. § 1.401(a)(17)-1(d)(4)(i) (as amended in 1994). A special transitional rule is provided for employees who first become a participant in a governmental plan prior to the first plan year beginning in 1996 or, if earlier, the last day of the plan year by which a plan amendment to reflect
and for plans maintained pursuant to one or more collective bargaining agreements ("collectively bargained plans").

There is some ambiguity in OBRA of which the reader must be aware. With respect to governmental plans, the statute specifically states that the transition rule applies to "State and Local Plans." IRC section 414(d), however, defines a governmental plan as including plans maintained by the federal government. Furthermore, OBRA does not clarify what is meant by the phrase "maintained pursuant to [one] or more collective bargaining agreements."

the OBRA changes is both adopted and effective. I.R.C. § 401 note (Supp. V 1993) (effective date of 1993 amendment). Under the transitional rule, the amount of compensation taken into account under the plan on July 1, 1993, may not be reduced, provided that the plan is amended to incorporate § 401(a)(17) by reference, effective with respect to non-eligible participants, for plan years beginning after December 31, 1995 (or earlier, if the plan amendment so provides). See generally Treas. Reg. § 1.401(a)(17)-1(d)(4) (amended 1994).

A collectively bargained plan is defined as a plan maintained pursuant to one or more collective bargaining agreements made between employee representatives and one or more employers that is ratified before August 10, 1993. OBRA § 13212(d)(2). I.R.C. § 401(a)(17), as amended by OBRA, applies to collectively bargained plans on the first day of the first plan year beginning on or after the earlier of (A) January 1, 1997, or (B) the latest of (i) January 1, 1994, (ii) the date on which the last of the collective bargaining agreements ratified before August 10, 1993, pursuant to which the plan is maintained, terminates (without regard to any extension, amendment or modification), or (iii) in the case of a plan maintained pursuant to a collective bargaining agreement under the Railway Labor Act, 45 U.S.C. §§ 151-188 (1988), the date of execution of an extension or replacement of the last of the agreements in effect on August 10, 1993. See generally Treas. Reg. § 1.401(a)(17)-1(d)(2)(ii) (amended 1994).

OBRA § 13212(d)(2). In describing the deferred effective date applicable to collectively bargained plans under ERISA, Congress determined that a plan covering both union and non-union employees was to be treated as being maintained pursuant to a collective bargaining agreement if at least 25% of the participants were covered by the bargaining agreement. H.R. Rep. No. 807, 93d Cong., 2d Sess. 52 (1974), reprinted in 1974 U.S.C.C.A.N. 4639, 4718; H.R. Rep. No. 1280, 93d Cong., 2d Sess. 267 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5074. A high ranking IRS official informally indicated to the Author that the ERISA standard is currently being favored. Note, however, the different standards applied in the case of welfare benefit funds under Temp. Treas. Reg. § 1.419A-2T, Q&A 22(2)(4) (1985), which requires that either 50% or 90% of the employees eligible to receive benefits be covered by the collective bargaining agreement. The applicable percentage is determined by the date the fund was in existence. Id.
As a general matter, allocations under a defined-contribution plan or benefits accrued under a defined-benefit pension plan for plan years beginning before the effective date of IRC section 401(a)(17) are not subject to the annual compensation limit. Instead, those allocations or benefit accruals, determined as if they had been frozen the day immediately preceding the applicable effective date, are "grandfathered" or "protected" and may not be reduced as a result of the annual compensation limit. Allocations or benefit accruals for plan years beginning after December 31, 1988, and before the OBRA effective date are subject to the pre-OBRA annual compensation limit. Allocations or benefit accruals for plan years beginning after the OBRA effective date are subject to the post-OBRA annual compensation limit.

D. Limitations on Deductions

OBRA contains a specific provision making the new annual compensation limit applicable not only in limiting compensation under qualified retirement plans, but also in determining the amount of an employer's plan contributions that is deductible for a

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52 Id. § 1.401(a)(17)-1(d)(5)(iii). When employee benefit accruals are "frozen" is determined as if the employee terminated his or her employment without regard to any amendment to the plan that was adopted after the earlier of (1) the "fresh start" date or (2) the date the employee actually terminated employment. Id.; see infra note 72. Amendments adopted after the earlier date, which are made effective under I.R.C. § 401(b) or Treas. Reg. § 1.401(a)(4)-11(g) (providing for retroactive amendments) are not included in this determination. As for employees who terminate employment before the date benefit accruals are frozen, employee benefit accruals are considered frozen upon the date the employee actually terminated employment, without regard to any amendments excluded from consideration as explained above. Treas. Reg. § 1.401(a)(4)-13(c)(3) (amended 1993).
53 Treas. Reg. § 1.401(a)(17)-1(d)(5) (1994). Thus, benefits accrued for those plan years generally do not include benefits accrued under an amendment increasing prior benefits that is adopted after the date on which the employee's benefits are to be treated as frozen.
55 Treas. Reg. § 1.401(a)(17)-1(d)(3) (as amended in 1994). The limit, as established by OBRA § 13212 and Treas. Reg. § 1.401(a)(17)-1(a)(3)(i), is $150,000 (as adjusted). The regulations generally apply to plan years beginning on or after the OBRA effective date. The effective date of the regulation is delayed until the plan years beginning after December 31, 1995, for qualified retirement plans and I.R.C. § 403(b) annuity plans with nonelective contribution only, maintained by an organization exempt from income taxation under I.R.C. § 501(a). Id. § 1.401(a)(17)-1(d)(3)(i). However, for plan years beginning before the effective date of the regulations and after December 31, 1988, the regulations require that the plan be operated in accordance with a reasonable good faith interpretation of I.R.C. § 401(a)(17). Id.
particular year. This is accomplished by amending IRC section 404(l), which provides:

For purposes of applying the limitations of this section, the amount of annual compensation of each employee taken into account under the plan for any year shall not exceed $150,000. The Secretary shall adjust the $150,000 amount at the same time, and by the same amount, as any adjustment under section 401(a)(17)(B). For purposes of clause (i), (ii), or (iii) of subsection (a)(1)(A), and in computing the full funding limitation, any adjustment under the preceding sentence shall not be taken into account for any year before the year for which such adjustment first takes effect. In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term "family" shall include only the spouse of the employee and any lineal descendants of the employee who have not attained age 19 before the close of the year.

This provision will also have an impact on the deductibility of contributions made to profit-sharing plans, including cash or deferred arrangements, and stock bonus plans. IRC section 404(a)(3) provides the general rule governing deductions for contributions to profit-sharing plans and stock bonus plans. It states that such contributions, in the tax year paid, are deductible up to fifteen percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan. Before

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56 OBRA § 13212(c)(1).
57 Id. OBRA § 13212 amended I.R.C. § 404(l) to make it generally effective for benefits accruing in plan years beginning after December 31, 1993. OBRA § 13212(d)(1). Guidance is needed as to how to apply the annual compensation limit under I.R.C. § 404(l) to profit-sharing and stock bonus plans where the deductible limit is based on compensation for the employer's tax year and to pension plans where the deductible limit is based on the plan year beginning, ending, or coinciding with the employer's tax year. See generally Treas. Reg. § 1.404(a)-9(b) (amended 1961) (basing deductible limit on compensation for employer's tax year); Treas. Reg. § 1.404(a)-14(c) (amended 1981) (providing for deduction limited to deductible limit for coinciding plan year where employer's taxable year coincides with plan year).
59 See supra note 57. The deductibility of contributions made to employee stock ownership plans ("ESOPs") may also be affected. Special rules under I.R.C. § 404(a)(9) (1988) allow for greater deductions for contributions to leveraged ESOPs. I.R.C. § 404(l) will have little impact on "pension" plans, since contributions made to money purchase pension plans are deductible up to 25% of a participant's compensation and contributions made to satisfy minimum funding requirements applicable to defined benefit pension plans are fully deductible under I.R.C. § 404(a)(1).
60 I.R.C. § 404(a)(3)(A)(i) (1988). Note that because the 15% of compensation limit is determined based on the aggregate compensation of plan participants, it may
the enactment of OBRA, the annual compensation limit ($235,840) was large enough to allow a fully deductible contribution of $30,000\textsuperscript{61} to a profit-sharing or stock bonus plan.\textsuperscript{62} The annual compensation limit of $150,000 will generally permit a deductible contribution of only $22,500 ($150,000 \times 15\%$). In order for an employer to contribute up to $30,000 on behalf of highly compensated individuals and be entitled to a current tax deduction, the employer must contribute the difference to either a defined benefit or money purchase pension plan.\textsuperscript{63}

This provision is likely to impact small employers and emerging businesses to a greater degree than large employers or established businesses. This is because the former tend to provide employees with higher retirement benefits—either because the benefits will go to only a few individuals or because they will serve as a means of attracting and retaining key employees.\textsuperscript{64} Additionally, many self-employed individuals who typically maintain a single, discretionary profit-sharing plan may be affected, including corporate directors, medical practitioners, consultants, and salespeople.

E. Treatment of Certain Family Members as Single Employees

To determine the compensation of an employee for purposes of applying the annual compensation limit, the IRC provides that "the rules of section 414(q)(6) shall apply, except that in applying such rules, the term 'family' shall include only the spouse of the employee and any lineal descendants of the employee who have not attained age [nineteen] before the close of the year."\textsuperscript{65} The

\textsuperscript{61} Id. § 415(c)(1)(A). Thirty thousand dollars is the maximum contribution permitted to be made on behalf of a participant. Id. The figure $235,840 includes the $200,000 pre-OBRA limit as adjusted for cost-of-living under I.R.C. § 415(d).

\textsuperscript{62} Id. § 404(a)(3)(A)(i) establishes the maximum amount of deductible contributions as no more than 15\% of the compensation paid.

\textsuperscript{63} Id. § 404(a)(3)(A)(iv). This section provides that contributions made to two or more stock bonus or profit-sharing trusts will be treated as contributions made to a single trust for purposes of the 15\% limitation. Id. Accordingly, the second qualified retirement plan cannot be a profit-sharing or stock bonus plan. Id.

\textsuperscript{64} See generally Peter Weaver, Retirees Losing Health Benefits, St. Louis Post Dispatch, Jan. 23, 1990, at 6D (indicating retirement benefits attracting employees to jobs are in jeopardy due to rising health care costs).

general rule indicates that this particular rule, which aggregates certain family members for treatment as a single employee, applies only to family members of a "five-percent owner" or of a highly compensated employee in a group consisting of the ten employees paid the greatest compensation during the year. The rules discussing this area of the law, however, were specifically reserved in the Treasury Regulations.

III. WHAT THE NEW RULES REALLY MEAN FOR HIGHLY COMPENSATED INDIVIDUALS

The reduction in the annual compensation limit from $235,840 to $150,000 will probably reduce the retirement benefits provided to highly compensated individuals under qualified retirement plans, including so-called Keogh plans for self-employed individuals. Although the $150,000 annual compensation limit is indexed annually for cost-of-living adjustments, the limit will only be increased in increments of $10,000. Assuming that cost-of-living adjustments, as determined under IRC section 415(d), remain at approximately three percent, the annual compensation limit may be adjusted roughly every two or three years as illustrated below in Exhibit II. As is evident, the post-OBRA annual compensation may not reach its pre-OBRA level until the year 2010.

The special "grandfather rule" protects a highly compensated individual's level of accrued benefits under defined-benefit pension plans based on the higher $235,840 compensation limit as of the

66 Id. § 414(q)(6)(A) (1988). This section states that if the family member is related to an employee who meets either of those two requirements, then any compensation paid to the individual will be treated as having been paid to the employee. Id. This is to ensure that highly compensated employees do not circumvent the compensation limit by allowing family members to receive what would be their compensation.

67 Treas. Reg. § 1.401(a)(17)-1(b)(5) (as amended in 1994). As Section 401(a)(17) refers to an "employee," and not to a highly compensated employee, which is the term used in Section 414(q)(6)(C)(i) for applying that section to other provisions, the family aggregation rules under Section 401(a)(17) may be found to apply to employees other than the ten most highly compensated employees.

68 A Keogh Plan is one designed for self-employed taxpayers and is also known as an "H.R. 10 plan." Such plans extend to self-employed taxpayers tax benefits similar to those available to employees under qualified pension and profit-sharing plans. Yearly contributions to the plan are tax deductible. BLACK'S LAW DICTIONARY 869 (6th ed. 1990).


70 Id. § 415(d) (1988).
end of the plan year beginning in 1993. As of the end of the plan year beginning in 1993, a highly compensated individual’s accrued benefits will therefore generally be greater than those of an individual whose accrued benefits are calculated based on total service with an employer under the $150,000 (indexed) annual compensation limit. Unless the defined-benefit plan is amended to adopt a “fresh start” benefit formula, the highly compensated individual may not earn additional retirement benefits under a plan until his or her accrued benefits, calculated based on total service and the $150,000 annual compensation limit, exceed the level of protected benefits. This will probably occur five to ten years later. Thus, if a highly compensated individual is close to retirement, he or she may be foreclosed from earning additional benefit accruals under the pension plan.

Highly compensated individuals may be affected in varying degrees, depending upon whether their allocations or benefit accruals are based upon current compensation or future compensation, such as under a final average pay formula. An actual reduction in a highly compensated individual’s retirement benefits may vary, depending upon the specific provisions of the plan, the indi-

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71 See supra note 52 and accompanying text.

72 A “fresh-start” is a date selected by the employer that is the last day of a plan year and is the same for all employees in the plan. Treas. Reg. § 1.401(a)(4)-12 (1993); id. § 1.401(a)(4)-13(c)(5)(iii) (as amended in 1993). For purposes of I.R.C. § 401(a)(17), the fresh-start date is no earlier than the last day of the last plan year beginning before the statutory effective date and no later than the last day of the last plan year beginning before the effective date of Treas. Reg. § 1.401(a)(17)-1; id. § 1.401(a)(17)-1(e)(2)(iii). For OBRA § 13212, the fresh-start date is no earlier than the last day of the last plan year beginning before the OBRA effective date and no later than the last day of the last plan year beginning before the effective date of Treas. Reg. § 1.401(a)(17)-1. Treas. Reg. § 1.401(a)(17)-1(e)(2)(iii) (amended 1994).
individual's current age, remaining years of service with the employer, and compensation level. For example:\textsuperscript{73}

- a highly compensated individual age forty-five who works until age sixty-five may lose approximately $316,000 under a six percent (6\%) of pay profit-sharing plan.

- a highly compensated individual age forty-five who works until age sixty-five may lose annual benefits of approximately $44,000 (or approximately $402,500 if distributed as a single sum) under a pension plan providing a retirement benefit equal to final average five-year compensation multiplied by 1.5\% for each year of service.

- a highly compensated individual may not earn additional benefits under a defined-benefit pension plan for several years, and may actually retire without earning additional benefits under the plan.

\section{Defined-Contribution Plans}

Exhibit III\textsuperscript{74} illustrates the relative values of a highly compensated individual's account balance under a profit-sharing plan based on the annual compensation limit before and after the OBRA change. It shows that in 1994, the pre-OBRA annual compensation limit of $242,280 would limit a 6\% profit-sharing contribution to $14,537. The post-OBRA annual compensation limit of $150,000 would limit the 6\% profit-sharing contribution to $9000.

Comparing relative values at age sixty-five, a highly compensated individual currently age forty-five will have an account balance approximately $316,000 less under the new rules. A highly compensated individual currently age fifty stands to lose approximately $186,000, and a highly compensated individual currently age fifty-five stands to lose approximately $100,000.

The impact of the post-OBRA annual compensation limit on future retirement benefits accumulated by a highly compensated individual under other types of defined-contribution plans will be similarly affected. For example, absent any changes to the design of the plan, the level of annual allocations made to highly compen-

\textsuperscript{73} These illustrations assume a seven percent annual rate of return.

\textsuperscript{74} Exhibit III assumes that the cost-of-living adjustments will remain at approximately three percent per year, that the pre-OBRA annual compensation limit increases each year, but not in increments of $10,000, and that the post-OBRA annual compensation limit increases as illustrated in Exhibit II. For the sake of simplicity, the highly compensated individual is deemed a new hire on January 1, 1994.
EXHIBIT III
$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—LOST BENEFITS EXAMPLE—DEFINED CONTRIBUTION—FUTURE BENEFITS

Assumptions:
Base Salary — Exceeds Compensation Limit Each Year
Annual Contribution — 6% of Compensation
New Hire on January 1, 1994

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* Assumes 1994 Compensation Limit of $242,280
** Earnings on Account Balance Projected At 7%

sated individuals under a money purchase pension plan, stock bonus plan, non-leveraged employee stock ownership plan ("ESOP"), or leveraged ESOP will generally be lower than for pre-OBRA years.

B. Defined-Benefit Pension Plans

Exhibit IV illustrates the relative values of a highly compensated individual's accrued benefit under a defined-benefit pension plan, based on the annual compensation limit before and after the OBRA change.

Comparing relative values at age sixty-five, a highly compensated individual, currently age forty-five, will receive an annual retirement benefit of approximately $44,000 less under the new rules. A highly compensated individual currently age fifty stands to lose approximately $28,000 in annual retirement benefits. A highly compensated individual, currently age fifty-five, stands to lose approximately $16,000 in annual retirement benefits. Upon

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75 Exhibit IV assumes employment until age 65 and a present value factor and earnings rate of seven percent. The final five-year average compensation is determined under the rules discussed above and based on the annual compensation limit in effect for the specific plan year. It also considers $150,000 as the annual compensation limit of all plan years beginning prior to 1994. It is assumed that the cost-of-living adjustments will remain at approximately 3% per year, that the pre-OBRA annual compensation limit increases each year, but not in increments of $10,000, and that the post-OBRA annual compensation limit increases as illustrated in Exhibit II. For the sake of simplicity, the highly compensated individual is deemed a new hire on January 1, 1994.
reaching age sixty-five, the present value of the lost retirement benefits would total approximately $402,500, $260,000, and $150,000, respectively.

**EXHIBIT IV**

**$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—LOST BENEFITS EXAMPLE—DEFINED BENEFIT—FUTURE BENEFITS**

Assumptions:
- Base Salary—Exceeds Compensation Limit Each Year
- Annual Accrual Rate—1.5% of Final 5-Year Average Compensation
- New Hire on January 1, 1994

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* Assumes 3% Annual Increase to Compensation Limit
** Present Value at 7% Using GAM Mortality Table for Males

Exhibit V illustrates the level of protected benefits (as of the end of the plan year beginning in 1993) under the defined-benefit pension plan described in Exhibit IV. Exhibit V also indicates the level at which the highly compensated individual would be entitled to retirement benefits, in the future, under a plan that exceeds the protected benefit amount.

Exhibit V demonstrates that a highly compensated individual currently having ten years of service will have a protected benefit amount of approximately $32,884 and will not be entitled to additional retirement benefits under the pension plan until completing a year of service in the year 1998. A highly compensated

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76 Exhibit V assumes the following: (1) 7% is the appropriate present value factor and earnings rate; (2) $150,000 is the annual compensation limit of all plan years beginning before 1994; (3) the cost-of-living adjustments will remain at 3% per year; (4) the pre-OBRA annual compensation limit increases each year but not in $10,000 increments; and (5) the post-OBRA annual compensation limit increases as illustrated in Exhibit II.

77 Section § 410(a)(3)(A) generally defines “year of service” as a 12-month period during which the employee does not have less than 1000 hours of service (as determined under Department of Labor regulations). I.R.C. § 410(a)(3)(A) (1988).
individual currently having twenty years of service will have a protected benefit amount of approximately $65,767 and will not be entitled to additional retirement benefits under the pension plan until completing a year of service in the year 2001. A highly compensated individual currently having thirty years of service will have a protected benefit amount of approximately $98,651 and will not be entitled to additional retirement benefits under the pension plan until completing a year of service in the year 2002.

EXHIBIT V
$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—
LOST BENEFITS EXAMPLE—DEFINED BENEFIT—
CURRENT BENEFITS

Assumptions:
Base Salary — Exceeds Compensation Limit Each Year
Annual Accrual Rate — 1.5% of Final 5-Year Average Compensation

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* Assumes 3% Annual Increase to Compensation Limit
** Assumes That Plan Provides No Maximum on Credited Service

C. Cash or Deferred Arrangements ("CODAs")

Qualified cash or deferred arrangements, also referred to as Section 401(k) plans, are subject to special nondiscrimination tests\(^78\) that permit highly compensated individuals to have a

\(^{78}\) See Michael W. Melton, Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective, 71 B.U. L. Rev. 47, 51 (1991). Nondiscrimination tests are the Internal Revenue Code's principle means of providing retirement benefits for lower and middle-income employees. Id. "These rules deny tax-favored status to plans that discriminate in favor of officers, shareholders, and highly compensated employees—referred to collectively as the prohibited group." Id. It is recognized that the current tax system is ill-equipped to provide for those with low or moderate incomes, especially since the higher a taxpayer's income is, the greater the benefits of favorable tax treatment. Employee Contributions to I.R.A.s and other Pension Plans:
higher percentage of their compensation allocated to a trust on their behalf than "nonhighly compensated employees." Under the Actual Deferral Percentage ("ADP") test, for example, pre-tax elective contributions may be allocated to the group of highly compensated employees, provided that the average percentage of total CODA contributions for the group (determined as a percentage of compensation up to the annual compensation limit) does not exceed the average percentage of total CODA contributions allocated to the nonhighly compensated employee group by the greater of 125% or two percentage points. Moreover, this is limited to 200% of the ADP for the nonhighly compensated employee group.

Contributions subject to the CODA generally include pre-tax elective contributions, qualified matching contributions ("QMCs"), and qualified nonelective contributions ("QNECs").

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Hearing on S.75, S.94, S.209 and S.557 Before the Subcomm. on Private Pension Plans and Employee Fringe Benefits of the Senate Comm. on Finance, 96th Cong., 1st Sess. 112, 124 (1979) (statement by Daniel I. Halpern, Deputy Assistant Secretary of the Treasury). Unfortunately, lower and middle-income employees are unlikely to take advantage of personal tax incentives such as tax deductions on savings used for IRAs. Daniel Halperin, Cash or Deferred Profit-Sharing Plans and Cafeteria Plans, 41 N.Y.U. Inst. on Fed. Tax'n § 39.02 at 39-3 (1983). In order to encourage employers to include lower and middle-income employees, therefore, employers are offered tax incentives. Melton, supra note 78, at 66. Fundamentally, such rules operate in two steps: first, a certain percentage of employees must participate in the plan; and second, employer contributions or benefit accruals cannot favor highly compensated employees. Id. at 67.

A qualified CODA is "any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of I.R.C. § 401(a)." I.R.C. § 401(k)(2) (1988). Additionally, the arrangement must allow a covered employee to elect to have the employer make non-forfeitable contributions to the trust under the plan on the employee's behalf, or directly to the employee in the form of cash. Id. § 401(k)(2)(A).

A similar non-discrimination test (referred to as the average contribution percentage or "ACP" test) separately applies to employee after-tax contributions and to employer matching contributions made outside of the CODA.

Matching contributions are generally defined as any employer contribution (including discretionary contributions) to a defined-contribution plan on account of an employee after-tax contribution or an employee pre-tax contribution to a plan maintained by the employer and any forfeitures allocated under a defined-contribution plan on the basis of employee after-tax or pre-tax contributions or matching contributions. See Treas. Reg. §§ 1.401(k)-1(g)(9) (as amended in 1993), 1.401(m)-1(f)(12) (as amended in 1992). Qualified matching contributions are defined as matching contributions that are non-forfeitable when made and satisfy special distribution requirements applicable to CODAs under I.R.C. § 401(k)(2)(B). See Treas. Reg. § 1.401(k)-1(g)(13) (amended 1993).

Non-elective contributions are generally defined as "employer contributions (other than matching contributions) with respect to which the employee may not elect
QNECs and QMCs include contributions made by the employer that, under the terms of the plan, are nonforfeitable and subject to special distribution requirements. To the extent that the ADP test is not satisfied, additional QNECs or QMCs may be contributed to the plan and allocated under the CODA to non-highly compensated employee participants. Alternatively, pre-tax elective contributions, QNECs, or QMCs may be "recharacterized" as after-tax contributions or returned to highly compensated employees. If contributions are to be returned, the Treasury Regulations require the CODA to follow a "leveling approach" under which pre-tax elective contributions are first returned to highly compensated employees having the highest ADP. This leveling approach apparently results in the return of contributions to the lower paid highly compensated employees (who may or may not be highly compensated individuals for purposes of this Article).

A separate restriction on the CODA is the annual limit on the amount of an individual's pre-tax elective contributions under the CODA. For taxable years beginning in 1994, the amount of pre-tax elective contributions for a highly compensated individual to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan. qualified non-elective contributions are defined as employer contributions (other than employee pre-tax contributions and matching contributions) that are non-forfeitable when made and satisfy special distribution requirements applicable to CODAs under code § 401(k)(2)(B). See Treas. Reg. § 1.401(k)-1(g)(13)(ii) (amended 1993). I.R.C. § 401(k)(2)(B) (1988). This section provides that amounts held under a qualified CODA which are attributable to employer contributions made pursuant to the employee's election may not be distributable to participants or beneficiaries earlier than (i) separation from service, death or disability, (ii) an event described in I.R.C. § 401(k)(10), which includes the termination of the plan, the disposition of a subsidiary or substantially all of the assets of a trade or business, (iii) attainment of age 59 1/2 in the case of a profit-sharing or stock bonus plan, or (iv) in the case of employee pre-tax contributions to a profit-sharing or stock bonus plan, the event of employee hardship. Id.

The amount of excess contributions to be recharacterized as after-tax contributions or returned to the highly compensated employee cannot exceed the amount of elective contributions made on behalf of such employee for the plan year. Treas. Reg. § 1.401(k)-1(f)(2) (as amended in 1993). To the extent that these "excess contributions" are returned to highly compensated employees after two and one-half months following the end of the plan year, a 10% non-deductible excise tax will be imposed on the employer. See I.R.C. § 4979 (1988). If all excess contributions are not returned to highly compensated employees by the end of the plan year following the contribution, the CODA will become non-qualified. Id. I.R.C. § 401(k)(8).


QUALIFIED RETIREMENT PLANS

may not exceed $9240.\textsuperscript{88} Under current guidance, it is unclear whether the amount of pre-tax elective contributions must be made from the first $150,000 paid to a highly compensated individual, or if it may be made ratably over the year.\textsuperscript{89} In any event, limiting annual compensation to $150,000 may affect the percentages computed under the ADP test. For instance, a highly compensated individual’s ADP resulting from a maximum pre-tax elective contribution of $9500 could increase in 1994 (based on the annual compensation limit) from 3.92% to 6.16%.

Whether a highly compensated individual will be able to continue to make at least the same amount of pre-tax elective contributions as he or she made in 1993 will depend upon the outcome of the ADP test—which will be affected by the level of pre-tax elective contributions made by other participants of the CODA.\textsuperscript{90} As a general principle, the reduced annual compensation limit may make the ADP test more difficult for CODAs to pass. Employers maintaining CODAs that experienced difficulty passing the ADP test in pre-OBRA years, or that passed ADP by a relatively small margin, may now need to impose restrictions on the amount of pre-tax elective contributions that highly compensated individuals, or at least certain highly compensated individuals, may contribute to the CODA. Generally, since the ADP for the highly compensated and nonhighly compensated employee groups will not be determined until close to the end of the year, or shortly thereafter, it may be difficult for employers to “lift” such restric-

\textsuperscript{88} Id. § 402(g)(1) and (5). The $7000 annual limit on pre-tax elective contributions is adjusted each year for cost-of-living at the same time and in the same manner as under Code section 415(d). The adjusted limit is $9240 for 1994. Effective for 1995 and later taxable years, the $7000 annual limit will be adjusted only in increments of $500. Uruguay Round Agreements Act, Pub. L. No. 103-465, § 732, 108 Stat. 4809, 5004-05 (1994). As a result, the annual limit for 1995 will remain $9240. Note that pre-tax elective contributions to a § 403(b) tax sheltered annuity are subject to a separate annual limit of $9500. Id. § 402(g)(4). When the $7000 annual limit reaches $9500, both limits will be adjusted in the same manner.

\textsuperscript{89} See id. § 401(a)(17) (setting compensation limit at $150,000). Treasury Regulation § 1.401(a)(17)-1(a)(1) (amended 1994) provides that “a plan may not base allocations, in the case of a defined contribution plan . . . on compensation in excess of the annual compensation limit.” Arguably, this regulation could be interpreted to restrict pre-tax elective contributions to the first $150,000 of compensation paid to a highly compensated individual. However, such an interpretation would be contrary to the legislative intent. First, it would appear not to further the policy underlying I.R.C. § 401(a)(17). Second, it would treat similarly situated highly compensated individuals differently. For example, a partner is typically deemed to receive his distributive share of partnership earnings on the last day of the partnership year.

\textsuperscript{90} See supra notes 78 to 86 and accompanying text (discussing contributions).
tions early enough in the year for highly compensated individuals to contribute their desired amount of pre-tax elective contributions.

Exhibits VI and VII below,\textsuperscript{91} illustrate how the post-OBRA annual compensation limit will affect highly compensated individuals differently, depending upon the actual operation of the CODA. As Exhibit VI demonstrates, this illustrative CODA would pass the nondiscrimination test for the 1993 plan year, since the average ADP for the highly compensated employees (5.69\%) was not more than two percentage points greater than the average ADP for the nonhighly compensated employees (4.0\%).\textsuperscript{92}

\textbf{EXHIBIT VI}

\textit{$150,000$ LIMIT ON RETIREMENT PLAN COMPENSATION—LOST BENEFITS EXAMPLE—401(k) PLAN}

\begin{center}
\begin{tabular}{l|c|c|c|c|c}
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\textbf{Category} & \textbf{Employee \#} & \textbf{Average Pay} & \textbf{ADP-1993} & \textbf{ADP-1994*} \\
& & & \textbf{HCEs} & \textbf{NHCEs} & \textbf{HCEs} & \textbf{NHCEs} \\
\hline
NHCEs & 200 & $25,000$ & 4.0\% & & 4.0\% & \;
\hline
HCEs & 30 & $75,000$ & 6.0\% & 6.0\% & & \\
HCIs & 5 & $250,000$ & 3.8\% & & 6.0\% & \\
\hline
Total & 235 & $36,170$ & 5.69\% & 4.0\% & 6.0\% & 4.0\% \\
\hline
ADP Test & & & Pass & Pass & \\
\hline
\end{tabular}
\end{center}

\textit{Assumptions:}

\begin{itemize}
\item No Qualified Non-Elective or Matching Contributions
\item 1993 Limit on Elective Deferrals = $8994
\item 1993 Limit on Compensation = $235,840
\end{itemize}

\textsuperscript{*} Based on 1993 contributions

Assuming that the highly compensated employees maintain their 1993 level of pre-tax elective contributions in 1994, the post-OBRA annual compensation limit will affect the ADP tests, but

\textsuperscript{91} For simplicity, the CODAs illustrated do not include any matching contributions or QNECS. Both Exhibits consider a qualified plan census of 235 employees, compromised of 200 nonhighly compensated employees ("NHCEs") and thirty-five highly compensated employees ("HCEs"), of which five are also highly compensated individuals ("HCIs").

Under Exhibit VI, the HCIs are assumed to contribute the maximum allowable pre-tax elective contribution for 1993 of $8994 with their ADP being 3.8\%. The ADPs for the NHCEs and HCEs are arbitrarily set at 4.0\% and 6.0\%, respectively.

Under Exhibit VII, all of the HCEs are assumed to contribute the maximum allowable pre-tax contribution for 1993 of $8994 and their average ADP is 10.8\%. The average ADP for the NHCEs is assumed to be 8.7\%.

\textsuperscript{92} See \textit{supra} note 80 and accompanying text (discussing ADP test requirements); \textit{see also supra} note 78 (discussing nondiscrimination tests in general).
QUALIFIED RETIREMENT PLANS

may not cause the CODA to fail. The ADP calculated solely for the highly compensated individuals increases from 3.8% ($8994/$235,840) to 6.0% ($8994/$150,000). For the 1994 plan year, the CODA would just pass the nondiscrimination test based on the average ADP for the highly compensated employees, which is 6.0%, since it is not more than two percentage points greater than the average ADP for the nonhighly compensated employees, which is 4.0%. If, however, the highly compensated individuals desire to make pre-tax elective contributions up to the 1994 limit of $9240, their revised ADP of 6.2% ($9240/$150,000) would cause the CODA to fail the nondiscrimination test, since it is 0.2% greater than the two percentage points allowed.

As Exhibit VII demonstrates, this illustrative CODA would pass the nondiscrimination test for the 1993 plan year based on the average ADP for the highly compensated employees of 10.8%, since that is not more than 125% greater than the average ADP for the nonhighly compensated employees of 8.7%.

Assuming that the highly compensated employees maintain their 1993 level of pre-tax elective contributions in 1994, the post-OBRA annual compensation limit may affect the ADP test and cause the CODA to fail. The ADP, calculated solely for the highly compensated individuals, increases from 3.8% ($8994/$235,840) to 6.0% ($8994/$150,000). For the 1994 plan year, the CODA would fail the nondiscrimination test, since the average ADP for the highly compensated employees of 11.14% is more than two percentage points and more than 125% greater than the average ADP for the nonhighly compensated employees of 8.7%. In order for this CODA to pass the nondiscrimination tests, either additional contributions must be made on behalf of nonhighly compensated employees under the CODA so that the average ADP for the nonhighly compensated employees increases to approximately 8.91% (in order to pass the 125% test), or contributions must be returned to the highly compensated employees so that the average ADP for the highly compensated employees is reduced to 10.875% (in order to pass the 125% test).93

If contributions are returned to the highly compensated employees, the regulations require that the contributions be first returned to those having the highest ADP.94 At the point that the amount of contributions returned causes the highly compensated

employees' ADP to equal the next highest ADP, contributions are returned to those highly compensated employees having the highest ADP. This "leveling process" continues until the average ADP for the highly compensated employees reaches the required level. Under the illustrated CODA, contributions would be returned to the highly compensated employees having the highest ADP, even though they are not the most highly compensated.

**EXHIBIT VII**

**$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—LOST BENEFITS EXAMPLE—401(k) PLAN**

Assumptions:
- No Qualified Non-Elective or Matching Contributions
- 1993 Limit on Elective Deferrals = $8,994
- 1993 Limit on Compensation = $235,840

<table>
<thead>
<tr>
<th>Category</th>
<th>Employee #</th>
<th>Average Pay</th>
<th>ADP-1993</th>
<th>ADP-1994**</th>
</tr>
</thead>
<tbody>
<tr>
<td>NHCEs</td>
<td>200</td>
<td>$25,000</td>
<td>HCEs</td>
<td>NHCEs</td>
</tr>
<tr>
<td>HCEs</td>
<td>30</td>
<td>$75,000</td>
<td>12.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>HCEs</td>
<td>5</td>
<td>$250,000</td>
<td>3.8%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Total</td>
<td>235</td>
<td>$36,170</td>
<td>10.8%</td>
<td>8.7%</td>
</tr>
</tbody>
</table>

ADP Test
- Pass
- Fail*

*Maximum HCE - ADP = 10.875%

**Based on 1993 contributions

IV. STRATEGIES TO MAXIMIZE BENEFITS UNDER THE $150,000 ANNUAL COMPENSATION LIMIT

There are a number of strategies that employers may consider to replace wholly or partially the retirement benefits that a highly compensated individual may lose as a result of the post-OBRA annual compensation limit. The obvious alternative is to increase sufficiently the amount of contributions or benefit accruals provided to nonhighly compensated employees under the qualified plan in order to allow the contributions or benefit accruals of the highly compensated individuals to remain unchanged or increase as they would have increased under the pre-OBRA annual compensation limit. Alternatively, the current compensation paid to highly compensated individuals could be increased to account for the amounts an employer would have contributed on their behalf

95 *Id.*
96 *Id.*
under the qualified plan absent the change in law. Unless the individual is paid additional amounts to offset the increased tax liability, less funds may be available for investment, resulting in only partial replacement of the lost retirement benefits.\(^9\) In most cases, however, these alternatives will prove to be too costly.

Other strategies are available to offset the effect of lost allocations or benefit accruals on the overall wealth of all or certain highly compensated individuals without substantially increasing the employer's current cost. These strategies generally include: (i) providing equity-based compensation, (ii) providing deferred compensation under a nonqualified, unfunded arrangement, (iii) allowing highly compensated individuals to participate in more than one qualified retirement plan, and (iv) altering the design of the qualified retirement plan.

**A. Equity-Based Compensation**

If appropriate, this strategy allows highly compensated individuals to accumulate greater wealth at retirement by sharing in the appreciation of the value of the employer's trade or business.\(^9\)

Generally, it is not deemed a taxable event when a nonqualified stock option ("NSO"),\(^9\) incentive stock option ("ISO"),\(^1\) or a stock appreciation right ("SAR")\(^1\) is granted to an employee.\(^1\)

At retirement, the employee could be in a position to increase available

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\(^9\) This alternative also presumes that the highly compensated individual invests the additional compensation and attributable earnings in a tax-deferred or tax-exempt investment having the same after-tax investment return as under the qualified plan.

\(^9\) Only incorporated enterprises would be in a position, however, to offer stock options and stock appreciation rights to employees. Additionally, the ultimate value of the option or SAR will depend upon the success of the employer, therefore making it unsecured.

\(^9\) See generally I.R.C. § 83(a) (1988); Treas. Reg. § 1.83-7 (1978) (stating that income realization may occur when NSO is exercised or disposed of in some other manner).

\(^1\) See generally I.R.C. §§ 421, 422 (1988) (as amended in 1990) (establishing that grant of ISO and transfer of underlying stock upon exercise of option may not result in realization of income, and that stock held for requisite holding period will give rise to capital gains upon sale or disposition).

\(^1\) See generally Treas. Reg. § 1.451-2 (amended 1979) (providing rules for constructive receipt applicable to SARs); Rev. Rul. 80-300, 1980-2 C.B. 165 (holding that "an employee who possesses [SARs] is not in constructive receipt of income by virtue of the appreciation of employer's stock").

\(^1\) Although beyond the scope of this Article, it should be noted that the impact of the alternative minimum income tax and accounting rules on ISOs or SARs may make them inappropriate as a compensation planning device in certain situations.
funds to the extent that the value of the stock underlying the option or SAR has increased. This type of arrangement can be structured so that the stock or cash due upon the exercise of the option or SAR, net of tax liability, is distributed to the highly compensated individual periodically. In this manner the availability of these funds can be timed to match benefits lost under the qualified retirement plan.\footnote{It should be noted that an employer's deduction for NSOs and SARs is deferred until the NSO or SAR is exercised and that the employer's deduction for ISOs is \textit{denied} unless there is a disqualifying disposition of the stock received for the ISO prior to the expiration of a statutory holding period. \textit{See} generally Treas. Reg. §§ 1.83-3(a)(2), -6 (1978) (providing deduction rules for NSOs) and I.R.C. §§ 421(a)(2), (b) (amended 1990) (providing deduction rules for ISOs).}

B. \textit{Supplemental Executive Retirement Plans ("SERPs")}

A SERP is a type of unfunded, nonqualified deferred compensation arrangement that typically is designed to provide benefits that for one reason or another cannot be provided under a qualified retirement plan.\footnote{Currently, many employers are taking advantage of SERPs to restore income to executive pensions. \textit{See}, e.g., \textit{Survey Finds More Employers Offer Supplemental Executive Pension Plans}, 21 Pens. & Ben. Rep. (BNA) No. 38, at 1814 (Sept. 26, 1994); \textit{see also} Alan J. Hawksley & Michael S. Melbinger, \textit{Finding the Best Compensation Plans for Key Executives}, 20 TAX’N FOR LAw. 357, 363-64 (1992) (stating that “employers wanting to provide additional compensation to valuable highly compensated employees find the SERP a useful tool.”). A SERP may be designed as a defined contribution plan or as a defined benefit plan. Because a SERP is not designed to satisfy the many qualification requirements found under I.R.C. § 401(a), however, it must be unfunded and SERP obligations must generally be unsecured in order to avoid current income tax consequences to participants. The term “unfunded” is the subject of continued debate. \textit{See}, e.g., U.S. DEp’T OF LABOR, Op. LTR. No. 91-16A, 1991 WL 60254 (Apr. 5, 1991); U.S. DEp’T OF LABOR, Op. LTR. No. 89-22A, 1989 WL 224558 (Sept. 21, 1989). The IRS and the Department of Labor have generally agreed that the setting aside of amounts in an irrevocable “grantor trust,” (a so-called “rabbi trust”) to provide a means of satisfying the SERP obligation, will not cause the SERP to be funded for purposes of ERISA and federal income taxation, provided that the employer is the grantor of the trust and that, in accordance with State law and trust provisions, the amounts held in trust remain available to the employer’s bankruptcy creditors. \textit{See} Rev. Proc. 92-64, 1992-2 C.B. 422 (providing model trust provisions to be included in rabbi trusts and required by the Internal Revenue Service for purposes of issuing private letter rulings).} A SERP can be designed to provide highly compensated individuals with retirement benefits equivalent to qualified retirement plan benefits lost due to the annual compensation limit. Generally, this type of SERP arrangement is designed to work in coordination with a qualified retirement plan. The timing of allocations, benefit accruals, and benefit distributions will be controlled by the provisions of the qualified retire-
ment plan being supplemented. If a qualified defined-contribution plan is being supplemented, the SERP could be designed to coordinate earnings with the highly compensated individual's account under the qualified plan. As discussed below, SERPs maintained by a not-for-profit employer or by a state or local government are subject to special rules which may prevent their full coordination with a qualified retirement plan.

As a general matter, any plan or arrangement that is established or maintained by an employer to defer compensation of employees until retirement or termination of employment is considered an "employee pension benefit plan" or "pension plan" within the meaning of ERISA section 3(1). A SERP that is coordinated with a qualified retirement plan will be subject to ERISA since it is likely to be established or maintained by an employer for employees and is designed to provide retirement benefits.

Unless a statutory exemption from ERISA coverage applies, such a SERP will be subject to ERISA's reporting and disclosure, participation, coverage, vesting, funding, fiduciary responsibility,

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105 The IRS has generally allowed employees to informally direct investments of deferred amounts under non-qualified deferred compensation arrangements. See, e.g., Priv. Ltr. Rul. 91-01-011 (Oct. 5 1990) (concluding that right to designate investments under plan will not effect realization of gross income timing); Priv. Ltr. Rul. 86-48-011 (Aug. 23, 1986) ("A participant can designate his or her preference for the investment of his or her deferred compensation."); Priv. Ltr. Rul 86-07-022 (Nov. 15, 1985) (stating that participants may deem amounts to be credited to "Hypothetical Investment Funds" without realization of gross income until "amounts are received or otherwise made available"); Priv. Ltr. Rul 82-15-054 (Jan. 18, 1982) ("[A] participating employee may elect . . . to defer a portion of the salary to be earned and/or all or a portion of the bonus that may be declared in the subsequent calendar year.").

106 Non-qualified deferred compensation arrangements maintained by any organization (other than a governmental unit) exempt from tax under Subtitle A of the Code are governed by I.R.C. § 457. See I.R.C. § 457(e)(1)(B) (1988).

107 Non-qualified deferred compensation arrangements maintained by a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State are governed by I.R.C. § 457. See I.R.C. § 457(e)(1)(A) (1988).

108 ERISA defines the term employer to mean "any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity." 29 U.S.C. § 1002(5) (1988).


110 29 U.S.C. § 1002(1) (1988). ERISA would not apply if deferrals could be made only for a specific period of years ending before retirement or termination of employment. ERISA mandates that the fund or program "provides retirement income" and "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." 29 U.S.C. § 1002(2)(A) (1988).
and enforcement provisions.\textsuperscript{111} If ERISA requires a SERP to be funded, and the SERP is in fact funded, an individual covered under the SERP would realize income each year in the amount of the increase in present value of his or her accrued benefit under the SERP, to the extent the individual's rights in the SERP benefit are "substantially vested."\textsuperscript{112} Typically, SERP benefits will become substantially vested, i.e., nonforfeitable,\textsuperscript{113} in accordance with the vesting provisions under the qualified retirement plan.\textsuperscript{114}

Three complete exemptions from ERISA are available. Governmental plans,\textsuperscript{115} church plans,\textsuperscript{116} and unfunded excess benefit plans\textsuperscript{117} are exempt from title I of ERISA.\textsuperscript{118} In addition to these complete exemptions from title I, an unfunded plan maintained by an employer primarily to provide deferred compensation to a select group of management or highly compensated employees (a


\textsuperscript{113} Treas. Reg. § 1.83-3(b), -3(c)(1) (1985). The Treasury Regulations state that property is substantially vested "when it is either transferable or not subject to a substantial risk of forfeiture" and, that a "substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance . . . of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied." Id.


\textsuperscript{115} A "governmental plan" generally means a plan established and maintained for its employees by the government of the United States, by the government of any State or political subdivision of any State, or by an agency or instrumentality of the United States, a State, or political subdivision of a State. 29 U.S.C. § 1002(32) (1988).

\textsuperscript{116} A "church plan" generally means a plan established and maintained for its employees by a church or by a convention or association of churches that is tax-exempt under Internal Revenue Code § 501. 29 U.S.C. § 1002(33) (1988)(amended 1989). If certain requirements are satisfied, plans maintained by tax-exempt entities controlled by a church or by a convention or association of churches may also constitute a "church plan." 29 U.S.C. § 1002(33)(c) (1988). Generally, a pension plan or welfare plan maintained by a tax-exempt entity which is controlled by or associated (i.e., shares common religious bonds or convictions) with a church or convention or association of churches for its employees will constitute a "church plan" if it is administered by a committee that is controlled by or associated with a church or convention or association of churches. Id.

\textsuperscript{117} An "excess benefit plan" is a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed on tax-qualified retirement plans under I.R.C. § 415. 29 U.S.C. § 1002(36) (1988).

“top-hat plan”) is exempt from ERISA’s funding, participation, vesting, and fiduciary requirements.\textsuperscript{119} Top-hat plans remain subject to ERISA’s reporting and disclosure requirements and relevant administrative and enforcement provisions. However, top-hat deferred compensation plans are generally exempt from ERISA’s reporting and disclosure requirements if the employer notifies the Department of Labor (“DOL”) that it maintains such a top-hat plan within the 120-day period commencing on the date the plan first becomes subject to ERISA.\textsuperscript{120}

A SERP that is designed to replace retirement benefits lost under a qualified retirement plan as a result of the annual compensation limit under IRC section 401(a)(17)\textsuperscript{121} does not satisfy the requirements for excess benefit plans.\textsuperscript{122} Therefore, only SERPs that are maintained by a government entity, church, or church-controlled tax-exempt entity are completely exempt from title I of ERISA.\textsuperscript{123} Furthermore, SERPs that are established or maintained by other employers must be designed as top-hat plans—unfunded and restricted to a select group of management or highly compensated employees—in order to avoid ERISA’s funding requirement.\textsuperscript{124}

Both ERISA and the DOL regulations fail to define the term “unfunded,”\textsuperscript{125} or provide guidance for interpreting the phrase “primarily for the purpose of providing deferred compensation to a

\begin{footnotes}
\item[119] 29 U.S.C. §§ 1081(a)(3), 1031(2), 1101(a)(1) (1988); see, e.g., Hollingshead, 747 F. Supp. at 1429. In U.S. Dep’t of Labor, Op. Ltrs. No. 90-14A, 1990 WL 123933 (May 8, 1990), the DOL indicated that it interpreted the word “primarily” as modifying the phrase “for the purpose of providing deferred compensation” and not the phrase “select group.” Under this interpretation, the inclusion of even a single non-management or nonhighly compensated employee may cause the SERP not to qualify as a top-hat plan. See Belka v. Rowe Furniture Corp., 571 F. Supp. 1249, 1252-53 (D. Md. 1983); infra notes 132-36 and accompanying text (discussing Belka decision).
\item[120] 29 C.F.R. § 2520.104-23 (1990).
\item[121] I.R.C. § 401(a)(17)(A) (Supp. V 1993). “A trust shall not constitute a qualified trust under this section unless, under the plan of which such trust is a part, the annual compensation of each employee taken into account under the plan for any year does not exceed $150,000.” Id.
\item[122] See supra note 117 (discussing excess benefit plans).
\item[124] See supra note 119 and accompanying text.
\end{footnotes}
select group of management or highly compensated employees.” Ultimately, whether a SERP that benefits only highly compensated individuals, that is, those individuals earning at least $150,000 in 1994, covers “primarily a select group of management or highly compensated employees” is a question of fact which must consider the employer’s specific circumstances.

In a 1990 Opinion Letter, the DOL expressed its view that exemptions were made to most ERISA title I requirements for top-hat plans because Congress deemed it unnecessary to protect the interests of the highly paid employees and executives who negotiated additional, nonqualified arrangements with their employers. The DOL has also indicated that it interprets “select group” as modifying only the phrase “management” and not “highly compensated employee.” Further, Treasury Department officials have indicated that the Code section 414(g) definition of “highly compensated employee” for qualified retirement plan purposes should not be relied upon, as it is overly broad for purposes of satisfying the policy goals underlying top-hat plans.

126 Belka, 571 F. Supp. at 1252-53; see Randolph M. Goodman & Laura E. Stone, Exempt Compensation Arrangements Under ERISA, 28 Cath. U. L. Rev. 445, 463-64 (1979) (suggesting tests to be used to determine whether group is composed of highly paid or management employees).


128 On April 22, 1992, the United States Department of Labor (“DOL”) announced that it had withdrawn proposed regulations providing guidance on top-hat plans. See 19 Pens. Rep. 90-14A, 1990 WL 123933 (May 8, 1990). Regulations have not yet been proposed. The DOL has informally stated that previously issued and outstanding Advisory Opinions may not be followed in regulations, when issued. See, e.g., U.S. DEP’T OF LABOR, OP. LTR. NO. 76-100, 1976 WL 6125 (Nov. 15, 1976); U.S. DEP’T OF LABOR, OP. LTR. NO. 75-48, 1975 WL 4590 (Dec. 23, 1975) (discussing possibility that published regulations may “adversely affect the conclusion”); see also ERISA Proc. 76-1, 41 Fed. Reg. 36,281 (1979) (indicating DOL would no longer rule on whether employees are highly compensated because such determination is a question of fact).

The Department ordinarily will not issue advisory opinions on the form or effect in operation of a plan, fund or program (or a particular provision or provisions thereof) subject to Title I of the Act. For example, the Department will not issue an advisory opinion on whether a plan satisfies the requirements of Part 2 and 3 of Title I of the Act.

Id.

129 See 17 TAX MGMT. COMPENSATION PLAN. J. 81 (April 7, 1989).

130 Cf. Treas. Reg. § 1.414(q)-1T pmbl. (1993) (“The definitions and rules provided in these questions and answers are provided solely for purposes of determining the groups of highly compensated employees.”). The Code would generally define “highly compensated employees” for calendar year 1994 to include (1) all employees having annual compensation greater than $99,000 (indexed); (2) those employees having annual compensation greater than $66,000 (indexed) who are among the top 20% by pay; (3) officers having compensation greater than $59,400 (indexed); and (4) more-
In a 1985 Opinion Letter, the DOL ruled that an unfunded pension plan designed to cover employees on the "executive payroll" was not maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees under ERISA. The executive payroll covered 50 of 750 employees, or 6.6% of the total work force, and represented a broad range of personnel, including past presidents, a chairman of the board, cost accountants, comptrollers, a foreman, a superintendent, an assistant in the cost department, an order department clerk, an expediter, a stepmaster inventory control worker, and an insurer. Although the covered group represented more highly paid individuals when compared to employees excluded from coverage, the Opinion indicated that the DOL considered the intended coverage too broad.

In Belka v. Rowe Furniture Corp., the district court held a nonqualified deferred compensation arrangement to be unfunded and "maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees," where agreements covered seventy-three present and former employees, constituting at most 4.6% of the employer's work force during any single year. The court's analysis compared covered employees to total employees and relied on the fact that (i) the average compensation level of covered employees was more than three times the average compensation of noncovered employees, and (ii) that specific individuals having compensation below this three-to-one ratio were in management level positions. Although some covered participants were not both highly compensated and management level employees, the court
held that the arrangement was a top-hat plan, reasoning that the exemption was for plans that are "'primarily' designed for those individuals who are either management or highly compensated."\textsuperscript{136}

1. Not-For-Profit and State and Local Government Employers

SERPs that are maintained by a not-for-profit organization or by a state or local government are subject to special rules under IRC section 457 that may make it difficult for lost qualified plan benefits to be replaced. For these employers, the annual increase in the value of SERP benefits (determined on a present value basis) provided to highly compensated individuals must be limited under the SERP to $7500; otherwise the full value of the SERP benefit and increases thereon will be includible in the individual's income in the first year that there is no substantial risk of forfeiture of the right to receive such amounts.\textsuperscript{137} Furthermore, a SERP designed for a not-for-profit or state or local government employer also must be unfunded\textsuperscript{138} and satisfy statutory distribution requirements\textsuperscript{139} in order for SERP benefits to be includible in income when received, rather than when there is no substantial risk of forfeiture.

2. Cash or Deferred Arrangements (401(k))

Essentially, a "401(k) plan SERP" refers to any nonqualified deferred compensation arrangement that mirrors the provisions of a CODA,\textsuperscript{140} because it either provides for elective contributions that can be invested as if made to the CODA, or it replaces benefits lost under the CODA.\textsuperscript{141} The latter type of SERP is generally designed to replace pre-tax elective contributions, nonelective con-

\textsuperscript{136} Belka, 571 F. Supp. at 1252 (emphasis added); see Pane v. RCA Corp., 868 F.2d 631 (3rd Cir. 1989) (finding "select group" where 61 management employees out of 80,000 persons were recipients of severance compensation).

\textsuperscript{137} See generally I.R.C. § 457(b), (f) (1988). Under I.R.C. § 457(f)(3)(B), the rights of a person to compensation are considered subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the future performance of substantial services by any individual. Note that the $7500 limit is coordinated with deferrals under other § 457 arrangements, pre-tax elective contributions under a CODA (whether part of qualified plan or SEP), and with contributions made by or on behalf of the individual to a § 403(b) annuity. I.R.C. § 457(c)(2) (1988).

\textsuperscript{138} I.R.C. § 457(b)(6) (1993); see Belka, 571 F.Supp. at 1251 (equating unfunded with payment of benefits out of employer's general assets).

\textsuperscript{139} I.R.C. § 457(b)(5) (1993); see id. § 457(d) (1988).


\textsuperscript{141} Id.
tributions (including QNECs), and matching contributions (including QMCs) that are lost or that must be returned to the highly compensated individual because of either the ADP or ACP nondiscrimination tests or the $150,000 annual compensation limit.

The design of such a SERP raises some technical concerns. For example, it is unclear whether amounts that are being returned from the CODA can be deferred under a nonqualified arrangement. Further, Internal Revenue Service ("IRS") representatives have raised concerns regarding a recent private letter ruling which most practitioners had thought would pave the way for these plans. In the private letter ruling, the IRS approved an arrangement in which employees could first defer compensation under a nonqualified deferred compensation arrangement and subsequently, within two-and-a-half months after the end of the year, have those deferrals contributed to a 401(k) plan by virtue of a second election. This arrangement was intended to keep the highly compensated individual whole by maximizing the individual's ADP under the CODA, with the balance of the deferral remaining under the nonqualified arrangement. This private letter ruling has since been revoked by the IRS.

It may be possible to resolve the above concerns simply by making a portion of a highly compensated individual's CODA contributions from amounts withheld from his or her final paycheck. Such contributions would be made to the CODA after the end of the year (and after the ADP tests have been performed) to the extent permissible under the ADP tests.

C. Using Multiple Qualified Retirement Plans

Generally, an employer can sponsor as many qualified retirement plans for its employees as it chooses, and can cover individual employees in more than one plan as long as each plan satisfies the applicable requirements for plan qualification. Further, if

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142 The IRS position appears to be that I.R.C. § 402(e)(3) provides the exclusive exception to an employee's constructive receipt of elective contributions to a CODA, even though a valid deferral election is made prior to the year the "excess contribution" is contributed to the CODA. See Treas. Reg. § 1.402(a)-1(d) (amended 1992).


145 Employers are provided with some latitude in testing their retirement plans separately, in combination with one or more other plans, or on a component basis.
the minimum participation, minimum coverage, and nondiscrimi-
natory benefit provisions under IRC sections 401(a)(26), 410(b),
and 401(a)(4), respectively, are satisfied by the “single” plan,\textsuperscript{146} a
highly compensated individual may participate in more than one
such plan and receive aggregate contributions and benefit accru-
als up to the applicable limitation under IRC section 415.\textsuperscript{147}

Contributions or benefits under each separate plan may be
based on the same compensation paid by the employer.\textsuperscript{148} Since
the annual compensation limit applies separately to each qualified
retirement plan of an employer, it is possible for a highly compen-
sated individual to earn contributions or benefits under more than
one plan.\textsuperscript{149} Accordingly, if an employer sponsors more than one

\textsuperscript{146} Treas. Reg. § 1.401(a)(4)-1(c)(4) (1993), 1.401(a)(26)-2(c) (1991), 1.410(b)-7(a)
(amended 1993). Treas. Reg. § 1.414(l)-1(b)(1) defines a “single plan” as follows:
A plan is a “single plan” if and only if, on an ongoing basis, all of the plan
assets are available to pay benefits to employees who are covered by the plan
and their beneficiaries. For purposes of the preceding sentence, all the as-
sets of a plan will not fail to be available to provide all the benefits of a plan
merely because the plan is funded in part or in whole with allocated insur-
ance instruments. A plan will not fail to be a single plan merely because of
the following: (i) The plan has several distinct benefit structures which apply
either to the same or different participants, (ii) The plan has several plan
documents, (iii) Several employers, whether or not affiliated, contribute to
the plan, (iv) The assets of the plan are invested in several trusts or annuity
contracts, or (v) Separate accounting is maintained for purposes of cost allo-
cation but not for purposes of providing benefits under the plan. However,
more than one plan will exist if a portion of the plan assets is not available to
pay some of the benefits. This will be so even if each plan has the same
benefit structure or plan document, or if all or part of the assets are invested
in one trust with separate accounting with respect to each plan.
Thus, two or more seemingly discrete and separate plans, or an amalgamation of sev-
eral independent plans may be deemed a “single plan.”

\textsuperscript{147} See generally I.R.C. § 415 (1988). I.R.C. § 415(b) limits annual benefits pro-
vided under a defined-benefit plan to the lesser of $90,000 or 100% of the participant’s
high-three-year average compensation. I.R.C. § 415(c) limits annual additions under
a defined-contribution plan to the lesser of $30,000 (or, if greater, one-fourth of the
dollar limitation in effect for defined-benefit plans) or 25% of the participant’s com-
pensation. I.R.C. § 415(e) defines additional limitations for individuals participating
in both a defined-benefit plan and a defined-contribution plan.


\textsuperscript{149} Treas. Reg. §§ 1.401(a)(17)-1(a), -1(c)(3) (amended 1994).
qualified retirement plan, it is possible to cover selected highly
compensated individuals under multiple plans while other em-
ployees are covered under a single plan. As long as uniform
benefits were provided under each plan, nondiscrimination testing
performed for the plan would be satisfied.

By applying these principles to an existing qualified retire-
ment plan, an employer can either duplicate the pre-OBRA bene-
fits or provide even higher benefits to highly compensated individ-
uals by dividing the plan into two or more separate plans. Each
plan would contain identical provisions and require identical
levels of contributions or benefit accrual. Simply by dividing the
nonhighly compensated employees and those highly compensated
employees earning less than the annual compensation limit into
two equally sized groups, and allowing each group to participate
in only one plan, a significant number of highly compensated indi-
viduals could be eligible to participate in both plans. Since each
plan would provide the same benefit or allocation formula as the
existing plan, these highly compensated individuals would earn
twice the annual benefit they would otherwise have earned if they
had participated in only one plan. If two plans are maintained,
employers could apply the existing benefit formula to an amount
of up to $300,000 of compensation, double the annual compensa-
tion limit for 1994. The benefit formula under each plan could be
designed to ensure that highly compensated individuals retain the
same level of benefits under the combination of plans that they
had under the single plan prior to OBRA.

Exhibits VIII and IX illustrate a very simple implementation
of the multiple plan approach. In Exhibit VIII, the employer spon-
sors a money purchase pension plan for all of its employees, to
which it contributes six percent of each employee's pay not in ex-
cess of the annual compensation limit set by OBRA. In 1993, the
employer contributed $505,750 to the plan, with approximately
$70,750 [($235,840 x 5 employees) x 6%] of this contribution allo-
cated to the highly compensated individuals. In 1994, the highly
compensated individuals would receive an allocation of only

150 The cost of sponsoring an additional qualified retirement plan would include
costs of filing the Form 5500, incurring an additional audit (if the plan covers more
than 100 participants), and additional plan administration expenses including record
keeping and actuarial services.

$45,000 [($150,000 \times 5 \text{ employees}) \times 6\%], and the employer’s required contribution would drop to $480,000.

EXHIBIT VIII
$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—MULTIPLE PLANS EXAMPLE 1

Assumptions:
Single Defined Contribution Plan
Formula — 6% of Pay Up to Compensation CAP

<table>
<thead>
<tr>
<th>Category</th>
<th>Employee #</th>
<th>Average Pay</th>
<th>1993</th>
<th>1994</th>
</tr>
</thead>
<tbody>
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<td>NHCEs</td>
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<td>$25,000</td>
<td>$300,000</td>
<td>$300,000</td>
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<tr>
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<tr>
<td>HCIs</td>
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<td>$70,750</td>
<td>$45,000</td>
</tr>
<tr>
<td>Total</td>
<td>235</td>
<td>$36,170</td>
<td>$505,750</td>
<td>$480,000</td>
</tr>
</tbody>
</table>

Rather than cutting back on contributions for the highly compensated individuals or increasing benefits for other employees, in 1994 an employer could duplicate the benefits received in the 1993 plan year by replacing the single money purchase plan with two “mirror image” money purchase plans. Exhibit IX illustrates the effect of dividing the plan described in Exhibit VIII into two “mirror image” plans, Plan A and Plan B. Plan A covers one-half of the nonhighly compensated employees, one-half of the highly compensated employees, and all of the highly compensated individuals. Plan B covers both the remaining nonhighly and highly compensated employees and all of the highly compensated individuals. The creation of two plans allows the employer to provide highly compensated individuals with dual coverage.

Plan A’s contribution and allocation formula is modified to provide for a contribution and allocation of six percent of each participant’s pay, up to $150,000. This is limited to a dollar amount determined as one-half of the contribution that would have been made for the participant had the compensation limitation remained at $235,840, the indexed pre-OBRA annual compensation limit. Plan B provides the same contribution and allocation formula. Under the combination of Plan A and Plan B, the employer’s 1994 contribution matches the 1993 contribution of $505,750, and the 1994 allocation to highly compensated individuals matches the 1993 allocation of $70,750.

In Exhibit IX, Plan A and Plan B each satisfy the minimum coverage requirements of IRC section 410(b)(1)(A) by applying the
QUALIFIED RETIREMENT PLANS

70% ratio-percentage test as follows: Plan A covers 50% of the nonhighly compensated employees (100/200) and 57% of the highly compensated employees and highly compensated individuals combined (20/35). The ratio-percentage test is satisfied because 50% divided by 57% is greater than 70%. Plan B satisfies minimum coverage in the same manner.\textsuperscript{152} Both plans also satisfy the section 401(a)(4) nondiscrimination requirements because they fall within the safe harbor provision for plans having a uniform allocation formula.\textsuperscript{153}

**EXHIBIT IX**

$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION — MULTIPLE PLANS EXAMPLE 2

Assumptions:
Two Defined Contribution Plans
Formula — 6% of Pay Up to Compensation CAP Limited for HCIs to
50% of Contribution Based on Plan Compensation Up to $235,840

<table>
<thead>
<tr>
<th>Category</th>
<th>Plan</th>
<th>Employee #</th>
<th>Average Pay</th>
<th>1994 Contribution</th>
</tr>
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<td>HCIs</td>
<td>A&amp;B</td>
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<td>Total</td>
<td></td>
<td>235</td>
<td>$36,170</td>
<td>$505,750</td>
</tr>
</tbody>
</table>

Since the multiple plan approach anticipates dividing employees among two or more plans, it may be better suited for employers having natural work force distinctions\textsuperscript{154}—including law firms

\textsuperscript{152} If all NHCEs and HCEs are benefiting under a plan and NHCEs are divided equally between two “mirror image” plans, then up to 42.8% of the HCEs may be covered under both plans. Each plan would then cover 50% of the NHCEs and 71.4% of the HCEs (42.8% of HCEs having dual coverage plus one-half of the remaining 57.2%). The ratio-percentage test would be satisfied under each plan because 50% divided by 71.4% equals 70.3% which is greater than 70%.

\textsuperscript{153} Treas. Reg. § 1.401(a)(4)-2(b)(2)(i) (1993). The Regulation provides that, as a general rule, defined-contribution plans satisfy the safe harbor provision for a plan year if the plan allocates all amounts taken into account under paragraph (c)(2)(ii) for the plan year under a formula that allocates to each employee the same percentage of plan year compensation, the same dollar amount, or the same dollar amount for each uniform unit of service (not more than one week) performed by the employee during the plan year. \textit{Id.}

\textsuperscript{154} Although I.R.C. § 410(a) appears to allow eligible participants to be named where the qualified retirement plan satisfies the minimum coverage requirements by applying the ratio percentage test, Treas. Reg. § 1.410(a)-3(d) explains that I.R.C. § 410(a) does not preclude plans from establishing criteria other than age or service that must be met by plan participants. This rule has traditionally been applied by
and other professional service organizations having partners, associates, and administrative personnel, and companies having qualified plans that cover more than one division, work location, or controlled group member. The following examples illustrate potential applications of the multiple plan approach.\textsuperscript{155}

Example 1. ABC Law Firm maintains a 6% of pay profit-sharing plan for its seventy-five partners and 100 nonhighly compensated support personnel. The Firm's 200 highly compensated associates are not covered under the plan. Starting in 1994, partners earning more than $235,840 (the 1993 annual compensation limit) would lose $5150 of annual contributions if the plan was left unchanged. If, however, the plan was divided into two “mirror image” plans each covering fifty support personnel, then all the partners could participate in each plan and earn a potential aggregate benefit of twelve percent of $150,000.\textsuperscript{156}

Example 2. DEF Corporation maintains a 6% of pay profit-sharing plan that covers 500 employees in Division A, 350 employees in Division B, and DEF's executive group, which consists of seven individuals each earning more than $250,000. Assume further that approximately five percent of the employees in each Division are highly compensated. By dividing the plan into two “mirror image” plans, one covering Division A employees and one covering Division B employees, the executive group could participate in both plans and earn a potential aggregate benefit of twelve percent of $150,000.\textsuperscript{157}

Example 3. Consultant J makes the maximum deductible contribution to his profit-sharing Keogh plan each year. For 1993, his deductible contribution was $30,000 (the lesser of $30,000 or fifteen percent of earned income, limited to $235,840). Beginning plans to limit eligibility by job classification or location. The “naming names” approach to plan eligibility is prohibited only where the average benefits test applies, that is, the reasonable classification requirement. Treas. Reg. § 1.410(b)-4(b).

\textsuperscript{155} Examples 1 through 3 illustrate the application of the multiple plan approach to defined-contribution plans. This approach is also adaptable to defined-benefit plans.

\textsuperscript{156} Excluding a large number of highly compensated employees from plan coverage enables all partners to participate in both plans. As mentioned, up to 71.4% of the combined HCES and HCI group may participate in each of two multiple plans where 50% of the NHCEs participate in each plan. To the extent that eligible HCES (other than HCIs) are excluded from benefiting under the plan, the 71.4% may be comprised of only HCIs.

\textsuperscript{157} The same result would occur if DEF Corporation maintained a profit-sharing plan for employees of separate subsidiaries; if DEF Corporation and its subsidiaries are considered a single employer under I.R.C. § 414(b), eligibility and compensation would be determined on the basis of a single employer.
in 1994, Consultant J’s maximum deductible contribution drops to $22,500 (the lesser of $30,000 or fifteen percent of $150,000) unless he adopts and contributes $7500 to a money purchase pension plan.\textsuperscript{158}

D. Integration with Social Security

Generally, social security benefits are designed to provide higher benefits to lower paid employees; therefore, larger contributions must be made on behalf of lower paid employees relative to their compensation.\textsuperscript{159} Social security benefits are based on the taxable wage base ("TWB"), which for 1994 is $60,600.\textsuperscript{160} Because social security benefits discriminate in favor of lower paid employees, IRC sections 401(a)(5) and 401(l) permit a level of disparity to exist in the contributions or benefits provided to higher paid employees under a qualified retirement plan. The effect of this statutory disparity is that a plan may consider a participant’s estimated or actual social security benefits in determining whether contributions or benefits provided under the plan will be nondiscriminatory.\textsuperscript{161}

If an employer maintains a qualified retirement plan that is not integrated with Social Security, introducing a permissible level of integration may mitigate the impact of the lower $150,000 annual compensation limit by providing increased contributions or benefits on compensation in excess of the TWB. The following example illustrates the way this approach may be applied to a defined-contribution plan.

Example 4. KLM Corporation maintains a money purchase pension plan requiring an annual contribution of ten percent of compensation. Of the twenty-five employees covered under the plan, seventeen are nonhighly compensated employees, six are highly compensated employees, and two are highly compensated indi-

\textsuperscript{158} In this situation, adopting an additional profit-sharing plan would not be a solution because I.R.C. § 404(a)(3)(A)(iv) limits Consultant J to a single 15% deduction.


\textsuperscript{161} I.R.C. § 401(a)(5)(C) provides that "A plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of, or on behalf of, the employees under the plan favor highly compensated employees (as defined in section 414(q)) in the manner permitted under subsection (l)." Distinct rules apply with respect to defined contribution plans and defined benefit pension plans.
individuals. One highly compensated individual (HCI-A) earns compensation in excess of the pre-OBRA annual compensation limit, and the other highly compensated individual (HCI-B) earns approximately $165,000. HCI-A's 1993 allocation of $23,584 ($235,840 \times 10\%) will decrease to $15,000 ($150,000 \times 10\%) in 1994. If, for 1994, KLM Corporation amended the plan to provide a fully integrated contribution formula of ten percent of compensation up to the TWB and 15.7\% of compensation above the TWB, HCI-A would receive an allocation of $20,096 [($60,600 \times 10\%) + ($89,400 \times 15.7\%)].

Alternatively, if KLM Corporation amended the plan to provide a partially integrated contribution formula of ten percent of compensation up to eighty-one percent of the TWB and 15.4\% of compensation above that amount, HCI-A would receive an allocation of $20,450 [($49,086 \times 10\%) + ($100,914 \times 15.4\%)].

In Example 4 above, had the plan remained unintegrated for 1994, HCI-A would have lost $8584 of employer contributions. By integrating the plan with Social Security, the impact of the annual compensation limit is mitigated by either $5096, assuming full integration, or by $5450, assuming partial integration.\footnote{See Treas. Reg. § 1.401(l)-2(d) (amended 1993).} The amended plan could be designed to limit contributions made on behalf of any highly compensated employee to the amount of the highly compensated employee's pre-OBRA benefit, without resulting in discrimination.\footnote{I.R.C. § 401(a)(4) generally does not prohibit discrimination among highly compensated employees.} Any nonhighly compensated employees earning more than the TWB would also benefit from the incremental contribution percentage.\footnote{For 1994 the TWB is $60,600 and the minimum compensation for qualifying as an HCE is generally $66,000. See supra notes 130 and 160; see also Feller, supra note 159.}

\section*{E. Additional Strategies for Defined-Contribution Plans}

IRC section 401(a)(4) generally provides that in order for a trust that forms part of a retirement plan to be qualified (and therefore tax-exempt), either contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees. Interpreting this section, the IRS promulgated final regulations under IRC section 401(a)(4) which allow allocations under a defined-contribution plan to be tested for nondiscrimination on the basis of the projected pension benefit that the
amount allocated to a participant’s account would provide at age sixty-five. The regulations refer to this testing methodology as “cross-testing.”\textsuperscript{165} Two allocation methods in particular, “age-based”\textsuperscript{166} and “comparability” or “new comparability”\textsuperscript{167} may significantly skew allocations in favor of older, higher paid employees. Recently, the Pension Benefit Guaranty Corporation (“PBGC”) 

\textsuperscript{165}Treas. Reg. § 1.401(a)(4)-8 (as amended in 1993). Under cross-testing, annual allocations are converted to so-called “equivalent benefit accrual rates” (“EBARs”) by (i) projecting the annual allocation to the testing age using a standard interest rate in the range of 7.5% to 8.5%, (ii) converting the projected amount to a hypothetical retirement benefit using a life annuity purchase rate derived from a standard mortality table and a standard interest rate as provided in Treas. Reg. § 1.410(a)(4)-12, and (iii) expressing the hypothetical retirement benefit as a percentage of the participant’s current compensation. Each employee is then assigned to one or more “rate groups” based on their EBAR and each rate group is required to satisfy the minimum coverage requirements under I.R.C. § 410(b) as if it were a separate plan that covers only employees included in the rate group for the plan year. A rate group exists for each HCE and includes that HCE and all other HCEs and NHCEs with an EBAR at least equal to that of the HCE. Thus, an employee is in the rate group for each HCE who has an EBAR less than or equal to the employee’s EBAR. See generally, Treas. Reg. § 1.401(a)(4)-2(c)(1) (as amended in 1993).

\textsuperscript{166}See generally id. Age-based allocation methods typically weight allocations based upon a uniform measure of “points” assigned to participants for plan year compensation and either years of age or years of service. Because allocation rates are higher for older or longer-service employees, the safe harbor non-discrimination test for plans having a uniform points allocation formula will generally not be satisfied. Treas. Reg. § 1.401(a)(4)-2(b)(3) (as amended in 1993). (Treas. Reg. § 1.401(a)(4)-2(b)(3)(i)(B) requires the average allocation rate for HCEs in the plan not to exceed the average allocation rate for NHCEs in the plan). Accordingly, most age-based allocation methods rely on cross-testing to pass nondiscrimination. Typically, a table of values is derived that produces a contribution/allocation for each participant that results in a uniform EBAR at normal retirement age. As the uniform EBAR produces only a single rate group, I.R.C. § 410(b) is generally satisfied based on the 70% ratio percentage test.

\textsuperscript{167}See generally id. Comparability allocation methods aim to maximize the EBARs for HCEs by relying on the average benefits test of Code section 410(b). As participants’ EBARs are not uniform, various rate groups are produced which must each satisfy I.R.C. § 410(b). Generally, section 410(b) will be deemed satisfied if each rate group separately passes the 70% ratio test of I.R.C. § 410(b)(1)(B). See Treas. Reg. §§ 1.401(a)(4)-3(c)(2) and -2(c)(3) (as amended in 1993). Alternatively, and more likely, the plan and each rate group must pass a modified version of the Code section 410(b)(1)(C) average benefits test. Each rate group is deemed to pass the average benefits percentage test if the plan as a whole passes the average benefits percentage test — requiring the average EBAR for all the NHCEs to be at least 70% of the average EBAR for all the HCEs. In addition, each rate group must pass a modified non-discriminatory classification test requiring that the percentage of NHCEs benefiting under the rate group be greater than or equal to the lesser of (i) the midpoint between the safe and unsafe harbor percentages applicable to the plan [under Treas. Reg. § 1.410(b)-4] and (ii) the ratio percentage of the plan (i.e., the ratio of nonexcludable NHCEs to nonexcludable HCEs). See generally Treas. Reg. §§ 1.401(a)(4)-2(c)(3)(ii) and (iii) (as amended in 1993).
proposed legislation\textsuperscript{168} that, if enacted, would have prohibited defined-contribution plans other than target-benefit plans from being tested for nondiscrimination on the basis of cross-testing.\textsuperscript{169} The provision was generally understood by practitioners to have been initiated and supported by Treasury officials.\textsuperscript{170} These controversial provisions were not included in the PBGC legislation, as enacted.\textsuperscript{171}

Assuming that the only aspect of the plan that is changed is the allocation formula, Exhibit X illustrates a reallocation of a six percent compensation contribution based on the pre-OBRA annual compensation limit in 1994. The exhibit compares participant allocations based on a flat six percent formula, a fully integrated formula, an age-based formula, and a comparability formula. Assuming five hypothetical employees receiving total 1993 compensation (up to the annual compensation limit) of $460,000, the aggregate 1993 contribution would be $27,600 ($460,000 \times 6\%). Employee E would be the only highly compensated individual affected by the annual compensation limit.

Assuming that the employer contributed $27,600 to the plan in 1994 and that no changes were made to the plan's allocation formula, employee E's allocation would decrease from $13,200 to $10,615. The allocation for all other employees would increase to reflect a new allocation percentage of 7.08\%. Amending the plan's allocation formula to integrate it with Social Security results in employee E receiving an allocation of $12,169. Creating an age-based allocation formula results in employee E receiving an allocation of $19,400. Amending the plan's allocation formula so that it is age-based with comparability results in employee E receiving an allocation of $20,400.


\textsuperscript{169} The purpose behind this provision is to eliminate certain plans that are viewed as abusive by the administration — mainly age-weighted or new comparability profit-sharing plans. The effect of the legislation, however, would have been to eliminate cross-testing for non-abusive situations as well. The legislation's broad coverage spurred resentment from many employers and coalitions, which acted to work with the administration to limit the proposal to "abusive" situations. 1994 Daily Tax Rep. (BNA) 193 at d12 (Oct. 7, 1994).

\textsuperscript{170} Treasury officials reportedly stated that the proposal was prompted by media reports alleging that some employers were using such plans to provide huge tax shelters for top-paid workers, but few benefits for the rank-and-file. See 1994 Daily Tax Rep. (BNA) 47 at d6 (Mar. 11, 1994).

QUALIFIED RETIREMENT PLANS

EXHIBIT X

$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION — ALTERNATIVE ALLOCATION DESIGNS

Assumptions:
Top Heavy Defined Contribution Plan
1993 Contribution Allocated As a Percentage of Pay — $27,600

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<thead>
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<th>Age</th>
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<th>Allocation</th>
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<tr>
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* Integration Level of $60,600 and 5.7% Excess Allowance

F. Additional Strategies for Defined-Benefit Pension Plans

IRS guidelines issued in 1994 offer employers a number of strategies to maximize the benefits provided to highly compensated individuals under qualified defined-benefit pension plans. Before the issuance of these guidelines, IRS regulations generally required a defined-benefit pension plan to be amended by the end of the plan year beginning in 1993 to enable it to take advantage of a “fresh-start benefit formula.” The new guidelines permit plan sponsors to delay adopting such amendments until the end of the plan year beginning in 1994. The sponsor must then operate the plan in accordance with a “good faith” standard of compliance in the interim. As a result, several strategies to maximize benefits under the new OBRA limit are available to plan sponsors during 1994.

1. Fresh-Start Benefit Formula

Under the IRS guidelines, defined-benefit plan sponsors are permitted to modify the plan’s benefit formula in certain circumstances to provide increased future accruals for highly compen-

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172 See generally Rev. Proc. 94-13, 1994-1 C.B. 566 (providing guidance for sponsors of qualified plans on amendments to plans).
Adoption of a "fresh-start" benefit formula allows the plan to calculate accruals under a new formula for service after 1993 and to base the calculations on pay after 1993 up to the annual compensation limit. Benefits earned under this fresh-start formula are added to the highly compensated individual's pre-1994 protected benefit and may provide a total pension benefit that is greater than that under the plan's original formula.

The Treasury Regulations provide for three alternative fresh-start options. The first option (Option 1), referred to as the "formula without wear-away," provides affected highly compensated individuals with an accrued benefit equal to the sum of their protected benefit as of the end of the plan year beginning in 1993 plus their accrued benefit determined under the plan's post-OBRA benefit formula as applied to the post-OBRA years of service credited under the plan for purposes of determining benefit accruals. The second option (Option 2), referred to as the "formula with wear-away," provides affected highly compensated individuals with the greater of (i) their protected benefit as of the end of the plan year beginning in 1993, or (ii) the accrued benefit determined under the plan's post-OBRA benefit formula as applied to the total years of service taken into account under the plan for purposes of determining benefit accruals. The third option (Option 3), referred to as the "formula with extended wear-away," provides affected highly compensated individuals with an accrued benefit equal to the greater of (i) their accrued benefit, based on the plan's post-OBRA benefit formula as applied to the highly compensated individual's total years of service taken into account under the plan for purposes of determining benefit accruals, or (ii) the sum of their protected benefit as of the end of the plan year beginning in 1993, plus their accrued benefit determined under the plan's post-OBRA benefit formula as applied to the highly compensated individual's post-OBRA years of service credited under the plan for purposes of determining benefit accruals.

175 Treas. Reg. § 1.401(a)(17)-1(e)(3)(i) (amended 1994). The adoption of one of three optional fresh-start benefit formulas, as described under Treas. Reg. § 1.401(a)(4)-13(c)(4), referred to as the formula without wear-away ("Option 1"), the formula with wear-away ("Option 2"), and the formula with extended wear-away ("Option 3"), is required. Id.
177 Id. § 1.401(a)(4)-13(c)(4) (amended 1993).
178 Id. § 1.401(a)(4)-13(c)(4)(i) (amended 1993).
179 Id. § 1.401(a)(4)-13(c)(4)(ii) (amended 1993).
Under the third option, some employees may eventually earn larger benefits under the plan's post-OBRA benefit formula, based on total service and the post-OBRA annual compensation limit. These three options are illustrated in Example 5, below. Under Option 2, the value of an affected highly compensated individual's protected benefit will generally be greater than the fresh-start benefit for a number of years. In contrast, under Option 1, as additional years of service are credited, the value of an affected highly compensated individual's accrued benefit will increase immediately.

Example 5. NOP Corporation maintains a calendar year-end defined-benefit pension plan that provides a benefit formula of one percent of final five-year average salary for each year of service. The protected benefit, determined as of December 31, 1993, for a highly compensated individual having twenty years of service and a five-year average salary of $200,000 would be $40,000 [0.01 x 20 years of service x $200,000]. If the plan is amended to adopt Option 1, the highly compensated individual's December 31, 1994, accrued benefit would be $41,500 [{$40,000 + (0.01 x 1 year of service x $150,000)}]. If the plan is amended to adopt Option 2, the highly compensated individual's December 31, 1994, accrued benefit would remain $40,000 [greater of $40,000 or $31,500 (0.01 x 21 x $150,000)]. If the plan is amended to adopt Option 3, the highly compensated individual's accrued benefit will generally be determined as the greater of Option 1 or Option 2.

Exhibit XI compares the fresh-start formula without wear-away (Option 1) with the fresh-start formula with wear-away (Option 2) by assessing the value of an affected highly compensated individual's accrued benefits under both options in the year that the value under Option 2 exceeds the value of the highly compensated individual's protected benefit.

2. Reasonable Good-Faith Compliance

During 1991, the IRS issued an internal memorandum to its assistant regional commissioners (Examination) and EP/EO division chiefs181 providing guidance (the "guidance") to determine whether a qualified plan's operation has complied with the "reasonable, good-faith compliance" standard for plan years 1989 through 1991, the "transition years." This guidance was extended

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$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—DEFINED-BENEFIT PLANS—FRESH-START FORMULA

Assumptions:
Base Salary — Exceeds Compensation Limit Each Year
Annual Accrual Rate — 1.5% of Final 5-Year Average Compensation

Final 5-Year Average Compensation*

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* Assumes 3% Annual Increase to Compensation Limit
** Assumes that Plan Provides No Maximum on Credited Service

to 1992 plan years. Plan sponsors that operate their qualified plans in accordance with this guidance during the transition years are deemed to be in compliance with the applicable nondiscrimination requirements. Since the issuance of this internal guidance, the IRS has delayed the effective date of the various nondiscrimination regulations until plan years beginning in 1993, and again until plan years beginning in 1994. Similarly, it extended the requirement of good-faith compliance, but has not formally extended the guidance for determining such compliance.

Examples 6 and 7 below show the effect of relying on reasonable good-faith compliance to determine a highly compensated individual’s protected benefit. According to the guidance, when determining a participant’s protected benefit as of the end of the plan year beginning in 1993, the annual compensation limit for each prior year can be as high as the annual compensation limit in effect for the 1993 plan year, that is, $235,840, instead of the

183 Id.
186 Certain representatives of the IRS National Office in Washington, D.C. have informally indicated to the author that the guidance will be followed by the IRS throughout the remedial amendment period (generally, the last day of the plan year beginning in 1994).
lower annual compensation limit in effect for each such year as required under the final section 401(a)(17) regulations.\textsuperscript{187} The specific language of the individual plan document may require an amendment to the plan in order to utilize good-faith reliance.\textsuperscript{188}

Example 6. Assume the same facts as under Example 5 and that the highly compensated individual earned $250,000 in fiscal year 1993. Further, assume NOP Corporation has operated the plan during the transition years relying on reasonable good-faith compliance. Using $235,840 as the applicable annual compensation limit for plan years 1989 through 1993, the highly compensated individual's protected benefit as of December 31, 1993, would be $47,000 \(0.01 \times 20 \text{ years of service} \times 235,840\).

The guidance also differs from the final regulations\textsuperscript{189} in providing that the adjustment to the compensation limit effective January 1 may be used with respect to the plan year that ends in that year during the transition years.\textsuperscript{190} As an example, when a plan year begins July 1, 1992, the adjusted compensation limit for January 1, 1993 may be the limit used for the plan year beginning July 1, 1992 (or any other prior transition year).\textsuperscript{191} The IRS has announced that the annual compensation limit will increase to

\textsuperscript{187} Treas. Reg. § 1.401(a)(17)-1(b)(2) provides that the annual compensation limit in effect for the current plan year applies only to the compensation for that year that is taken into account in determining plan allocations or benefit accruals for the year. The compensation for any prior plan year taken into account in determining an employee's allocations or benefit accruals for the current plan year is subject to the applicable annual compensation limit in effect for that prior year. Thus, increases in the annual compensation limit apply only to compensation taken into account for the plan year in which the increase is effective.

\textsuperscript{188} It is unclear whether plans that have not been operating in accordance with this guidance may subsequently rely on the "reasonable good-faith compliance" standard to provide a greater protected benefit to highly compensated individuals. Plans that have been operating in accordance with this guidance but that have specific provisions to the contrary, require a plan amendment. See generally IRS Summary, Memorandum Providing Guidelines for Determining Whether Plans Meet Reasonable, Good Faith Interpretation of Certain Qualification Rules in 1989, 1990, 1991, 18 Pens. Rep. (BNA) No. 43, at 1975 (Oct. 29, 1991).

\textsuperscript{189} Treas. Reg. § 1.401(a)(17)-1(a)(2) provides that the compensation limit adjustment that takes effect on January 1st of each year is effective for plan years that begin in that year.


\textsuperscript{191} See Rev. Proc. 94-13, 1994-1 C.B. 566.
$242,280, effective January 1, 1994, with respect to collectively bargained plans, which are unaffected by the OBRA amendments, for the plan year beginning in 1994.\textsuperscript{192} It appears, therefore, that fiscal year plans that rely on reasonable good faith reliance can also benefit from the $242,280 annual compensation limit. Again, the specific language of the plan document may require an amendment to the plan in order to claim good-faith reliance.

Example 7. Assume the same facts as Example 6, except that the plan has a fiscal plan year ending June 30, 1994, and that the highly compensated individual’s compensation for such plan year is $250,000. Also assume that NOP Corporation has operated the plan during the transition years relying on reasonable good faith compliance. Using $242,280 as the applicable pay cap for plan years 1989 through 1993, the highly compensated individual’s protected benefit as of June 30, 1994, would be $48,456 \[.01 \times 20 \text{ years of service} \times \$242,280\].

Exhibit XII follows the same assumptions as Exhibit XI and compares a highly compensated individual’s protected benefit determined as of the end of the 1993 plan year under the methodologies of both the final regulations and reasonable good-faith compliance. In addition, Exhibit XII indicates the year in which the value of the highly compensated individual’s accrued benefit under the fresh-start formula with wear-away (Option 2) exceeds the value of the highly compensated individual’s protected benefit. Under reasonable good faith compliance, the value of a highly compensated individual’s protected benefit increases, and the year in which the highly compensated individual’s accrued benefit under Option 2 exceeds the protected benefit is generally delayed by one year.

Exhibit XIII takes the illustration in Exhibit XII one step further and compares the value of the highly compensated individual’s accrued benefit under fresh-start—Option 2 and fresh-start—Option 1 in the year that the value of the highly compensated individual’s accrued benefit exceeds the value of the highly compensated individual’s protected benefit, assuming the reasonable good-faith compliance standard is followed. A highly compensated individual having ten years of service on December 31, 1993, will not earn a more valuable benefit under Option 2 until the year 1999, when the Option 2 benefit is valued at $37,920, and the Option 1 benefit is valued at $49,596. A highly compensated indi-

\textsuperscript{192} I.R.S. Notice 94-6, 1994-1 C.B. 332.
Assumptions:

Base Salary — Exceeds Compensation Limit Each Year
Annual Accrual Rate — 1.5% of Final 5-Year Average Compensation

Final 5-Year Average Compensation*

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* Assumes 3% Annual Increase to Compensation Limit
** Assumes that Plan Provides No Maximum on Credited Service

An individual having twenty years of service on December 31, 1993, will not earn a more valuable benefit under Option 2 until the year 2002, when the Option 2 benefit is valued at $75,690, and the Option 1 benefit is valued at $94,242. A highly compensated individual having thirty years of service on December 31, 1993, will not earn a more valuable benefit under Option 2 until the year 2003, at which time the Option 2 benefit is valued at $108,000, and the Option 1 benefit is valued at $133,128.

CONCLUSION

The new annual compensation limit will significantly reduce the amount of retirement benefits available to highly compensated individuals under qualified retirement plans. The actual magnitude of the reduction will depend upon the specific provisions of each plan and upon variables specific to each individual. As illustrated in this Article, there are strategies available to employers that can lessen the impact of the new rules. Some of these strategies may require that plan amendments be adopted during the 1994 plan year. Other strategies may require new plans to be adopted or existing plans to be amended, but will not necessarily require action during 1994. Any change to the design of a qualified plan or nonqualified arrangement will have an impact on em-
**EXHIBIT XIII**

$150,000 LIMIT ON RETIREMENT PLAN COMPENSATION—
DEFINED BENEFIT PLANS—FRESH START AND GOOD FAITH
COMPLIANCE

Assumptions:
Base Salary — Exceeds Compensation Limit Each Year
Annual Accrual Rate — 1.5% Of Final 5-Year Average Compensation

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* Assumes 3% Annual Increase to Compensation Limit
** Assumes That Plan Provides No Maximum on Credited Service

Employer costs and participant benefits, as well as employee morale. Accordingly, before any approach discussed in this Article is implemented, all possible approaches should be adequately explored, and consideration should be given to employee preferences. A consultant knowledgeable in employee benefits can provide invaluable assistance in this area. Such a consultant should have expertise in tax and ERISA, actuarial capability, and strong employee communications skills.