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Legal Developments

Qualified Separate Lines of Business Rules Allow Competitive Retirement Benefits for Diversified Businesses and Their Employees

This column provides an overview of three major parts of the Qualified Separate Lines of Business Rules and highlights certain areas where these rules are less intuitive.

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The qualified separate lines of business (QSLOB) rules enable companies with diversified business structures to provide competitive retirement benefits to employees in each line of business. The complex and technical nature of these

rules, and risks of noncompliance, warrant a careful and thorough analysis.

Overview

Employers that operate multiple lines of business often provide different tax-qualified retirement benefits to employees across those businesses. These retirement benefits may be based, for example, on the particular industry, market, or geographic location of the business, or the employer may decide to maintain a legacy plan of an acquired business. However, it may be difficult for these retirement plans to satisfy the coverage requirements of Internal Revenue Code (Code) Section 410(b), which generally prohibit a single plan from providing disproportionately greater benefits to highly compensated employees (HCEs), or lesser benefits to non-HCEs, relative to all employees of all businesses in the employer's controlled group.

Without the QSLOB structure, the coverage rules might require employers to provide above-market or below-market benefits to employees of certain businesses, putting the employer at a competitive disadvantage. Congress addressed this concern by establishing special coverage rules for QSLOBs, which generally allow employers to perform coverage testing separately with respect to each of their QSLOBs.

Although the QSLOB rules offer much-needed relief to employers with diverse businesses, the availability of these rules is dependent on compliance with a series of highly complex and technical requirements and, therefore, should not be undertaken without a careful and thorough analysis. The consequences of noncompliance can be severe, as the ability to utilize the QSLOB rules generally is dependent on every line of business satisfying those rules.

While it is not possible to address all of the technical details and requirements here, the following provides an overview of three major parts of the QSLOB rules and highlights certain areas where these rules are less intuitive.

Part I: Establishing Separate Lines of Business

As further described below, under the QSLOB rules the "line of business" determination is distinct from the "separate" determination. The line of business determination considers certain characteristics of each business based on the property and services provided to its customer, while "separateness" of each business refers to whether, and the degree to which, each business is organized and operates separately from the remainder of the employer.

Line of Business

An employer's lines of business are determined by the property and services provided to the employer's customers during the year. [Treas. Reg. § 1.414(r)-(2)(b)(3)] Employers have the flexibility to designate which portion of those property and services are provided by each line of business for purposes of the QSLOB rules (which must reasonable and comport with the employer's bona fide business operations), and may need this breadth of flexibility to ensure the lines of business are separate and qualified. [Treas. Reg. §§ 1.414(r)-1(d)(2), 1.414(r)-1(b)(2), and 1.414(r)-2(2)(b)(3)] Accordingly:

> Under the QSLOB rules, there is no requirement that a single line of business provide only one type, or even related types, of property or services. For example, a domestic conglomerate employer could properly designate as a separate line of business one that sells consumer food and beverage products, a second that provides data processing services, and a third that provides all other property and services to its customers through its regional commuter airline, professional basketball team, pharmaceutical manufacturer, and leather tanning company. [Treas. Reg. § 1.414(r)-2(c)(2), Example 3]

Further, an employer may also designate two or more lines of business that provide the same, or related, types of property or services, provided the designation is reasonable and aligns with bona fide business operations. An employer might designate different lines of business that have different types of customers, are subject to different regulatory requirements, or operate in different geographic regions. [Treas. Reg. § 1.414(r)-(2)(b)(3)] For example, an employer that provides data processing through two subsidiaries, one that operates in the western half of the United States and one that operates in the eastern half, may designate each as a line of business. [Treas. Reg. § 1.414(r)-2(c)(2), Example 5] Or, an employer might designate an acquired business that provides the same property and services as a business that developed internally as two lines of business.

However, under the regulations there are some limitations on designations of the lines of business. It would not be reasonable for an employer to divide a business into separate lines where the property or services are inextricably related. For example, it would not be reasonable for a manufacturer of generators that provides labor and repairs to its customers pursuant to a warranty, to have one manufacturing line of business

and another warranty-related business. [Treas. Reg. § 1.414(r)-2(c)(2), Example 7]

Separate Lines of Business

While an employer has flexibility in determining its lines of business, the next step—establishing that each line of business is organized and operated as a "separate" line of business—requires satisfaction of the following objective requirements:

- *Separate Organizational Unit.* Each line of business must be a formal, separate organizational unit (or group of separate organizational units), such as a corporation, partnership, or division on each day of the testing year. [Treas. Reg. § 1.414(r)-3(b)(2)]
- *Separate Financial Accountability.* Each line of business must be a separate profit center (or group of separate profit centers) on every date of the testing year. The employer must maintain books and records that provide separate revenue and expense information for internal planning and controls with respect to each profit center comprising a line of business. [Treas. Reg. § 1.414(r)-3(b)(3)]
- *Separate Employee Workforce.* Each line of business must have its own separate employee workforce. This determination is made by a numerical test that requires at least 90 percent of the employees who provide services to the line of business be "substantial service employees" with respect to that line of business. [Treas. Reg. § 1.414(r)-3(b)(4)]
- *Separate Management*. Each line of business must have its own separate management. This determination is made by a numerical test that requires at least 80 percent of the employees who are "top-paid employees" in the line of business to be "substantial-service employees" with respect to that line of business. [Treas. Reg. § 1.414(r)-3(b)(5)]

The technicalities of the separate employee workforce and separate management tests go beyond the scope of this column. However, it is important to know that, when performing these tests, *all* employees in the controlled group on the first day of the testing year are taken into account, including those who might otherwise be excluded for nondiscrimination testing purposes (for example, collectively bargained employees), except for nonresident aliens with no US source income. [Treas. Reg. §§ 1.414(r)-1(b)(1), 1.414(r)-3(c)(4)] Every employee must be assigned to one, and only one, line of business, and must be assigned to the line of business to which "more than a negligible" portion of the employee's services are (generally) rendered. [Treas. Reg. § 1.414(r)-3(c)(5)] Keep in mind that there are additional rules, described in the "Allocating Employees" section below, that need to be taken into account. There also are special rules for vertically-integrated lines of business where the "upstream" business provides property or services to the "downstream" business. [Treas. Reg. § 1.414(r)-3(d)]

The separateness requirements reflect that use of the QSLOB rules is intended to align with an employer's bona fide business operations. However, it is permissible, and may be necessary, for an employer to revisit (by combining or dividing) its designated lines of business in order to satisfy the separateness requirements.

Part II: Establishing Qualified Separate Lines of Business

In order for a separate line of business to be "qualified," each separate line of business must have at least 50 employees (excluding certain part-time and seasonal employees), on each day of the testing year, who provide services exclusively to that line of business and no other line of business. [Code § 414(r)(2)(A); Treas. Reg. §§ 1.414(r)-1(b)(2)(iv)(B), 1.414(r)-4(b)]

Each separate line of business must also satisfy so-called "administrative scrutiny" and notify the Internal Revenue Service (IRS) that it operates QSLOBs, as described below.

Administrative Scrutiny

There are six administrative scrutiny safe harbors, one of which each separate line of business must independently satisfy in order to be qualified: a statutory safe harbor and five administrative safe harbors. [Treas. Reg. §§ 1.414(r)-1(b)(2)(iv)(D), 1.414(r)-5] The variety of safe harbors afford a degree of flexibility; if one separate line of business does not satisfy a safe harbor, a combination of separate lines of business may do so. Furthermore, each separate line of business (or combination) may satisfy a safe harbor that is different from that used by the other lines.

- *Statutory Safe Harbor.* Available if the ratio of HCEs providing services to the separate line of business is between 50 to 200 percent of all HCEs who work for the employer as a percentage of the employer's

workforce; or at least 10 percent of the total HCEs in the employer's controlled group provide services only to the separate line of business. [Treas. Reg. § 1.414(r)-5(b)]

- *Separate Industry Safe Harbor*. Available if the separate line of business, and no other lines of business, operates exclusively in one or more industry categories established by the IRS. [Treas. Reg. § 1.414(r)-5(c); Rev. Proc. 91-64]

  This often is referred to as the "SIC code safe harbor," but, like many of the QSLOB rules, it is not as straightforward as it may initially seem. The IRS established these industry categories in Revenue Procedure 91-64, and, despite recognizing that periodic updates may be appropriate, has made no such updates. Moreover, the industry categories in Revenue Procedure 91-64 were derived from the 1987 Standard Industrial Classification (SIC) codes, which are no longer updated. (For the most part, the SIC codes were replaced by the six-digit North American Industry Classification System (NAICS) in 1997; however, the IRS has not sanctioned use of the NAICS codes for this purpose.) Furthermore, Revenue Procedure 91-64 acknowledges that the SIC codes used by an employer are not determinative, because they look to the activities conducted rather than to the ultimate property or services provided by the separate line of business to customers of the employer. Thus, the employer must look directly to the property or services provided by the separate line of business to customers of the employer to determine whether the requirements of the safe harbor are satisfied. [Treas. Reg. § 1.414(r)-5(c)(1)-(3); Rev. Proc. 91-64]
- *Mergers and Acquisitions Safe Harbor.* Aavailable to businesses acquired through a corporate transaction, and through the end of the fourth year after the transaction, provided the business otherwise meets the requirements of a separate line of business and, generally, no more than 10 percent of its substantial-service employees are from, or perform services for, another separate line of business. [Treas. Reg. § 1.414(r)-5(d)]

  Note: There is a special acquisition rule (QSLOB transition rule) in the regulations, different from the administrative scrutiny rule, under which an acquired business can be disregarded *for all purposes* and deemed to constitute a QSLOB through the end of the year following the transaction. [Treas. Reg. § 1.414(r)-5(d)] This rule is based on the parallel coverage testing rule, generally applicable if the plan satisfied coverage testing immediately prior to the transaction and there is no significant change in the plan or its coverage (except for the transaction). [*Id*; *see also* Code § 410(b)(6)(C) and Treas. Reg. § 1.410(b)-2(f)]
- *FAS/Industry Segment Safe Harbor.* Available where the separate lines of business are reported as different industry segments on the employer's annual filing with the Securities and Exchange Commission. [Treas. Reg. § 1.414(r)-5(e)]
- *Average Benefits Safe Harbor.* Available where the separate line of business provides the same average benefits as other separate lines of business, depending on the HCE percentage ratio on an employer-wide basis: (i) if the HCE percentage ratio is less than 50 percent, the actual benefit of the non-HCEs in the separate line of business must be at least as great as the actual benefit percentage of all the non-HCEs employer-wide, or (ii) if the HCE percentage ratio is more than 200 percent, the actual benefit of the HCEs of the separate line of business must be no greater than the actual benefit percentage of all the HCEs employer-wide. [Treas. Reg. § 1.414(r)-5(f)(2)-(3)]
- *Minimum and Maximum Safe Harbors.* Available if the HCE percentage ratio of the separate line of business is less than 50 percent and 80 percent of the non-HCEs in the separate line of business receive specified minimum benefits or allocations. If the HCE percentage ratio is more than 200 percent, the benefits or allocations to the HCEs in the separate line of business cannot exceed the maximum rates prescribed under the Treasury regulations. [Treas. Reg. § 1.414(r)-5(g)]

If a separate line of business does not satisfy any of the safe harbors, the employer may request an individual determination from the IRS if certain threshold criteria are met. [Code § 414(r)(2)(C); Treas. Reg. § 1.414(r)-6]

Notice to the IRS

An employer must notify the IRS that it operates QSLOBs, by timely filing a Form 5310-A that identifies all of the QSLOBs. This is not, however, a set-it-and-forget-it filing; if there is any change to the QSLOBs, a new Form 5310-A must be filed. [Code § 414(r)(2)(B); Treas. Reg. §§ 1.414(r)-1(b)(2)(iv)(C), 1.414(r)-4(c); Rev. Proc. 93-40].

Allocating Employees

In performing the QSLOB analysis, the employer must assign each employee to a separate line of business in accordance with specific rules. [Treas. Reg. § 1.414(r)-1(b)(3)] Employees who provide at least 75 percent (and in some cases, 50 percent or more) of their services to a line of business are "substantial-service employees" to that line of business. [Treas. Reg. § 1.414(r)-11(b)(2)] Frequently, however, there are employees who provide services to multiple lines of business, for example, those at corporate headquarters. Each of these "residual shared employees" must also be assigned to a qualified separate line of business, based on one (and only one) of the following methods:

- *Dominant Line of Business Method.* All residual shared employees are allocated to the employer's dominant line of business (generally, with at least 50 percent of the substantial service employees in the controlled group, with certain exceptions). [Treas. Reg. § 1.414(r)-7(c)(2)]
- *Pro-Rata Method.* All residual shared employees are allocated to a QSLOB in proportion to the substantial service employees assigned to the QSLOB. [Treas. Reg. § 1.414(r)-7(c)(3)]
- *HCE Percentage Ratio Method.* All residual shared employees are allocated to a QSLOB in proportion to the HCEs, assigned to the QSLOB. [Treas. Reg. § 1.414(r)-7(c)(4)]
- *Small Group Method.* Each residual shared employee is allocated to a QSLOB chosen by the employer, but only if the residual shared employees are no more than three percent of all of the employer's employees. [Treas. Reg. § 1.414(r)-7(c) (5)]

Again, the above is a summary of the employee allocation methods; the requirements to comply with each method are detailed and technical and beyond the scope of this article.

Because employees assigned to a line of business may only participate in the retirement plans of that line, consideration should include how the allocation will affect testing within the qualified separate line of business. Furthermore, re-assignment of residual employees after the first testing year could complicate matters.

Part III: Application of Nondiscrimination Testing Rules to QSLOBs

Once an employer has established its QSLOBs, each plan in that QSLOB must satisfy two Code Section 410(b) coverage tests: an employer-wide "gateway test" and a coverage test with respect to the employees of that particular QSLOB.

Gateway Test

Each plan in a QSLOB (and thus, each plan of the employer) must satisfy either the Code Section 410(b) ratio percentage or nondiscriminatory classification test (without regard to the average benefits percentage test) on an employer-wide basis, by reference to all employees in the controlled group. [Code § 410(b)(5); Treas. Reg. §§ 1.410(b)-6(e), 1.414(r)-8(b)] More often than not, plans will need to rely on the nondiscriminatory classification test, which affords the plan a lower passing threshold determined by the percentage of non-HCEs in the controlled group. [Treas. Reg. § 1.410(b)-4(c)(4)] These rules are further liberalized for QSLOB purposes.

Generally, plans that do not meet the "safe harbor" threshold of the nondiscriminatory classification test may use a lower "unsafe harbor" threshold, if they satisfy a facts and circumstances test. For purposes of the QSLOB rules, however, satisfaction of the QSLOB rules is the sole, determinative facts and circumstances requirement, except in unusual circumstances, effectively allowing QSLOBs to use the unsafe harbor percentage (generally from 20 percent to 50 percent). [Treas. Reg. § 1.414(r)-8(b)(2)] In addition, if the plan's coverage percentage on a QSLOB basis is above 90 percent, the unsafe harbor percentage is further reduced. A plan that does not meet the reduced passing threshold may nonetheless be deemed to satisfy the coverage test on the basis of the relevant facts and circumstances. [Treas. Reg. § 1.414(r)-8(b)(2)(iii)]

QSLOB Coverage Test

If an employer is treated as operating QSLOBs, the employer may perform coverage testing for each plan in the QSLOB as if it were its own controlled group. If an employer applies the Code Section 410(b) coverage tests on a QSLOB basis, it must do so with respect to all plans, all employees, and all QSLOBs. [Treas. Reg. §§ 1.414(r)-1(c)(1), 1.414(r)-1(c)(2), 1.410(b)-4] If an employer also maintains a plan for all employees (for example, an employer-wide 401(k) plan), however, that employer-wide plan need not be tested on a QSLOB basis if it passes the 70 percent ratio coverage test. [Treas. Reg. § 1.414(r)-1(c)(2)]

Section 401(a)(4) and ADP/ACP Testing

The portion of a plan that benefits employees of one QSLOB is treated as a separate plan from any portion that benefits employees of another QSLOB, unless it is an employer-wide plan. [Treas. Reg. § 1.414(r)-1(c)] In addition, to the extent Code Section 401(a)(4) requires a group of employees to satisfy Code Section 410(b), those requirements apply with respect to employees of the QSLOB. [Treas. Reg. § 1.414(r)-1(c)(2)]

Application of Other Tax-Qualification Provisions

Employers should remember that the QSLOB rules provide only limited relief from the tax-qualification rules that otherwise apply on a controlled group basis. Thus, for example, the determination of highly compensated employees, service crediting rules for eligibility and vesting, the determination of whether a participant has terminated employment for distribution purposes, top-heavy determinations, and Code Section 415 annual benefit and contribution limits apply on a controlled group basis, without any exception for QSLOBs.

Conclusion

The QSLOB rules are essential to diversified businesses, both small and large, in providing competitive retirement benefits. The complex and technical nature of these rules, and risks of non-compliance, warrant a careful and thorough analysis. Although the QSLOB rules offer significant flexibility for certain testing requirements, they do not provide a "free pass" across the board. The QSLOB regulations discussed above expressly prohibit an employer from utilizing the rules in a way that "literally" complies with the statutory and regulatory requirements but are not used for bona fide business reasons; the QSLOB rules are not intended to allow employers to evade coverage and nondiscrimination requirements. ■

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